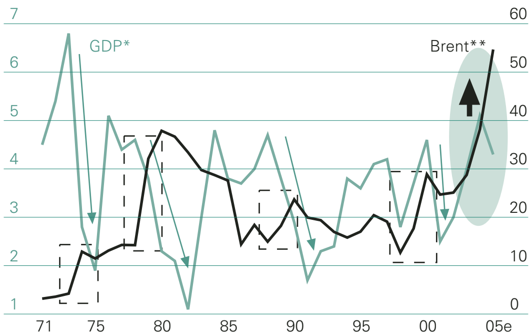
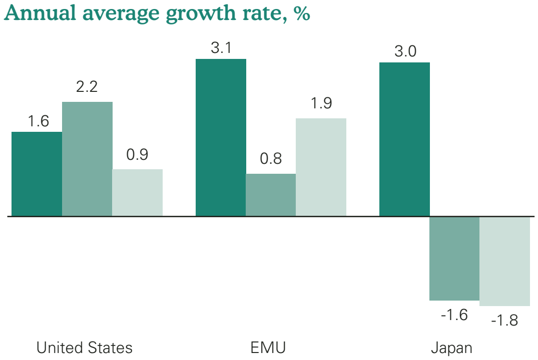
### World Growth and Oil Prices




* Real annual world % change
** Dollars per barrel
e estimated
Source: BBVA with IMF and Bloomberg data

### Unit Labor Costs
Annual average growth rate, %




1991 - 1995
1996 - 2000
2001 - 2005
Source: BBVA with National Statistics data

## A Different World

One of the main characteristics of 2005 has been the positive balance in economic growth despite the rise in oil prices. The coincidence in the timing of both of these factors could respond to the increase in world demand that could be translating into a significant growth of trade flows and an increase in the prices of raw materials, mainly energy products and metals. Therefore, the shock that would be taking place would not be due to rising crude oil prices, but would be derived from the growing trade participation and activity of new countries, such as China and India, which account for almost half of the world population.

In terms of supply, the relative growth of the work force has led to lower growth in wages that would partially offset the rise in oil prices and that presumes the existence of a global contention factor on inflationary pressures. This has allowed the central banks to maintain high liquidity in times of high economic growth, without a rebound in the outlook for higher prices in the medium term. Only in those countries with more advanced cyclical phases have inflation expectations experienced a rallying trend, fearing the appearance of "second round" effects derived from higher energy prices. Despite this, long-term interest rates remain low, a reflection of the credibility surrounding inflation control by the monetary authorities, and of the growing importance of the flows.

## Continuity of solid growth in the United States

In 2006, overall economic growth will be similar to that of the previous year, but with a somewhat different composition. In the United States we expect a slowdown in growth, from 3.6% in 2005 to rates closer to 3% in 2006. This performance will be mainly the result of moderation in private consumption growth, within a context of a negative savings rate.

Its evolution would be conditioned by various factors. First, there is lower growth in real disposable income due to the convergence of productivity with its long-term trend (2-2.5%), a process that could have already started and that would moderate the growth of real wages. Second, consumption will be affected by more moderate job creation in view of greater caution on the part of companies and a lower generation of new jobs in the real-estate sector, which has strongly boosted the creation of private employment in the last three years. In fact, the gradual cooling off of the real-estate sector (wealth effect) that is beginning to be reflected clearly in some leading indicators will help moderate consumption when it reduces mortgage refinancing.

As a result of this lower rate of expansion in consumption, the rise in the cost of financing and the moderation in the expansion of cash flow and business profits, private investment will tend to moderate, particularly the residential. The cash flow trend suggests lower private investment going forward. Also, even though profits remain at historically high levels, we expect that their growth rate will continue with a moderation trend, affected by a lower rate of increase in sales, higher labor costs and interest rates, and price power, which although higher, is still limited by high competition and globalization. As a whole, the above aspects will affect business expectations and optimism; this greater uncertainty will add to the caution of the companies, moderately limiting non-residential private investment.

Lower growth in consumption and investment will lead to lower expansion in consumer goods and capital imports. Thus, reduced demand will imply lower growth in imports than in exports, by which the current account deficit will be reduced as a percentage of GDP in 2006 and 2007. In contrast, we expect the fiscal deficit to GDP ratio to rise in 2006, mainly due to reconstruction costs of the areas affected by the hurricanes. In 2007, the reduction of the additional appropriations relative to the war in Iraq and the fight against terrorism, mainly, and greater economic growth, which will boost tax collection, will allow reducing this ratio.

