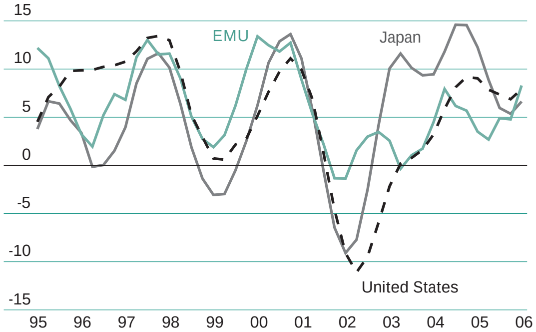
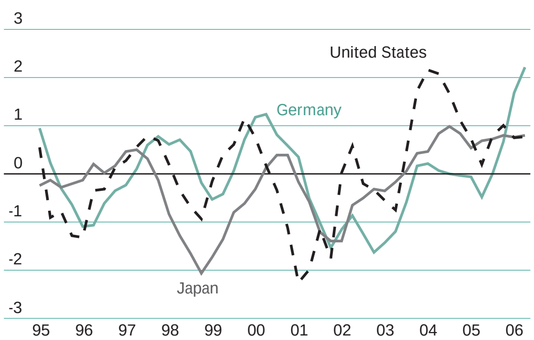
Real Exports
Annual % change



Source: BBVA with Bloomberg data

Industrial Confidence
Standardized indices



Source: BBVA with IFO, ISM and Tankan data

Global growth continues, but so do the risks

The first half of 2006 ended with some global economic growth levels that have continued to surpass the most optimistic forecasts. Among the developed countries, the U.S. registered an annual average GDP growth rate of 3.5% during the last year, while both Japan and the Euro zone have shown signs that point to strong growth rates. The main emerging economies have remained at levels of high growth.

This international environment continues to be characterized by moderate inflation, despite not only the economic expansion course itself, but also the price increases in raw materials. However, there is a growing concern regarding the possibility that inflationary pressures derived from the higher prices of inputs may eventually be transmitted to the rest of the economy. This has led to greater uncertainty regarding the monetary policy, particularly in the U.S., although we are approaching the conclusion of the upward cycle; and in the area of the euro and Japan, clearly already en route to higher rates. When comparing the interest rates discounted in May with current ones, it is clear that there has been an increase; and, consequently, lower global liquidity is a scenario with greater probabilities than some months ago. This has translated into a situation where volatility abandons minimums and the appetite for risk decreases.

The emerging markets are where this lower liquidity seems to be having a greater impact. Financial investment has shown more aversion to risk since May, which has translated into a significant drop in the stock markets of the main emerging markets. Markets that are more vulnerable in their fundamentals (i.e. Hungary, South Africa, Turkey), or that had been revalued to a greater extent in previous quarters, have supported a greater adjustment, through the depreciation of their currency or of a rise in their risk premiums.

In any case, the forecasts are indicating that relatively generalized growth is going to continue. There is also greater concern regarding the imbalances characterizing this expansion cycle. In fact and, although in the short term the global economy could coexist with this situation (a high current account deficit in the U.S., oil prices), the consensus regarding the need of an adjustment in the medium term is increasingly higher. We must take note of statements by the IMF calling for a modification of the exchange rates as a tool to balance the capital flows of the global economy. Despite everything and, given the adjustment in some financial variables, optimism is prevailing and the geographical distribution of global growth makes the strength observed up to now less vulnerable

World activity: more major players

It has already been several quarters ago that diverse and multiple risk factors with respect to global growth have been considered. But despite these, the economy continues to experience marked strength that includes several geographic regions and which, in turn, has been the one with the highest intensity since the end of the decade of the sixties.

Despite the fact that some economic indicators in the U.S. have recently pointed toward moderation in activity, the growth rate observed and forecast continues to be positive. The industrial sector and its investment levels continue to be favored by business earnings, although the upward trend in interest rates and a possible increase in nominal wages, which have risen less in this expansive cycle, could moderate this trend. On the other hand, consumption tends toward certain stability. Despite the performance of energy prices or real estate assets, the consumer confidence indices are favored by the cumulative financial wealth on the stock markets and by low unemployment levels. These factors could offset the slowdown of the real-estate sector, from which a slight moderation in private consumption could follow in the second half of 2006. In our central scenario, we expect U.S. GDP growth of 3.3% in 2006 and slightly lower next year.

