U.S. Economy

We maintain expectations of higher economic growth than the potential in 2005 (3.6%) and close to it in 2006 (3.2%)

The performance of the economy in the 1H05 confirms our base scenario of economic growth converging toward its potential, supported by solid fundamentals. The strength of private consumption and the strong boost from investment will continue to be the main support for expansion. As a result of the Katrina and Rita hurricanes, some uncertainty was generated regarding their effects. Even though the impact will be negative on economic growth in the 3Q05, it will be offset in the 4Q05 and the 1Q06 due to the reconstruction efforts in the affected areas. The greatest risk is not its transitory effect on economic activity in the affected area, but the probable negative impact on consumer confidence and spending that the permanence of fuel prices at such high levels would have. Nevertheless, the advance made in the reconstruction of oil and natural gas production seems to be going faster than initially estimated. We therefore maintain our forecast for economic growth of 3.6% for 2005 and 3.2% for 2006.

The factors that have supported the expansion in family spending will continue to boost it in the following quarters, although to a lesser extent. In this sense, we continue to foresee that growth in productivity will continue to converge with its long-term trend (2%-2.5%) and that the creation of jobs will decrease its rate (1.7% in 2005 and 1.4% in 2006). Likewise, we expect a significant moderation in growth of families' wealth, derived from the lower expansion in housing prices, mainly due to the effect of higher real interest rates. In face of the moderation of wealth and the greater cost of credit, we expect a moderation in the consumption of durable goods. Although housing investment will continue to be strong in 2005, it will moderate in 2006 in view of higher interest rates.

Non-housing investment will continue a moderation trend, in view of the rise in the cost of capital, lower growth in demand and, mainly, an adjustment in business profits due to higher production costs and limited price power, the latter a consequence of globalization and technological change. Nevertheless, the solid financial situation of companies and the need to replace obsolete equipment will help investment to continue to grow more than the rest of the economy.

With the slowdown of consumption and private investment, imports will also decelerate, while the greater economic expansion of the rest of the world will boost exports. However, the contribution of net exports will continue to be negative in 2006 (-0.2 pp) and, due to lower economic growth, the current account deficit as a percentage of GDP will increase slightly.

On the other hand, in 2005 we expect a correction in the public balance as a percentage of GDP of 0.8 pp compared to 2004, mainly due to the marked increase in fiscal revenue. However, in 2006 this will increase 0.3 pp due to the moderation in revenue growth in view of the lower economic expansion and higher public spending from the reconstruction of the areas affected by the Katrina hurricane.

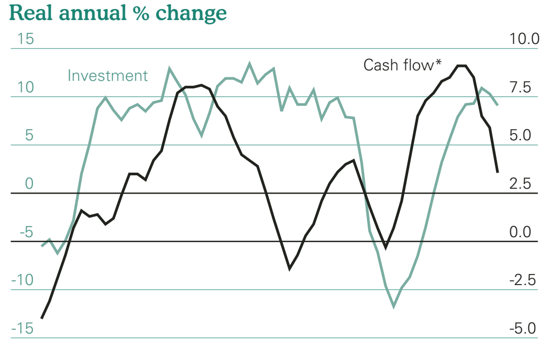
Real Disposable Personal Income and Productivity

Real ann. % chge., 4Q moving avge., non-agric. sector

Source: BBVA U.S. with BEA and BLS data

Non-Residential Investment and Cash Flow

Real annual % change



* 8 quarters moving average
Source: BBVA U.S. with BEA data

Base Scenario GDP

	Real ann.% chge. 2005	Real ann.% chge. 2006	Share* 2005	Share* 2006
Gross Domestic Product	**3.6**	**3.2**	**3.6**	**3.2**
Pers. spend. consump.	3.5	3.0	2.5	2.1
Gross fixed investment	6.4	5.5	1.1	1.0
Total exports	7.3	5.2	0.8	0.6
Total imports	6.6	4.5	-1.0	-0.7
Gvment. consumption	1.7	2.0	0.3	0.4

* Share of growth, percentage points
Source: BBVA U.S.

Base Scenario

	Annual average 2005	Annual average 2006
Inflation		
CPI		
Headline	3.3	2.8
Core	2.3	2.5
PCE		
Headline	2.8	2.3
Core	2.0	2.1
	End of period	
Monetary policy		
Federal funds (%)	4.25	4.75
Other indicators		
Current account (% GDP)	-6.2	-6.4
Fiscal balance (% GDP)	-2.8	-3.1
Employm. (monthly avge., thds.)	173	134
Industrial prod. (% change)	3.3	3.0

Source: BBVA U.S.

Risk Scenario

	Real annual % chge. 2005	Real annual % chge. 2006
GDP (annual % change)	3.5	1.3
CPI (annual %)		
Headline	3.4	3.9
Core	2.4	2.7
Federal funds (% fdp)	4.25	4.00
Current account (% GDP)	-6.3	-6.1
Fiscal balance (% GDP)	-2.8	-3.5

Source: BBVA U.S.

Risk of transmission to core inflation increases

Our models indicate that core inflation will continue its rallying trend, although it will remain contained. For 2005, the strength of the dollar in recent months and the lower industrial growth delimit the core prices of imports and prices to the producer, and will continue to allow stable core inflation which could even be 0.1 pp below our estimate of 2.3%.

However, higher production costs (fuels and labor), the position of the economy in the current expansion cycle—with the labor market strengthening, growth in productivity converging with its long-term trend (2-2.5%), unit labor costs increasing and the remaining idle capacity in the economy decreasing—clearly imposes upward risks on core inflation and inflation expectations in the coming quarters. Moreover, with the economy growing above its potential, the competitive pressure on producers could diminish slightly, thereby increasing its price power. However, the flexibility of the markets, high competition, external prices, the absorption of higher costs in view of high margins and, mainly, the expectations of inflation anchored, will delimit these rises. Therefore, we foresee a rallying trend for core inflation in 2006, which could average 2.5%.

In contrast, taking into account the oil scenario of the Group, which presumes continued drops in oil prices of more than 4% per quarter, general inflation will tend to moderate from 3.3% in 2005 to 2.8% in 2006. A fundamental element in our estimates is based on inflation expectations. The greatest short-term risk is that fuel prices will remain high and will have an impact on the prices of other goods and services and that this, in turn, will contaminate inflation expectations.

Risk scenario 2005-2006

This scenario assumes that the imbalances of the economy provoke an abrupt shock as of 2006. In this sense, the risk scenario not only hastens the greater economic slowdown of the base scenario, it makes it more pronounced and lasting. This scenario considers a significant drop in housing prices, an abrupt slowdown in business profits, low productivity growth and higher oil prices. This environment would imply a prolonged loss of confidence with significant consequences in consumption and investment, which, in turn, would imply an important correction in the current account deficit.

The higher oil prices, together with the rallying impact on core inflation derived from a greater transmission of costs to final prices in view of the significant slowdown in business profits would more than offset the downward effect on prices due to a greater negative output gap in 2006. The deterioration of inflation and the contamination of inflation expectations would lead the Fed to raise its reference rate up to 5% at the end of June 2006. However, in view of the economic slowdown and the change in the inflationary trend, the Fed would revert the rises quickly, considering that they have raised it too much, thereby closing the year at 4%.

Interest rates and exchange rate

The recent performance of the financial markets has been dominated by two interrelated factors. On the one hand, doubts regarding the macroeconomic scenario linked to the rise in oil prices. On the other, the maintenance of high capital flows within a context of high world savings. Both elements are giving rise to an environment of long-term yields below what was expected. In the U.S. it is significant that the 10-year rates are currently standing below those observed at the start of the rising cycle of the federal funds rate in June 2004, despite the fact that it has increased from 1% to 3.75%.

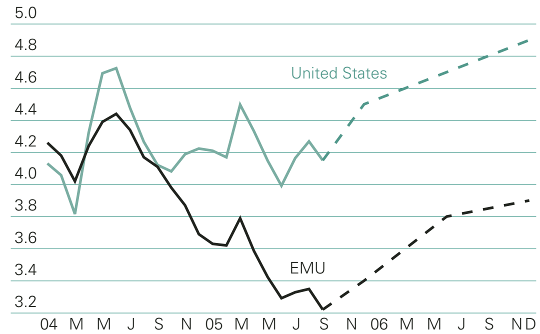
Two key questions thus arise for the coming months. The first deals with the possibility of a recession of the economy in which oil would serve to unleash a correction of expectations, particularly of the confidence of families, who have increased their indebtedness in recent years. In this case, long-term interest rates would discount a recession and their rallying run would be limited. The second is whether, even in a macroeconomic environment characterized by a notable vigor of the U.S. economy, long-term yields continue at low levels as a consequence of the performance of international capital flows.

Oil prices, which in 1999 stood at US$11 per barrel, are now at about US$60. Despite these price levels, the world economy is maintaining notable strength, with a moderate slowdown from the maximum growth levels of 2004. The gradual nature of price rises, which has allowed an adjustment in the expectations of agents, the greater energy efficiency or the lower effect of the mechanisms of wage indexing have caused the impact on the economy to be moderate. In reality, together with the oil shock, a globalization process is being produced that is acting by offsetting this shock at least partially. World trade is more dynamic and there is a greater supply of labor, which contributes to making labor costs cheaper. The corporate sector, which had realized a notable process of reorganization, is showing significant growth in the benefits, which increases its share in the national product, to the detriment of wages.

Everything points to the probability that a scenario of recession linked to the performance of oil prices is limited, but not all the uncertainties have been dispelled. In the first place, it is feasible to expect a moderation of these prices to levels more in accordance with the equilibrium, which could stand at between US$40 and US$50. Price levels such as the current ones increase the oil supply and reduce demand, making the exploitation of alternate energy sources more profitable. Now, given that the market has a narrow differential between supply and demand, it appears quite vulnerable to any shock and, within the context of an increase in the geopolitical risk, a scenario of higher oil prices (a risk scenario) is possible.

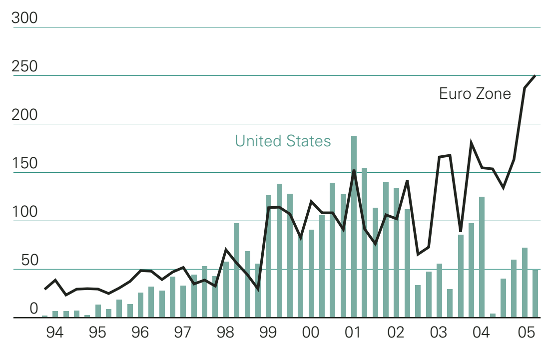
In the second place, the manner in which monetary policy is handled is important. In economies with a high degree of the use of productive resources such as the U.S., the upward trend in inflation, which the rise in oil prices presupposes, should lead to the continuation of the trend in rises of the official rates, trying to place them at levels closer to the neutral rates in the early months of 2006. In this

10-year Interest Rates
%



Note: Estimated as of October 2005
Source: BBVA with Federal Reserve and BCE data

Net Debt Issue
Billions of dollars

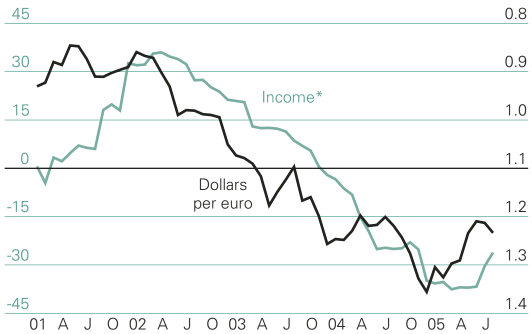


Source: BBVA with Bloomberg data

Exchange Rate
Dollars per euro

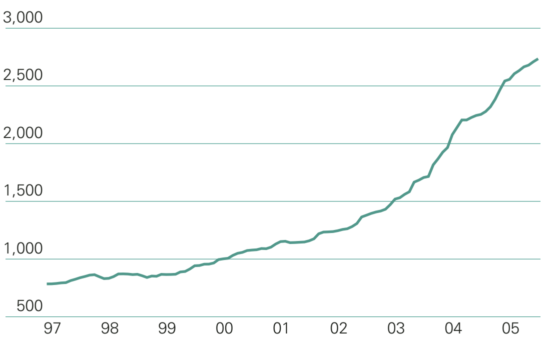
Note: Estimated as of October 2005
Source: BBVA with Federal Reserve data

M&A Announcements



* Net income in the U.S. from the EMU, billions of dollars
Source: BBVA with Bloomberg data

World International Reserves
Billions of dollars



Source: BBVA with Bloomberg data

Financial Base Scenario
Averages

	Current	2005	2006
Official rates			
United States	3.50	3.20	4.70
EMU	2.00	2.00	2.15
10-Year rates			
United States	4.17	4.30	4.85
EMU	3.12	3.40	3.65
Exchange rate			
Dollars per euro	1.23	1.20-1.25	1.17-1.25

Source: BBVA

sense, the Federal Reserve will maintain a principle of gradual rises until it has reached 4.75%. This scenario would support the dollar, which in its exchange with the euro would quote within the range of 1.17-1.25.

In the third place, as has been commented, the channel of expectations that turn into a key element should be watched, particularly in economies in which families are highly indebted. A drop in confidence could lead to a reduction in the demand for assets such as housing and, because of this, a reduction in real estate wealth and consumption. In this case, in the U.S., interest rates that initially would have increased to put a brake on inflation expectations could begin to drop before the end of 2006. In this scenario we cannot rule out a tendency of the dollar to depreciate within the 1.25-1.33 range.

As a result, in the base scenario, the economies will continue to grow at notable rates, although lower than in the previous year, while the monetary policy is adjusted upward, particularly in the U.S., and the dollar consolidates levels with the euro or appreciates slightly. However, long-term interest rates do not have an important upward run due to the significant demand for bonds that is linked to the financial globalization process.

The real interest rate is the result of the interaction of savings and world investment, especially when the domestic trend of investors is reduced. Within the current context, savings could be increasing, with a clear differentiation of performance by groups of countries. The industrialized countries are reducing their savings; however, savings are increasing in Asia, given the growth model, or in the Middle East as a result of the revenues of the oil-exporting countries. This could be behind a drop in the real yields. Also, world inflation expectations are now at low levels, in part anchored by the rise in credibility that the central banks have had in recent years, which contributes to reducing the long-term nominal yields. For its part, the lower volatility of inflation is an element that has reduced the risk premiums per term in the longer-issue bonds, although they perhaps have dropped excessively.

Low interest rates generate capital flows in search of yield toward emerging countries, appreciating their currencies. To resist this appreciation, these countries intervene in the currency market. The accumulation of reserves continues to be important, although it has slowed down compared to the previous year. By this, on the one side, they increase their domestic liquidity; on the other, they implement these interventions by purchasing bonds and contributing to maintaining interest rates low, thus closing a circle that constitutes an accelerator of world liquidity. With all of this, the expected increases for long-term interest rates will be limited. In the U.S., the 10-year yields could end the year 2006 at 4.9%.

Unexpected Developments Boost Oil Prices

Four important developments

The fragile balance between supply and demand that is reflected in an additional short-term production capacity equivalent to barely 2% of demand makes the oil market extremely sensitive to any combination of unfortunate developments. The third quarter was particularly notable in this regard with four major developments occurring that had important repercussions on the oil market.

The first such development was the **death of King Fahd**. Even though the royal succession took place as was expected, the new King Abdullah is a member of an octogenarian generation that represents the line of succession of the Saudi throne, which points to strong volatility in relation to the establishment of a government that has demonstrated being a key factor in the stabilization and unification of the world's main oil producer. In addition, in this line of succession counterposed visions coexist toward the West that lead to greater uncertainty in terms of the country's future behavior.

The second development was the **Iran crisis**. The election of the ultra conservative Ahmadinejad as the country's new president reverses the reformist line. One of the new government's first actions was to renew its nuclear energy program, which had been suspended, in a clear challenging tone to the United States and Europe. A diplomatic solution will be difficult, and this results in a greater probability of a scenario marked by geopolitical conflict.

The third element is the **current hurricane season in the North Atlantic**. A total of 21 tropical storms and 11 hurricanes are expected, of which more than half can become major hurricanes. So far 17 storms have occurred, of which nine have reached the category of hurricanes and there are still two months left to go in the season. The most affected area has been the Gulf of Mexico, where 28% of the oil consumed in the United States is produced, 60% of imported crude enters the country, and where 47% of refinement capacity and 20% of the natural gas output is located, Therefore, it was a particularly sensitive season for the oil market.

The fourth element involves **heightened problems in oil refinery activity in the United States**. Prior to the impact of the hurricanes, different developments occurred that in various degrees paralyzed around 11 refineries, a situation that was reflected in a decrease in gasoline inventories beyond what had been anticipated and a lower buildup in distillation inventories than was expected in the summer.

The combination of these four elements, which separately have a low probability of occurring, can explain the 30% rise in Brent prices since May.