In other areas, such as the Economic and Monetary Union (EMU), the economic outlook has improved. Confidence has begun to rally significantly, particularly in Germany, which allows expecting a recovery of activity toward rates of 2.0% of GDP in 2006, after 1.3% growth the previous year. Nevertheless, the uncertainty regarding European growth has not dissipated completely. The Asian Southeast, and in particular China, which has just revised the value of its aggregate production upward, will continue to show rates close to the high average of recent years. Nevertheless it will continue strongly biased toward notable growth in investment, consistent with an expansion model seeking the development of exporting platforms and a moderate pause in family consumption. In turn, in 2006 Japan could incorporate the positive impact of growth in the area, recovering GDP growth rates close to their potential. Finally, other regions like the Middle East will continue to benefit from the shock in the exchange terms, derived from the rise in the prices of raw materials that they export and will maintain growth rates at around 5%.

## Gradual adjustment of the monetary policies

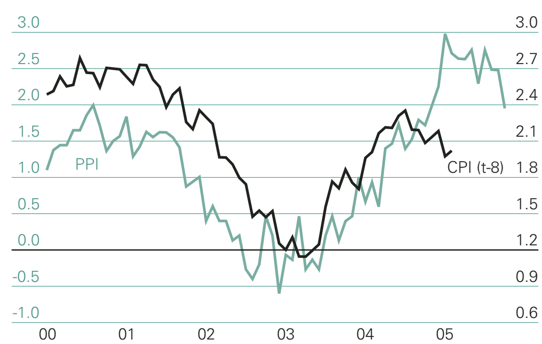
Within the previous context, in which the global growth rate will remain high in 2006, it is foreseeable that the central banks will adopt a less expansive policy. However, given that the priority of the monetary authorities is the control of price expectations, and these in general terms remain moderate, the adjustment in interest rates will be gradual, ruling out a scenario of a strong adjustment in the economies.

In the United States, core inflation will maintain a moderate upward trend during 2006 (2.5% on average), as a result of the delayed transmission of higher production costs to final prices. The position of the economy in the current expansion cycle, with the labor market strengthening and lower idle capacity, imposes upward risks, although the notable growth in productivity, market flexibility, high competition, low external prices, absorption of greater costs in view of high margins and mainly, anchored inflation expectations, will all

### U.S.: Non-Agricultural Productivity and Real Disposable Income
**Annual % change**


Source: BBVA with BLS & BEA data

### Production and Consumption Prices
**Core, annual % change**




Source: BBVA and BLS data

delimit these increases. Under these parameters, and with expected headline inflation at 2.8% for 2006, in view of the expected drop in oil prices, we foresee that the Federal Reserve will place official interest rates at levels of 4.75% in the first quarter of 2006, levels of greater monetary neutrality in which it could halt the process of increases begun in June 2004.

In the EMU, although the European central bank began an upward cycle in interest rates in December 2005, justified by monetary growth and the fear of a deterioration in inflation expectations, it does not seem likely that significant increases will be produced. In face of the doubts and uncertainty regarding the future growth of the area, we expect official interest rates to stand at 2.75% by the end of 2006. In Japan, the forecasts are less aggressive, and the first increase in rates could even be delayed more than what the market discounts, placing it in mid 2006. The route is limited, since a premature rise in interest rates could have a negative impact on the exit of the deflationary process.

## Globalization and financial diversification support the anchoring of long-term rates.

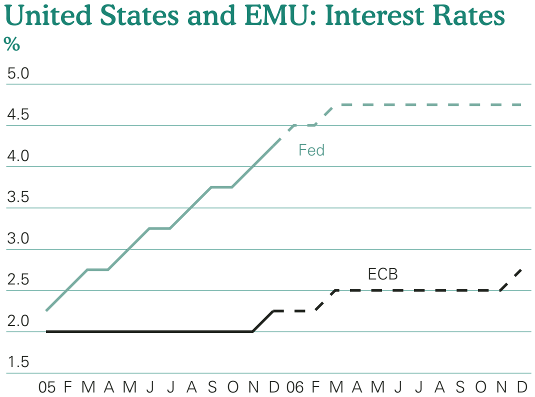
The leveling seen in interest rate curves in a generalized context of less expansive monetary policies would respond to the confluence of two factors. The first would be the deepening of the capital flows, in whose expansion of recent years the increase in the bond volumes operated has been significant. Behind this evolution would be the uncertainty in the world economy, high savings in Europe and Japan due to the life cycle, regulatory issues that mainly affect insurance companies or pension funds, and the development of the European corporate market or of the emerging bond markets in local currencies.

