

# Monthly Report



## REFORM AND IMBALANCES IN THE EUROPEAN MONETARY UNION

*Times of crisis - the chance for economic reform?* [Page 18](#)

Will the crisis trigger structural reforms?

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The Greek crisis casts doubt on the European monetary union

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Member countries of the euro area might jointly issue a single sovereign bond

*External imbalances within the euro area* [Page 64](#)

The loss of competitiveness and strong domestic demand explain the euro area's big deficits

# Forecast

% change over same period year before unless otherwise noted

	2008	2009	2010	2009				2010	
				1Q	2Q	3Q	4Q	1Q	2Q
INTERNATIONAL ECONOMY	Forecast			Forecast					
Gross domestic product									
United States	0.4	-2.4	3.0	-3.3	-3.8	-2.6	0.1	2.6	3.5
Japan	-1.2	-5.2	1.6	-8.4	-6.0	-4.9	-1.4	2.6	1.3
United Kingdom	0.5	-4.9	1.2	-5.3	-5.9	-5.3	-3.1	-0.3	1.0
Euro area	0.5	-4.1	1.0	-5.0	-4.9	-4.1	-2.2	0.5	1.0
Germany	1.0	-4.9	1.3	-6.7	-5.8	-4.8	-2.4	1.3	1.5
France	0.3	-2.2	1.4	-3.4	-2.8	-2.3	-0.3	1.3	1.4
Consumer prices									
United States	3.8	-0.3	2.1	-0.2	-1.0	-1.6	1.5	2.4	2.2
Japan	1.4	-1.4	-0.1	-0.1	-1.0	-2.2	-2.0	-1.1	-0.5
United Kingdom	3.6	2.2	2.5	3.0	2.1	1.5	2.1	3.3	2.8
Euro area	3.3	0.3	1.2	1.0	0.2	-0.4	0.4	1.1	1.3
Germany	2.6	0.3	0.9	0.8	0.3	-0.2	0.4	0.8	0.8
France	2.8	0.1	1.5	0.7	-0.2	-0.4	0.4	1.4	1.6
SPANISH ECONOMY	Forecast			Forecast					
Macroeconomic figures									
Household consumption	-0.6	-5.0	-0.1	-5.5	-6.0	-5.0	-3.5	-0.8	0.8
Government consumption	5.5	3.8	-0.2	6.0	4.7	4.1	0.8	-0.4	-0.4
Gross fixed capital formation	-4.4	-15.3	-5.7	-14.9	-17.0	-16.0	-12.9	-8.0	-6.3
Capital goods	-1.8	-23.1	-0.7	-24.0	-28.3	-23.8	-15.3	-2.0	-1.0
Construction	-5.5	-11.2	-7.6	-11.3	-11.6	-11.4	-10.2	-9.6	-7.9
Domestic demand (contribution to GDP growth)	-0.5	-6.4	-1.5	-6.3	-7.4	-6.6	-5.3	-2.5	-1.2
Exports of goods and services	-1.0	-11.5	2.2	-16.6	-14.7	-10.8	-2.9	-0.7	1.1
Imports of goods and services	-4.9	-17.9	-2.3	-22.3	-21.7	-17.0	-9.6	-5.1	-2.3
Gross domestic product	0.9	-3.6	-0.4	-3.3	-4.2	-4.0	-3.1	-1.4	-0.4
Other variables									
Employment	-0.6	-6.7	-2.3	-6.3	-7.2	-7.2	-6.1	-3.9	-2.4
Unemployment (% labour force)	11.3	18.0	19.5	17.4	17.9	17.9	18.8	20.0	19.4
Consumer price index	4.1	-0.3	1.5	0.5	-0.7	-1.1	0.1	1.1	1.5
Unit labour costs	4.6	0.2	-0.9	0.9	0.9	-0.1	-0.1		
Current account balance (% GDP)	-9.5	-5.1	-3.8	-7.9	-4.5	-3.8	-4.2		
Net lending or net borrowing rest of the world (% GDP)	-9.1	-4.7	-3.4	-7.6	-4.0	-3.6	-3.7		
General government financial balance (% GDP)	-4.1	-11.2	-10.3						
FINANCIAL MARKETS	Forecast			Forecast					
International interest rates									
Federal Funds	2.1	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
ECB repo	3.9	1.2	1.0	1.8	1.1	1.0	1.0	1.0	1.0
10-year US bonds	3.6	3.2	3.8	2.7	3.3	3.5	3.4	3.7	3.8
10-year German bonds	4.0	3.3	3.2	3.1	3.4	3.3	3.2	3.2	3.1
Exchange rate									
\$/Euro	1.48	1.39	1.36	1.30	1.36	1.43	1.48	1.38	1.38

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## Reform and imbalances in the European Monetary Union

The Greek crisis has sparked off a serious financial and political storm. The unexpected appearance of a much higher than expected deficit in a country whose fiscal situation is about to burst has led to a tremor whose scope, like the eruption of Iceland's volcano Eyjafjallajökull, goes far beyond the country itself. The very viability of the Monetary Union has been called into question, eleven years after it was born.

The question lies in how to handle and prevent a crisis in the euro area. The euro has brought macroeconomic stability, low inflation and greater market integration. It has also acted as a protective shield against the ups and downs of exchange and interest rates in the worldwide economic crisis. But the crisis has revealed that economic policies are not properly coordinated and this now represents a serious obstacle. This was acknowledged two weeks ago by Olli Rehn, