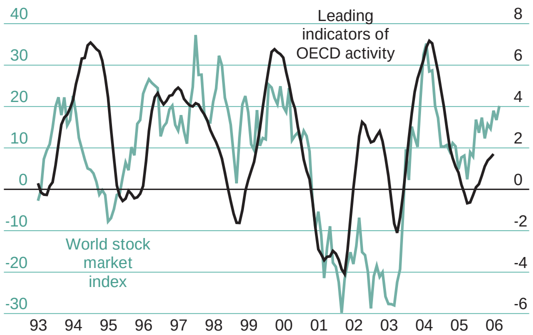
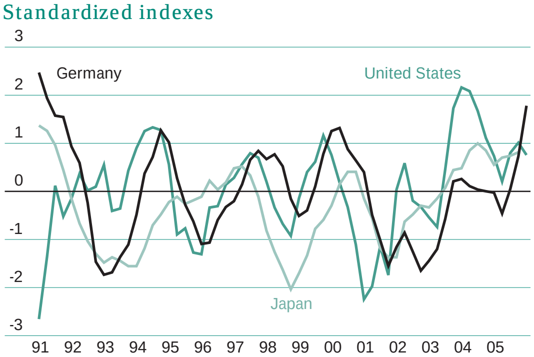
Leading Indicators of Activity



Source: BBVA with OECD and Morgan Stanley data

Industrial Confidence
Standardized indexes



Source: BBVA with IFO, ISM and Tankan data

Economic Outlook

	2005	2006f	2007f
GDP (real % change)	3.5	**3.3**	**3.2**
CPI (% change)			
Headline	3.4	**2.9**	**2.1**
Core	2.2	**2.5**	**2.3**
Federal Funds (% eop)	4.25	**5.00**	**5.00**

eop end of period
f forecast
Source: BBVA US

Dynamic World Activity

World economic activity has remained relatively dynamic despite high oil prices. The indicators published in the first months of 2006 point to high growth in the industrialized countries, including Japan. In particular, in the U.S., annualized quarterly growth in the 1Q06 will be around 5%, spurred by a rebound in the expansion of consumption, compared to growth registered in the 4Q05, mainly in durable goods. Economic growth will be more moderate later, in line with its potential.

Thus, we expect GDP growth of 3.3% in 2006 and 3.2% in 2007. The moderate drop in the growth rate in the U.S. compared to 2005 will be the result of lower real estate wealth extraction—in view of lower appreciation of housing prices and the rise in interest rates—, which will cause consumption to moderate its expansion rate to levels more in line with the growth rate of disposable income. Also, job creation seems to have reached its maximum in the current expansion cycle, and everything points to the fact that it will maintain a stable trend in the coming quarters at an average annual rate of between 1.2% and 1.7%. Non-residential investment will continue to grow over the rest of the economy, supported by a favorable outlook and strong business profits obtained through solid gains in efficiency and high productivity.

Lower growth in domestic demand and, particularly, in consumption in 2006 could be partially offset by greater growth of foreign demand. On the one hand, in Europe, the recovery of confidence is a fact and should be accompanied by an improvement in activity data, especially in countries that, up to now, have shown moderate growth, like Germany. The favorable financial conditions for companies or the recovery of families' disposable income within a context of job creation are solid bases to further European domestic demand. On the other hand, Japan continues to show notable growth, superior to its potential, which could lead to the end of deflation in 2006.

Despite the environment of solid growth and high oil prices, inflation has remained within a relatively narrow range, especially in the core component. Even in the U.S., where the use of productive resources, capital and work has risen significantly and surpassed its historic averages, the rally in energy inflation has been barely transferred to final prices. In fact, the impact of globalization and the performance of real wages, with practically nil growth rates, despite the cyclical situation of the economy, provide a certain margin for inferring that any rally in inflation will be relatively limited. The forecast for core inflation in the U.S. for this year is of annual 2.5% growth, which implies a moderate trend upward as of the 2Q06. The expectation for headline inflation is that it will remain contained at an annual average of 2.9% in 2006.

Within a context where idle capacity continues to diminish and core inflation presents potential upward risks, we expect the Fed to continue to restrict monetary policy. Nevertheless, to the extent that idle capacity seems to have reached its lowest level, core inflation and inflationary expectations will remain delimited, and economic indicators will validate, as we expect, a moderation in activity going forward, mainly in the real-estate market. We anticipate a pause in the restrictive cycle of monetary policy when it reaches 5% in May, although, to the extent that greater pressure is perceived on core inflation in a context of high growth, the FOMC could act cautiously and delay this pause.