In the EMU, the first signs of a recovery in family spending have finally appeared. In Germany, one of the economies lagging the most in the current expansion, indicators continue to be positive and there is a more generalized optimism. The marked strength observed in the first quarter of 2006 will continue in the second. However, some of the recent indicators of industrial confidence have regressed slightly. This would be reflecting a divergence between the expectations of analysts (more pessimistic) and those of businessmen (more optimistic). Lastly, Japan continues on its course toward average growth of 3%. At the end of the first quarter of this year, the output gap of the Japanese economy was situated on positive territory for the first time in more than eight years. Expectations continue to be optimistic and sustained throughout 2006 and 2007.

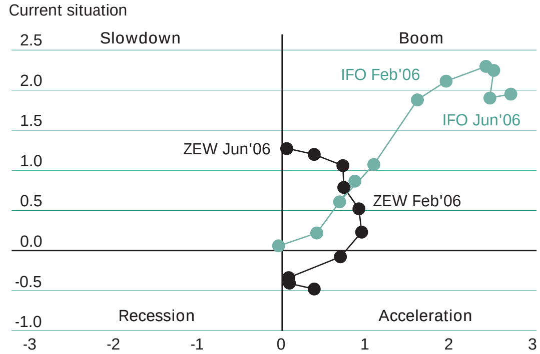
This new world equilibrium, where domestic demand is recovering in Europe and Japan, allows less dependence on economic growth in the U.S. and China and is seen as a factor that could help in the gradual adjustment of imbalances. This favorable international environment will continue to boost support for world trade and for the exporting industrial sectors.

Monetary policy at the forefront

During the first quarter of 2006, the U.S. continued its upward cycle that began in June 2004 and the question was: "Has this cycle already ended? The answer seemed clear; the cycle was about to end. However, following the Federal Reserve meeting of May 10, during which a pause in interest rate increases was not confirmed; and following the bullish statements by the monetary authorities, the markets began to discount greater increases in interest rates, pointing toward 5.50%. Within this context, the Fed is debating between two possibilities. Either to continue the upward course, given the concern over core inflation, or, in contrast, estimate that the upward cycle has come to its end and make a pause on rate increases so as to analyze the effects of its monetary policy strategy and have more data available regarding the effect of the cumulative rise in energy prices, inflation and consumption.

In any case, even if the upward cycle continues in the U.S., and taking into account that the EMU would follow this same course throughout

