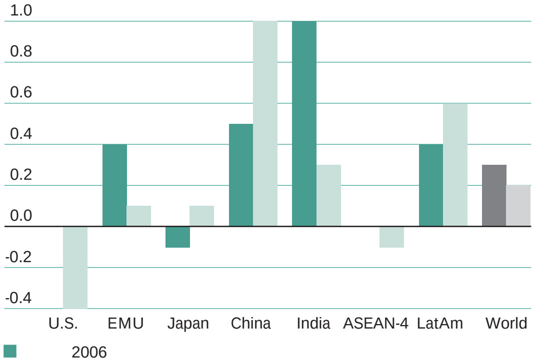
IMF Revision of Growth Projection for April to September 2006

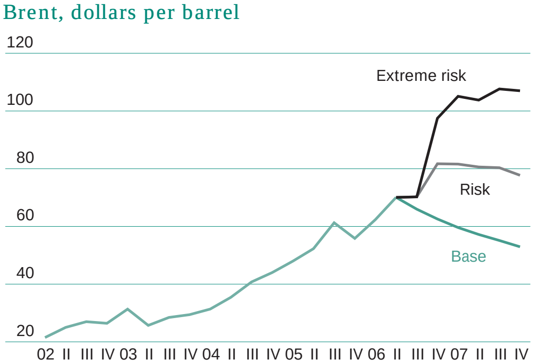
Percentage points



Source: BBVA with IMF data

BBVA: Oil Scenarios

Brent, dollars per barrel



Source: BBVA

Economic expansion continues and diversifies geographically

The world economy continues to expand at a rate that has remained at about 5%. Also, and in contrast with other cycles, current growth is supported by an increasingly more extensive geographic base. Together with the strength shown by the recovery in Europe, the division of the main emerging markets continues to surprise favorably, which is leading to positive reviews of expected growth for the end of 2006. BBVA has modified its projections upward for the second half of the year, for China, the European area and Latin America by 1.4, 0.5 and 0.3 points, respectively. The only exception is the United States, for which we have maintained our GDP growth estimate at 3.3%. In general, as also shown by the IMF forecasts (see the attached graph), growth worldwide in the coming quarters is visualized as more solid than was expected at the beginning of 2006.

With this broad geographic base backing global growth, we find ourselves facing the most expansive phase worldwide since the decade of the seventies. Factors such as technological development and globalization of the world economy, the markets and the financial systems favor the current environment. In this cycle, inflationary risks have been delimited, despite the fact that the rise in the price of raw materials has co-existed with extraordinarily low interest rates. For these reasons, if we were to place on a scale both the apparent reversion of an inflationary rallying trend and the shift in the OECD monetary policy from expansive to neutral interest rates, the risk of inflation rises would be maintained relatively under control.

However, to continue on the global growth path would depend, to a large extent, on whether growth in the more dynamic regions would be relatively immune to the moderate slowdown that is already evident in the U.S. In fact, and as we specify below, it is in this country where we observe the most uncertainty during the coming months.

Uncertainties in the world economy are changing ...

One of the most significant events since the end of the third quarter has been the generalized price drop in raw materials, which, among others, has affected gas, copper, aluminum, zinc, nickel and oil. If we concentrate on this last good, we will be able to appreciate the important changes that have taken place in some of the factors that in recent months have led to their revaluation.

On the one hand, the relatively benign hurricane season in the Gulf of Mexico has eliminated the possibility of risks in the supply of oil in that zone, as opposed to what happened in 2005. On the other, lower geopolitical risks have given oil prices a breather, which is particularly important both for the diplomatic progress in Middle East tensions and because we suppose that the recent events in North Korea will not have an impact on the market. In September, Israel ended its troop withdrawal from Lebanon, in observance of the main UN resolution aimed at resolving the conflict. Another political risk that has had a bearing on the expectations of oil prices is that the dispute being faced by the U.S. and Iran with respect to nuclear energy also seems to be easing, although the Korean nuclear test could make the negotiations become more expensive.