There is no doubt that as the end of the cycle of monetary policy approaches, uncertainty regarding its future course increases, giving space for periods of greater volatility in the forecasts than those seen in recent quarters. However, with the economy growing near its potential and stable core inflation, we believe the pause could be prolonged, as occurred following the restriction cycle in 1995.

In the EMU, interest rates will continue to rise also gradually and calmly, until they stand at 3% by the end of 2006. Japan also took the first step in changing its monetary policy: it modified its policy of "quantitative" monetary easing that could signal the abandonment of zero interest rates toward the end of this year. Jointly, the main central banks are moderating the degree of easing that has characterized monetary policy in previous years, even though the expected interest rates are still lower than the maximums reached in previous tightening cycles.

A world with structural changes?

Today, one of the most vivid debates among economists is the sustainability of the current model for world growth in which, by way of simplifying, China invests and exports, while the U.S. imports and consumes, at the same time that inflationary pressure remains low at a global level. This model is mirrored in excess savings in China (similar to other Asian countries and oil-producing countries), which finances negative savings in the U.S. (with a current account deficit of 7% in GDP) and helps long-term interest rates remain low.

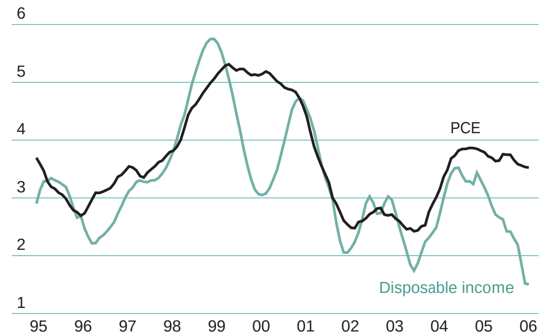
In addition to greater credibility of the fight against inflation by the central banks, there are other factors that provide support for this situation to respond, in part, to structural change, such as the technological development and globalization of activity with new participants in the market economy, which is assuming a change in the traditional mechanisms for the transmission of prices and wages. This globalization, transferred to the financial markets together with the lower volatility of macro variables, implies a reduction in the risk premiums and, therefore, presumes a reduction in long-term interest rates.

This last novel factor could explain the fact that, despite the rise in the U.S. federal funds rate, long-term interest rates have remained relatively stable, thereby leading to a significant flattening of the yield curve, and even at some moments to its slight inversion.

Usually, an inversion of the yield curve is interpreted as a signal of economic recession, with an average advance notice of four quarters. Now, on this occasion, it is possible to add, as Bernanke has

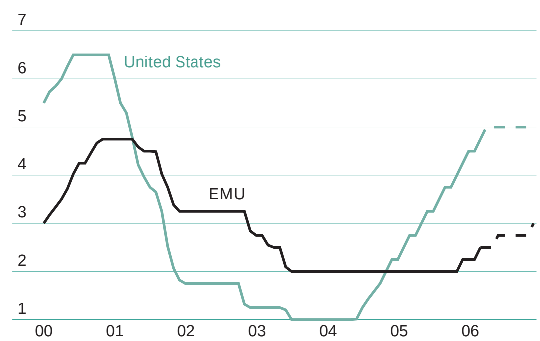
U.S.: Disposable Income and Personal Consumption Expense (PCE)

Real annual % change, 12-month moving average



Source: BBVA with BEA data

Official Interest Rates



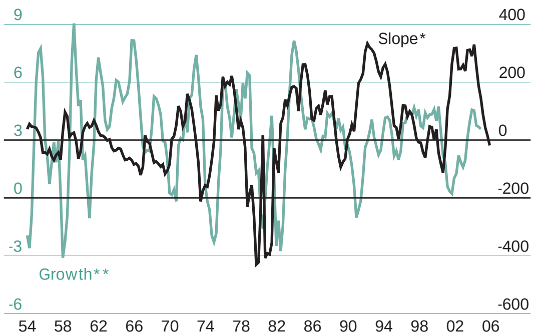
Note: Estimated as of April 2006
Source: BBVA with Federal Reserve and BCE data

Decomposition of the Explanatory Factors for the 10-Year Rates

	10-year rate	Real rates
1990	8.70	4.00
2005	4.30	2.00
Change	**4.40**	**2.00**
Real rate expectations	-90	
Inflationary expectations	-100	
Premium in real terms	-150	
Risk premium due to inflation	-30	

Source: BBVA

U.S.: Growth and Slope



* 10 years / 3 months
** 6 quarters lagging
Source: BBVA with BEA and Federal Reserve data

Evolution of the Yuan / Dollar Since the Revaluation of July 2005

Source: BBVA with Bloomberg data

recently indicated, that the flattening of the debt curve could be the result of a lower risk “premium”, derived from lower macroeconomic uncertainty and greater demand for bonds by agents who are not too sensitive to the profitability-risk criteria. This explanation could assume that a flat yield curve is compatible with stable growth in the coming months.