Iran: has the most impact on the market

Beyond the short-term impact from the hurricane season, which will depend on the amount of damages and the recovery time to repair the oil production facilities, the factor with the greatest potential effect on the market is unquestionably the evolution of the conflict over Iran's nuclear energy program. It should not be forgotten that Iran produces 4 million barrels of crude oil daily. The factor that detonated the current crisis was the renewal of what the Iranians term a peaceful nuclear energy program, ignoring the veto imposed in the past by the United Nations. For the West, such a program represents a step toward the production of atomic weapons.

The United States and the countries of the European Union have rejected the Iranian arguments and are attempting to bring the issue before the United Nations Security Council, which would imply placing an ultimatum on Iran that if not met, would result in economic and military sanctions and which could possibly include an embargo on the country's exports. However, China and Russia, two permanent members of the Security Council, and therefore with the power to veto its decisions, oppose any immediate action against Iran.

Meanwhile, Iran reacted angrily to the resolution of the European countries and has threatened to proceed further and renew its uranium enrichment program in case the motion is approved. Teheran has also threatened to suspend its commitment to comply with the Additional Protocol to the Treaty on the Non-Proliferation of Nuclear Weapons, which allows inspections in the country without prior notification.

A diplomatic solution to the situation will be difficult, which will introduce tension into market given the possibility that Iranian oil production may be removed from the world market. Even if this does not occur, the likelihood (which cannot be ruled out) that it could take place is undeniably the factor with the greatest impact at the present time.

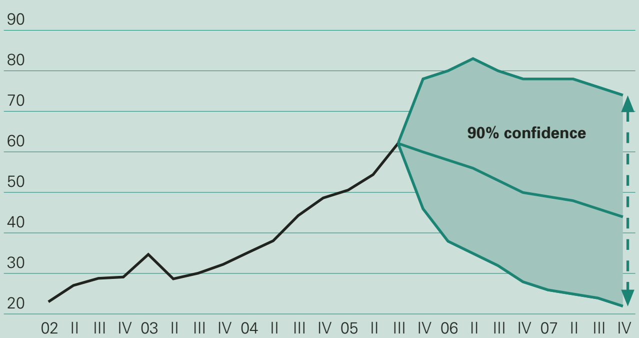
Review of the price scenario

One of the main features of the market is the considerable persistence of the effect on prices from the news and the market's fears concerning the future balance between crude oil supply and demand. The four previously described developments, some of which will continue to be elements of concern, make it necessary to review the scenario for oil prices.

The new base scenario presupposes that the losses from the hurricane season will be short term and that the factor that will persist is the uncertainty surrounding the possibility that Iranian crude could be withdrawn from the world market. For 2006, a 20% rise in prices is expected in relation to the previous period, which would translate into an average price of 54.6 dollars per barrel for the Brent crude and **42 dollars per barrel for the Mexican mix**.

Estimate of the Brent Oil Price 2005-2007

Dollars per barrel



Source: Estimates by the BBVA Banco Provincial of Economic Research

However, **the Iranian situation opens a risk scenario**, with a probability of between 10%-15%, which would imply a real withdrawal of that country's oil production for a period of more than one year. This would bring the 2005 price to 61.2 dollars per barrel for the Brent and 47.1 dollars per barrel for the Mexican mix (9% higher than in the base scenario) and to 89.9 dollars for the Brent and 69.2 dollars for the Mexican mix for 2006 (64% above the base scenario).

For 2007, the base scenario would mean an average projected price of 46.2 dollars per barrel, while the risk scenario would raise this to 84 dollars. **For the Mexican mix, the price would be 35.6 dollars for 2007** and 64.6 dollars in the risk scenario.

Are we moving toward a new price balance?

The key question is whether we are witnessing a prolonged upside movement toward a new balance or if it is an over-reaction that will undergo a correction at a lower level.

In analyzing the historical behavior of oil prices, we can see that we are in an atypical cycle of continuous increases that has already extended for nine quarters, the longest such cycle since 1957. The permanent changes in price levels have been characterized by being rapid upside movements that contrast with processes involving more gradual rises in which price levels do not consolidate and converge at a lower level. This classic behavior of the market, coupled with a better performance of supply in the medium term, makes it possible to anticipate that we are in a phase marked by an over-reaction, in which prices will be adjusted, with the Brent oil quoting at levels that are closer to 40 dollars than the current 63 dollars per barrel, and as a reference for the Mexican mix, with the latter's prices declining from 50 to 30 dollars. But to reach these levels, even in the main scenario, it will be necessary to wait a few more quarters.

Giovanni Di Placido giovanni_diplacido@provincial.com