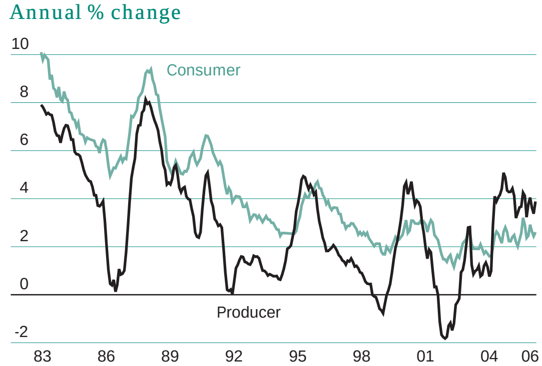
Activity Phases as Per Indicators



Source: BBVA with Bloomberg data

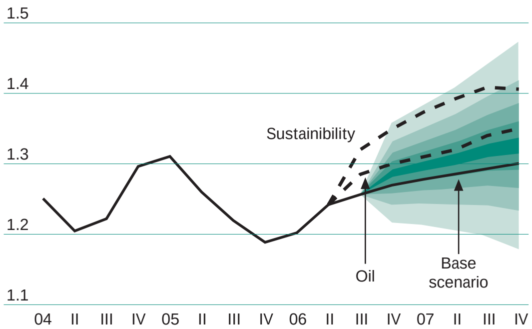
OECD: Inflation

Annual % change



Source: BBVA with Bloomberg data

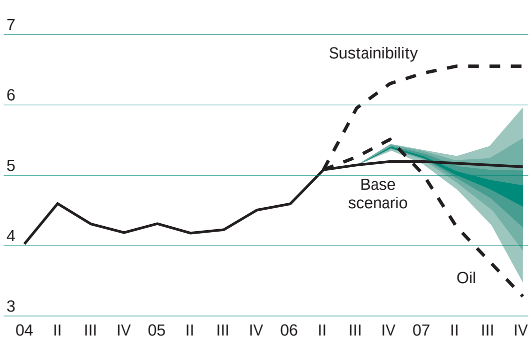
Euro - Dollar



Source: BBVA with Bloomberg data

U.S.: 10-Year Interest Rates

%



Source: BBVA with Federal Reserve data

2006, interest rates would move within a neutral rate range. On the other hand, Japan, with its good results in activity and prices, would also be on the verge of starting its upward cycle and abandon its relaxed monetary policy. For the time being, after abandoning its policy of extraordinary liquidity, the reference rate has already risen for the first time in six years from 0% to 0.25%.

In the U.S., there are signs pointing toward the acceleration of core inflation, which would remain high during the second half of this year (although still within the range of the Fed's forecast, which has been high for the whole of 2006). This, together with the potential rise in short-term inflationary expectations, a low unemployment rate and high capacity utilization are important risks that the monetary authority will have to consider. This, together with the moderation in the activity growth rate, assumes a more detailed attention of the current situation so as to determine the course that monetary policy will take, although what is relevant are the forecasts for inflation and growth in the medium term.

The central forecast is that, given stable growth and relatively controlled inflation, the official rates in the U.S. will remain at 5.25% in 2006 and 2007. Meanwhile, the EMU will end this year at 3.50% and next year at 4.0%, given the improvement in growth expectations and the existence of inflationary pressures. With this base scenario and in the assumption that the upward cycle in the U.S. has ended, the ten-year rates would fluctuate within a range of 5.1%-5.25%, although maintaining a bias upward should situational surprises in growth or inflation emerge. The forecast for the base scenario for the euro zone leaves long-term rates between 4.2% and 4.3%. This performance in interest rates will no longer favor the dollar as it did some quarters ago, which together with the growing consensus on the need for a greater depreciation of the U.S. currency, takes our forecast to a range of 1.25-1.30 per euro.

The risks give an upward bias to short-term rates

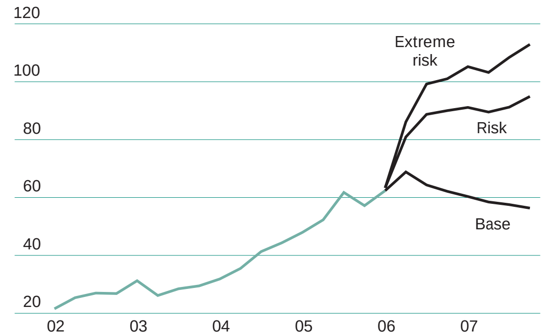
Within this economic framework, what are the main risks? One of the most important is a direct consequence of the relative uncertainty of the U.S. Federal Reserve policy. We cannot eliminate the possibility of the Fed showing a greater rallying attitude for the sake of not only containing inflationary tensions but also of convincing the markets of its determination regarding monetary policy. This context tends to favor a slight "over-restriction", which will raise reference interest rates above the levels the market is currently discounting. With these considerations, should this scenario materialize, we would hope that the rise in interest rates would increase the inflows of foreign investors in U.S. public debt, guided by the "refuge effect", which reduce the volume of financial flows that the emerging economies have received until very recently. The inflows into the U.S. fixed-income market would not prevent a depreciation of the dollar or a limited rise in the long-term rates in that country. Now, in this scenario, part of the rise in the official rates would revert in 2007.

The second risk scenario has, as the triggering factor, the generalized conviction regarding the non-viability of the U.S. deficit. This financial shock would bring with it considerable rises in U. S. interest rates, a depreciation of the dollar, drops in stock market prices and a later drop in GDP. In Europe, the appreciation of the euro would limit interest rate increases.