In addition to these structural factors, some temporary situations are contributing to reducing the risks in the current situation. In the first place, the progressive adjustment to a rise in the official interest rates constitutes a first step for limiting excess liquidity that could have led to undervalue the risk in some assets. Secondly, the difference in the growth of domestic demand between the U.S. and other economies is moderating, at the same time that growth in Europe and Japan is being boosted, and growth in the real-estate sector and consumption in the U.S. economy has moderated. Finally, the growth of the Chinese economy is allowing it to slowly but gradually adjust its exchange rate to the dollar.

Risk scenarios on activity: not very likely

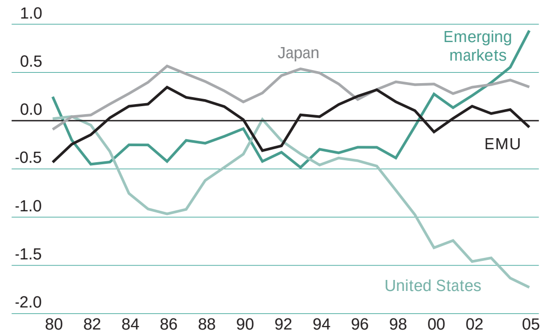
Despite these structural changes, which are the support of the base scenario for growth in the world economy, there are some elements that could presume downward risks to activity. The probability that the valuation of risk on the part of investors is too low, causing an increase in the asset prices in an environment in which families are highly indebted, could imply an economic adjustment. Similarly, the high and growing current account deficit in the U.S. is an uncertainty factor, especially considering that part of the deficit is being financed by the surplus of the oil-exporting countries and by official capital flows stemming from the accumulation of international reserves from a series of countries, in particular emerging Asian countries that are trying to avoid the revaluation of their currencies.

Now then, together with the previously mentioned support factors, it should be pointed out that, in any case, it is not easy to anticipate either the form of a potential adjustment or its detonator. A real “shock”, such as a sudden increase in oil prices might be, as the result of a significant reduction in supply, would not necessarily cause a strong rise in inflation and could lead to a recession in the economies and lower interest rates. A financial “shock”, in which the rise in the risk aversion could lead investors to request higher remuneration for U.S. assets and could cause a depreciation of the dollar, would mean a notable increase in the debt profitability in that economy. An error in monetary policy that were to imply too-high official interest rates and were to provoke a drop in the price of real-estate assets more than a moderation in its price growth rate, would lead to a significant recession and to a drop in interest rates in the future. Evidently, any of these scenarios would have more negative consequences on the prices of assets if accompanied by a rise in inflation, within a context in which the gains in productivity in the U.S. were doubted and there were a regression in globalization, derived from having adopted protectionist steps in world trade. The risk map, consequently, is diverse and the detonator of an adjustment is difficult to anticipate. In any case, when a balance is made of the support factors and the risk elements, the conclusion is that the probability of these adjustment scenarios, within the current context, is low.

Long-term interest rates with a limited upward run and a stable dollar

Consequently, in the central economic scenario, the yield curve slope in the U.S. will remain relatively "flat", although to the extent that uncertainty regarding monetary policy rises and some capital flows of non-residents slow down, it could show a slight slope. Long-term rates in the U.S. will stand at 4.8% and at 5.1% on average in 2006 and 2007, respectively. In Europe, the long-term rates that dropped significantly in 2005 will remain at historically low levels to the expected scant upward run for official interest rates and to the demand for long-term assets of domestic investors, to a large extent as a result of regulatory measures. Thus, on average, ten-year interest rates in Europe will stand at 3.7% and 4.1% in 2006 and 2007, almost one point below those of the U.S. This spread in the interest rates will continue to be one of the main supports for the dollar, which, in relation with the euro, will remain within a stable range of about 1.21% in 2006 and 1.25% in 2007. Now then, the situation of the current account balance in the U.S. implies a balance of downward risks for the dollar.