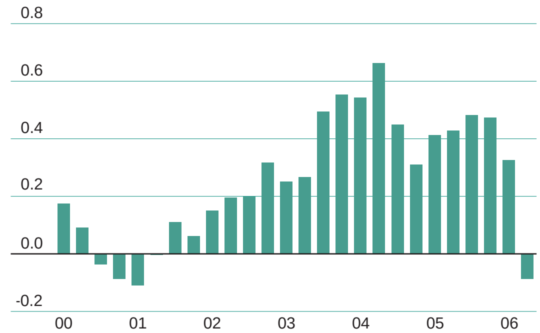
In this case, even though we are far from an arbitrated solution such as the one that brought to an end the confrontation between Lebanon and Israel, it seems that Washington is increasingly tending toward rejecting a military solution to the conflict. With oil prices at about US$60, the risk for the global economy derived from a price shock is, today, considerably lower than a few months ago. Therefore, there is a greater probability for the base scenario that would imply an average price of almost 65.5 dollars per barrel (dpb) in 2006 and 58.2 dpb for the Brent in 2007, equivalent to 56.2 dpb and 51.9 dpb for the Mexican mix. This performance would find backing in a scenario of lower strength in world growth. In brief, our base scenario considers oil price stability close to the levels reached at the end of September.

This scenario does not imply the absence of risks for the world economy, since other factors of uncertainty have acquired a predominant role recently. Among these, the adjustment of the real estate sector in the U.S. is undoubtedly the most important. The base scenario presumes that the U.S. economy will slowly moderate its growth rate. Thereby, housing investment will have a negative contribution for the first time since 1995 and consumption will moderate slowly, at the same time that it has less support derived from earnings in income and wealth, which has represented the price rise in housing in recent years, all of which should lead to a slight moderation in the ratio of consumption to GDP.

However, the U.S. economy could continue to grow very close to its potential level, reaching a rate of about 2.8% in 2007. On the one hand, the expansion in the rest of the world and the accumulated dollar depreciation are allowing net exports to make a positive contribution to growth for the first time since 1995. On the other, non-housing growth is maintaining a positive tone, supported by high business earnings, high liquidity levels and low interest payments in an environment where the global financing conditions continue to be quite favorable.

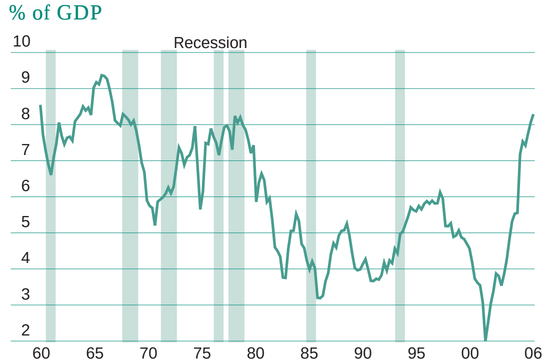
The most probable response from the monetary authorities to this economic situation will be maintaining the official interest rates at the current 5.25% levels for a prolonged period. There are several reasons for this. In the first place, inflation will moderate, although it will continue to be close to the high end of the range desired by the Federal Reserve. In the second place, moderation in activity will be limited—the economy has the internal and external support with which to face a slowdown in housing investment—and to the extent that it is moderate, it will be viewed by the Federal Reserve as favorable to containing inflation and perhaps to increasing the private savings rate and reducing the foreign imbalance. In the third place, following a period of notable liquidity in the whole world, generated by a very lax monetary policy in recent years, the central banks will be very cautious when reducing their official interest rates.

United States: Contribution of Housing Investment to GDP
Percentage points



Source: BBVA with National Statistics data

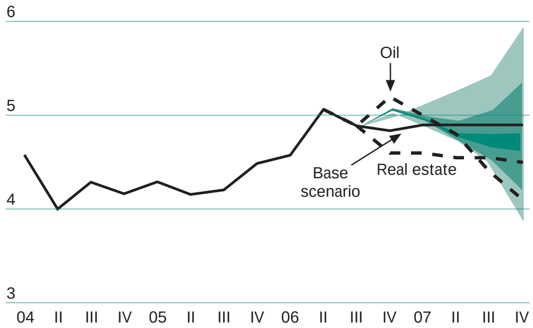
Business Benefits
% of GDP



Source: BBVA with National Statistics data

U.S.: 10-year Interest Rates

%



Source: BBVA

Monetary conditions in the U.S. are not in a restrictive zone and consumers' and businessmen's expectations seem to be relatively anchored. Within this context, long-term interest rates have a limited run, with a margin for increase of up to 5% for the 10-year bond. In this scenario, we believe that this figure is one of reference in view of the current market expectation of a reduction in interest rates in 2007. In turn, capital flows continue to show notable strength and buyers' interest for U.S. assets has reactivated, both by the central banks and private agents, which also limits the rise in the long-term interest rates.