The second factor would be the diversification in the capital flows, since a higher number of agents and countries actively participate in the financial market. Thus, the dispersion of the current account balances not only has not diminished, but has risen in recent years. The current account deficit of the United States is rising and among the economies showing a surplus, not only do those of Southeast Asia and Japan stand out but also the oil-exporting countries.

This deepening and diversification of the capital flows could be assuming, among other estimates, almost one percentage point less in the 10-year bond rates. Given than an inflection in both trends is not expected and there are no elements to consider an increase in the nominal and real volatility of the economies, long-term interest rates can be expected to remain at low levels.

In particular, the debt curve in the United States could remain practically flat, with 10-year rates ending 2006 at levels of 4.8%, which could advance toward 5.1% in 2007, minus one percentage point over their level in December 2005. In the EMU, the 10-year rate could stand at 4.0% and at 4.3% at the end of 2006 and 2007, respectively.

### United States and EMU: Interest Rates



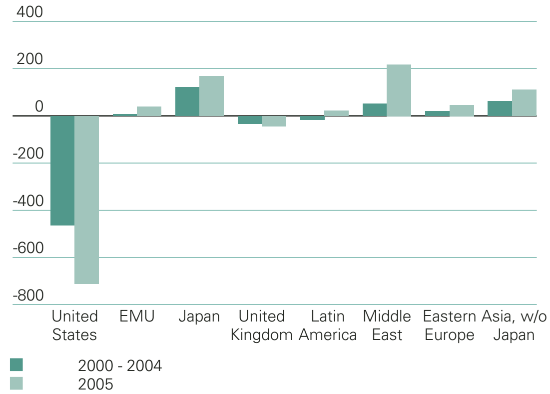

Note: Estimated as of January 2006
Source: BBVA with Bloomberg data

## Risks of the central scenario

Among the global risk factors for 2006, the slowdown of some of the most dynamic economies of the world should be mentioned, especially China and the United States. In the case of China, its current dynamism and the absence of signals of clear reheating lead us to assign low probability to a scenario of an abrupt slowdown. In the case of the U.S., the signs of moderation in the real-estate sector warn of the risks derived from an adjustment in the price of assets, which, should it occur, could slow down consumption and investment and lead to a reduction in interest rates in all the terms of the yield curve. The probability that such an adjustment might occur is limited, since there are factors that could offset the negative effect on the wealth of families: financial conditions, productivity levels and, especially, the performance of the labor market.

Another risk element lies in a possible rise in oil prices, relative to the difficult geo-political situation in some of the main oil-producing countries. Were this to derive in the price remaining higher than our current forecast of a slight moderation in 2006, not only would growth tend to moderate but also the pressure on inflation would lead to rises in the short-term rates.

### Current Account Balance by Region
**Billions of dollars**




Source: BBVA with IMF data

# Oil: Calm after the Storm?

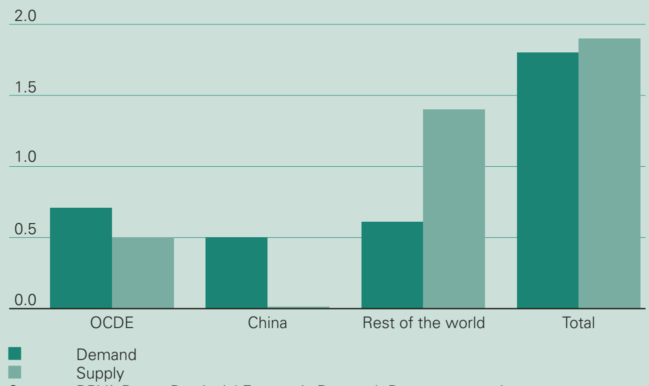
After a year of strong rises in oil prices (along the order of 60%) up to September 2005, at the beginning of 2006 the market seemed to be entering a period of calm. To begin with, the factors that boosted the rise in energy prices were a perception of a weak equilibrium in the market, a period of sustained growth in demand, the fear that an important producer would halt sales (although only on a temporary or transitory basis) in a market with a limited capacity to offset such an eventuality, and a more intense hurricane season than is normally the case. The latter had a significant impact in the Gulf of Mexico, the area in which the greater share of U.S. crude oil and hydrocarbon products are produced, refined, and imported. It would seem that at the end of 2005, there was a return to a period of calm. In the fourth quarter of 2005, oil prices fell 11%, to close the year at an average of US$54.48 for the Brent and US$42.72 for the Mexican mix. The big question is whether the trend will continue or if, on the contrary, prices will once again increase.