Current Account Balance
% of world GDP



Source: BBVA with IMF data

Financial Outlook

	2005	2006f	2007f
		End of period	
United States			
Official rates	4.25	**5.00**	**5.00**
10-year rates	4.50	**5.20**	**5.10**
EMU			
Official rates	2.25	**3.00**	**3.25**
10-year rates	3.40	**3.80**	**4.20**
Currencies			
Dollar / euro	1.19	**1.23**	**1.26**
		Average	
United States			
Official rates	3.20	**4.90**	**5.00**
10-year rates	4.30	**4.80**	**5.10**
EMU			
Official rates	2.00	**2.60**	**3.20**
10-year rates	3.40	**3.70**	**4.10**
Currencies			
Dollar / euro	1.24	**1.21**	**1.25**

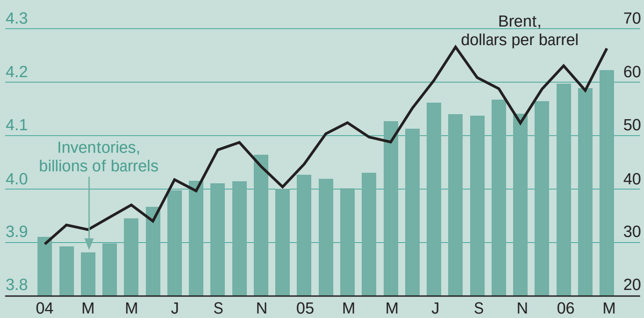
f forecast
Source: BBVA US

Oil Market: Hysteria or Hysteresis

The fundamentals support a decline in prices

Between June 2004 and March of this year, we have noticed a structural change in the oil market. Demand has increased 3.8%, representing an average rise of 3 million barrels daily, which in annual terms reflects accumulated growth of an additional 1.14 billion barrels. About 70% of the growth of this demand comes from the emerging markets, especially from China, which accounts for 40% of the total. However, in this same period, about 255 million barrels in total inventories have been created for the OECD countries, bringing the total inventory stock to more than 4.22 billion barrels, equivalent to 137 days of current production of all the OPEC member states, including Iraq. Paradoxically, the Brent price has doubled since June 2004. It would seem that the current price cycle is disconnected from the fundamentals of supply and demand, which should have given rise to a decline in crude oil prices (correction due to the effects of the hurricane season).

OECD Inventories and Brent Prices



Source: BBVA Banco Provincial Economic Research Department

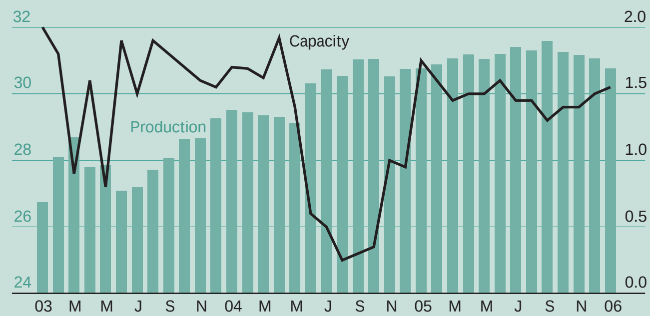
New focus: the risk "premiums"

Given this behavior, in order to analyze the oil market, it would be pertinent to consider the hysteresis models, in which expectations, which have an important weight, are an exogenous variable that has been subject to a permanent change, leading to new long-term equilibrium values. The elements that feed the expectations have to do with the fact that the emerging economies, the current driving forces of demand, will face a growing need for energy in proportion to their GDP, for the simple reason that a convergence is underway in consumption toward levels in the developed countries.

On the supply side, the concentration of more than 60% of oil reserves in the Middle East incorporates a premium (different from the case of other commodities) that we would have to term "geopolitical" and that represents, in fact, a structural element. Moreover, continuing on the subject of supply, the non-OPEC countries face declining production rates, and therefore for purposes of analysis, this can presuppose static behavior, without a significant contribution to supply.

OPEC Additional Capacity and Production

Millions of barrels daily



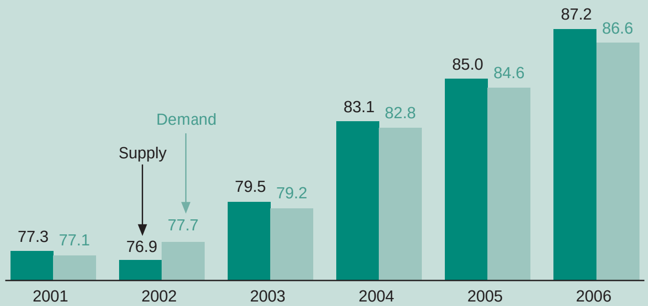
Source: BBVA Banco Provincial Economic Research Department

In analyzing these elements, considering a long-term horizon, demand on the part of the emerging markets based on convergence has not been growing at rates expected by the analysts. Part of this growth can be absorbed via a gain in efficiency, thus softening the growth in projected demand.