… but the probability of this remains contained

The risk scenario being faced by the Federal Reserve corresponds to a greater adjustment in housing investment and private consumption, which would lead to a slowdown in growth to levels of between 1% and 1.5% in the coming two years. In any case, the probability of this scenario is limited. Recent adjustment experiences of the housing sector in countries such as the United Kingdom or Australia are showing that the impact on the overall economy is not high, as the structural reduction in interest rates justifies, to a large extent, that housing price levels are high and that they do not undergo prolonged adjustments. Now, if this scenario materializes, the Federal Reserve could "purchase an insurance policy" in face of low growth, reducing their official interest rates to 4.5% in 2007, which would take the 10-year rates to levels close to 4.3%.

In addition to circumstances that could limit the effects of the real estate adjustment on the rest of the U.S. economy, there are also doubts regarding their significance for the world economy. The current globalization process in some cases has led to a redirection of the trade flows. In Asia's case, a trend is evident toward more endogenous growth, intensifying the intra-regional trade links and to the detriment of the peso with regard to the U.S. in terms of Asian exports. On the other hand, the macroeconomic situation of the emerging markets is very satisfactory in general, with several countries in a surplus situation in their current accounts and accumulation of reserves that lead to a macroeconomic position much less vulnerable than the characteristic one of financial crises of the past decade.

Europe, for its part, would achieve growth of 2.5% in 2006, higher that the expectations that existed with respect to this area. The recovery of internal demand should be underscored, backed by a good business situation and the recovery of business and consumer confidence. Within this context, official interest rates would reach 4% in this region towards mid-2007, while the euro would maintain its relative strength against the dollar, at figures close to the current ones, that is, close to 1.30.

Central Scenario: GDP Growth by Region

%

	2005	2006	2007p
United States	3.5	3.3	2.8
EMU	1.4	2.5	2.2
China	9.9	10.0	9.5
Latin America	4.4	4.7	4.0
World	**4.9**	**4.9**	**4.6**

p projection
Source: BBVA

The Weight of Fundamentals in the Oil Market

Analysts' appreciation of the reality of the oil market tends to be dichotomic. There is always a group who thinks that the price of oil will reach levels higher than 100 dollars a barrel, and others, among them our analysts, who defend the idea that the equilibrium market price will be below 50 dollars.

The "Malthusian" focus

The first of these views (the most popular) is based on the structural imbalance in supply and demand. The economies with the highest demand for oil are the emerging markets, led by China. This has been the cause of a true structural change in the energy market, since in the past 20 years it has quadrupled its consumption of oil, tripled that of natural gas, and quintupled demand for electricity. China, together with other emerging markets such as India, has accounted for more than half of the growth in world demand for oil in recent years.

On the supply side of the equation, there is considerable pessimism. The following question seems legitimate: how long can a nonrenewable resource such as oil last? The obvious answer is that sooner or later supplies of oil will run out. This well-founded view is accompanied by other short-term evidence. Many analysts affirm that since 1980, no new important oil fields have been discovered, giving rise to the suspicion that there is not much more to discover. That is, the maximum level of production has been reached and net output will begin to decline, with the greater growth in demand over supply being structural. The obvious result of this scenario is, of course, an explosive wave of price increases. This also implies a "Malthusian" view of the oil market.

A more optimistic approach

The second opinion recognizes a good part of the arguments advanced by the first viewpoint, but with extenuating factors, both on the demand as well as the supply side, similar to those contained in "An essay on the principle of population" by Thomas Malthus (1798).

On the demand side, the elasticity of oil consumption to GDP is greater in the developed countries given the high current price levels in response to technological advances that allow for saving energy. In terms of the emerging markets, they are beginning to absorb part of the price increases with gains in efficiency, as can be seen in economies such as China and India.

On the supply side, it is not completely true that no new oil reserves and production have entered the market since 1980. The fall in prices since that year up until the latest cycle of increases, with the exception of periods of geopolitical conflict, was a factor that inhibited exploration and launching production in more complex oil fields.

Projects previously were valued at prices below 18 dollars a barrel, with only 20% of potential new reserves being economically exploitable. However, these projects are currently valued at 40 dollars, with almost the entirety of projects that were not previously considered feasible now activated. We are beginning to see the concrete result with Canada's launching of operations involving an important oil deposit on the coast of Alberta, which signified a 14% increase in the world's proven reserves, similar to what occurred at one point in the North Sea.

A similar situation can be observed in the Caspian Sea, the Orinoco Oil Belt in Venezuela, and the previously mentioned North Sea, without considering the "marginal" reserves of the rest of the OPEC countries. The apocalyptic vision that the end of oil is near is far from incorporating these elements, both on the demand as well as the supply side of the equation. The idea of a convergence of prices to an equilibrium level below 50 dollars incorporates these elements, and the short-term de-alignment with regard to this price is based on geopolitical risk factors and the expectations corresponding to the predominance of the first of the above-mentioned views.