The final risk abandons the financial aspects to concentrate on the real economy, in particular on the continued high levels of oil prices. The base scenario considers an average price per barrel for the Brent of US$61.4 per barrel in 2006 and of US$56.7 in 2007. In an alternative scenario, oil would reach US$82.5 in 2006 and US$91.6 in 2007. Also, there would be a considerable drop in the main stock market indices, of 10% in 2006 and 20% in 2007. Interest rates would experience an increase somewhat higher than that of our base scenario in 2006, to drop substantially in 2007.

Even so, inflationary pressures as well as stability in global growth depict a horizon in which interest rates show a slight upward trend during 2006. In 2007, the bias would be downward both in the U.S. and in the euro zone. For its part, the dollar shows a clearly depreciating bias, given the ample current deficit in the U.S. and the distancing of the U.S. advantage in the interest rates.

BBVA; Oil Price Scenarios
US dollars per barrel



Source: BBVA with Bloomberg data

![BBVA Bancomer]

After a Strong Appetite, Some Caution

2006 began with an appetite and is now neutral

Net capital inflows in the emerging markets have been basically shored up by two very important factors: a strong appetite for risk on the part of investors—accompanied by low volatility in the capital markets—and abundant international liquidity. In 2005 and through May 2006, volatility was maintained at minimum levels and the appetite for risk at maximum levels. This supported the rise in the price of assets and strong capital inflows. In June, investors' appetite began to correct, but it has done it going toward an area of neutrality, not of aversion. In addition, in the case of the appetite for risk, it could be argued that it was also backed by a clear strategy of a search for yields on the part of investors.

Volatility: MSCI of Emerging Markets
Annualized volatility

Source: BBVA with Capital Flows data

Should volatility be of concern?

On one hand, based on the startup levels, increased volatility should not generate excessive concern. In May 2006, after the Federal Reserve meeting during which the rising cycle of interest rates was not finalized, volatility rallied to levels not seen since May 2004. Later, it corrected downward. In fact the markets were expecting a moderate rebound in volatility, although it is true that the abrupt performance took investors by surprise. So much so that, in May, there was speculation as to the start of a financial crisis or about volatility being caused by the Hedge Funds operation. The truth is that there were no important changes at a macroeconomic level. Therefore, everything seems to indicate that the most reasonable explanation of what occurred in May is that, after a long period of bonanza, investors judged that "certain" emerging markets could be over-valued and decided to take their profits. Expectations of higher interest rates supported that decision.

In the last month and a half, market performance has confirmed the probability of this explanation. Volatility has corrected to a large extent, given that part of the uncertainty that existed on the market dropped with the rise in interest rates by the Federal Reserve on June 30 and, particularly, by a communication that seemed to discard extreme scenarios of rises in interest rates. Jointly, we have a patent differentiation by the investors when purchasing assets, in which countries with weaker fundamentals are penalized. Markets such as Mexico or Brazil were not "punished", while others, such as Turkey, have been penalized. On the other hand, investors could assimilate the negative effects that could be produced on the markets, in view of the current situation. The latter is determined to a large extent by the higher interest rates in developed countries and the strong geopolitical tensions that are being produced in the Middle East.

Latin America: Aversion Index
Dollars

Note: Aversion to risk in each period is calculated as the slope of the transversal regression between the returns in excess and volatility
Source: BBVA with Capital Flows data

Undoubtedly, these conflicts could trigger a higher rise in the prices of raw materials, something that could produce inflationary pressures and, ultimately, higher interest rates. For the emerging markets, a scenario of higher interest rates, volatility and a growing aversion to risk would be less comfortable.

In conclusion, there should be caution

The effects of a higher level of volatility, together with the significant risk of higher global interest rates (inflation), would have a negative impact on investors' appetite for risk. In that respect, the valuation of emerging assets would be impaired and the risk premiums would rise. Everything indicates that investors are more selective. Because of this, perhaps this is the time to be prudent as well as bold, to approach the reforms (macro and micro) that could isolate the economies from such negative effects.

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