The pessimists (high prices) believe that the strong growth of the world economy and of demand will be maintained. This behavior, given the low additional production capacity that is available and the persistence of production losses due to the hurricanes, together with a greater geopolitical risk associated with the situation in the Middle East, could explain a sustained rise in prices, as has occurred in the past few weeks. This could bring the Brent to US$63 per barrel, as estimated by the U.S. federal government's Energy Information Administration (EIA) and would maintain prices in real terms at such levels over the next few years.

The optimists (low prices) base their projections on lower growth of the world economy and demand, which in turn, reflects the effect of the impact of high prices, accompanied by a greater recovery in inventories, higher growth capacity of supply, and lower geopolitical risk. From this perspective, the correction in prices will be much faster than expected and average oil prices would be close to or below US$50 dollars per barrel for the Brent and US$38.50 for the Mexican mix.

In the short term, the pessimists have the advantage. The current year began with a conflict between Russia and Ukraine, with Moscow fulfilling its threat to cut off the supply of natural gas to Kiev after the latter definitively rejected the price increase decreed by Russia. *Gazprom* (the Russian public gas corporation) began to lower the pressure in the gas pipeline that carries the fuel to Ukraine, reducing supplies by about 120 million cubic meters daily and affecting the rest of Europe, which receives 85% of the supply that passes through Ukraine. This boosts prices due to a possible impact on demand for such products, mainly as a result of the lower temperatures on the European continent at the beginning of the year. Beyond representing a precise and short-term element, this is coupled with a number of potential risk factors that loom in the future.

### Increase in Supply and Demand in 2006




Source: BBVA Banco Provincial Economic Research Department estimates

The other element, perhaps of greater importance, is the increase in the geopolitical risks in the Middle East associated with the renewed conflict over Iran's nuclear intentions and the possible impact that such a development would have on the region's stability.

## What to expect in 2006?...

The behavior of the market in 2006 will be halfway between the position of the optimists and the pessimists. This will be a year of solid growth of the world economy, with an average increase in demand that is 1.8% above 2005 levels, but with a similar or slightly higher improvement in terms of supply. In relation to oil supply, at current price levels, the reaction of the producer countries is not insensitive, since a stable price of US$60 dpb (dollars per barrel) in real terms incorporates a 40% increase in supply from non-OPEC countries over the next five years, by activating 85% of these nations' reserves and making such efforts viable from an economic standpoint. On the other hand, in a scenario of US$20 dpb, 70% of those reserves would not be developed, and in a situation in which prices fall to US$40 dpb, 55% of the reserves would not be. In this price cycle, the non-OPEC countries will once again play a central role in the growth of supply.

In fact, the OPEC's announcement that for the second quarter of 2006 it will be necessary to cut back production by at least a million barrels, since producers will be undergoing a year of building up inventories, has begun to reflect this greater strength on the supply side. Following up on the OPEC's behavior and reaction will be key, although it should be pointed out that the OPEC is caught in the dilemma that sustained levels of real prices at US$60 dpb could imply a loss in market share in the medium term, similar to what occurred with the expansion generated by the North Sea operations. Therefore, it is likely that such developments will favor a medium-term target price somewhere in the neighborhood of US$40 to US$45 dpb rather than the current levels

A more detailed review on the demand side indicates that despite having low elasticity, the improvement in efficiency is allowing the greater requirements associated with growth and improvement in living conditions in the developing countries to be absorbed without an explosive growth in demand, although a sustained increase can be projected.

These structural changes that would accompany a rather optimist vision would face geopolitical factors in the short term that are indeed intensifying at the beginning of the year and which will incorporate greater uncertainty. Of particular importance in this regard is the case of Iran, which is the greatest risk factor for 2006, together with a break in the possibility of a negotiated solution to the Israeli-Palestinian conflict.

Given our vision of a greater strength in market fundamentals than those contemplated by the pessimists and a more intensified geopolitical risk than that advanced by the optimists, the scenario for 2006 involves an intermediate outlook between the two approaches, which will be reflected in an average price of US$54.6 for the Brent and US$42 dbp for the Mexican mix, similar to the levels registered in 2005.

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