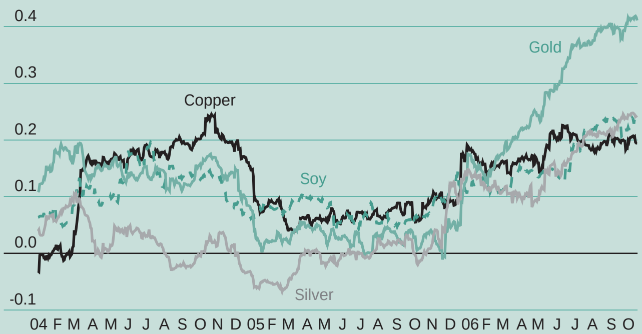
Interpreting the market...

What has occurred in the past three months is a reflection of the second viewpoint. The downward adjustment in prices has exceeded 25%, as a result of a) reduced expectations of adverse supply shocks following the end of a benevolent hurricane season, in line with estimates at the close of the first quarter, b) the possible opening of negotiations with Iran, c) the conclusion of the conflict in Lebanon and, finally, d) potential lower "speculative" investment following what occurred with the strong losses in the Amaranth hedge fund in the gas market, a development that shifted attention away from investments in this type of raw material during the past month. It should be added that North Korea's recent nuclear test is not expected to have a significant impact on the market, although it could make the negotiation with Iran somewhat more expensive.

Some analysts affirm that the recent movement in oil prices is based more on a greater weakness of the global economy, whose scope has still not been fully felt, mainly because the changes in price are synchronized with those of the rest of the raw materials. Even though, in fact, there is a perception of lower dynamism, it is, from our point of view, modest, with the projected growth of the U.S. economy near its potential level in 2007.

The performance of the past quarter could be indicating that the speculative component in the raw materials market is more important than expected. In fact, about 60 billion dollars have been channeled toward these markets. The volume of these speculative investments has a clear effect in that it generates an additional and fictitious demand for raw materials that upwardly pressures futures prices.

12-month Correlation of Daily Changes Between Oil Prices and Other Raw Materials



Source: BBVA

This element could be a key factor that explains the combined movement of raw material prices in this cycle and explains, for example, why copper is at more than double its equilibrium price, divorced from its fundamentals. In addition to Chinese demand, the speculative component is playing a key role. One hypothesis could be that raw material prices as a whole are following the behavior of oil even though they are in dissimilar markets, with part of this relationship indeed attributable to speculative investments.

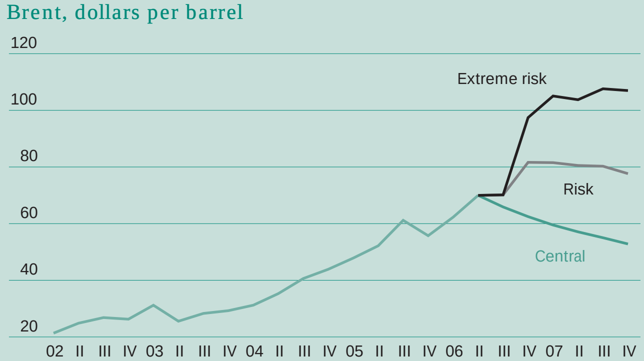
Output Cut in the OPEC quota

OPEC, which currently produces almost 1.5 million barrels daily above its quota, has announced a possible cut in output of 1 million bpd, with the aim of halting the fall in prices registered in the past few weeks. The perception of excess supply in the market is reflected in the behavior of U.S. inventories, which are above their maximum level of the past five years, even if adjusted by demand.

The countries that most promoted these cuts within the OPEC are those whose output is below the current quota, and therefore a reduction would not imply abandoning production, while the rest of the nations, if such cutbacks were introduced, would be sacrificing heavy crude. What remains to be seen in terms of evaluating the viability of realizing this proposal involves the behavior of the countries allied with the United States within the OPEC, given the proximity of Congressional elections in that nation.

Oil Scenarios

Brent, dollars per barrel



Source: BBVA

An additional element to be evaluated is that as of 2002, to the extent that supply improves and U.S. inventories increase, oil prices will react by rising. Up until that point, there was a clear negative and strong correlation between oil prices and reserve stocks. It should be taken into account that a key variable is price expectations associated with additional production capacity. To the extent that this capacity is greater, it is perceived that the market is better prepared to face the geopolitical risk factors resulting from an eventual reduction of a member country's production.

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