On the supply side, real oil prices above 40 dollars would activate 95% of the projects that were not feasible at prices close to 20 dollars. To quantify this potential impact, there would be approximately 128 billion barrels of non-OPEC reserves, equivalent to 1,500 days of current world demand and 4,153 days of current OPEC production. Of course, should such a situation occur, the central question is the rate of investments and the time frame for placing this potential production in the market.

The element of geopolitical risk would have two components, a structural factor associated with the Middle East and a situational aspect, such as the cases of Iran and Nigeria. A central element in evaluating the geopolitical shocks that lead to fears of a contraction in oil supply is that they will generate a price increase similar in scope and persistence to the shocks that have been associated with actual declines in production. In fact, a larger proportion of the historical fluctuations in Brent prices can be attributed to the former rather than the latter, given that they are a strong conditioning factor in current prices, even if the feared reduction in production does not take place.

Balance Between Supply and Demand for Oil
Millions of barrels daily



Source: BBVA Banco Provincial Economic Research Department

In short, these geopolitical risk factors have led to constant pressure from speculative purchases that translate into additional demand, which does not consider the major equilibriums in the market and that partially explain the behavior of oil inventories. In addition, the growing world liquidity has also been directed at future purchases in the oil market, which has incorporated elements characteristic of financial assets that have limited prices. This has resulted in greater short-term stability in current levels and responds less to the fundamentals typical of current supply and demand.

The Nigeria effect: an additional "premium"

An armed organization, the self-proclaimed "Movement for the Emancipation of the Niger Delta" (MEND), established in December 2005, demands greater control of oil resources for Nigeria and wants to eliminate the power of the transnational companies in this regard. To achieve its objective, the MEND has engaged in attacks on the oil industry that have resulted in a decline in production of approximately 600,000 barrels daily. The International Energy Agency has pointed out that the OPEC has covered this drop in production and that it is not necessary to establish an emergency policy for crude oil inventories involving OECD member states, while at the same time Nigeria has announced the prompt restoration of production. This factor represents an element of geopolitical risk that has been having an impact since the end of 2005 and which is beginning to have a greater effect due to Nigeria's market share in the current cycle.

Iran: little likelihood of an embargo

The main geopolitical risk factor that affects the oil market is the complicated situation in Iran regarding the country's decision to resume its program of uranium enrichment for the generation of energy. The West views this decision with caution since it believes the program is aimed more at developing the country's arms than energy resources.

The case has been the subject of a unanimous motion by the United Nations Security Council demanding that Iran completely suspend all activities in uranium enrichment within 30 days, the deadline for which expired at the end of April. The key question is whether this dispute will end in an embargo on Iranian exports. It would appear that the trivial answer is no. From the Iranian point of view, the country has less maneuvering room than expected in relation to an embargo. The country's international reserves, excluding gold, only cover 10 months of imports (22% of GDP). At the same time, public spending represents 40% of GDP, with a strong component of direct subsidies to the population, with fiscal oil revenue accounting for 55% to 60% of the total.

From the standpoint of the West, given the weak additional production capacity that the world currently has, it would be very difficult to cover the withdrawal of Iranian exports, currently at 2.9 million barrels daily, from the market. This would generate a strong short-term impact on prices. It would appear there are objective conditions to extend the time frame for adopting a decision or to reach an "honorable" solution for the parties involved.

To place the situation in context, the typical occasions in which there has been a contraction in Iranian oil production that have occurred since 1985 have usually been transitory, with oil production recovering within a few quarters, and have been relatively minor in relation to the size of the decline (an average of 5%, maximum of 10%, which today would represent 200,000 and 400,000 b/d, respectively).

On those occasions, the suppliers of crude oil rapidly boosted their production to compensate the reduction in Iranian output, which cushioned its impact on oil prices. Such prices progressively rose, accumulating an increase of 3% in real terms four quarters after the reduction in production and dropping again, also progressively, in the following quarters. However, a reduction five times greater than the maximum registered in the past, in the current situation marked by reduced surplus production capacity, could not be offset by the remaining oil producers, and would thus generate a strong real increase in oil prices. The leveling of future prices around the current price levels would appear to be discounting a scenario of low probability of an embargo, but also of the persistence of a risk premium in the next few months.

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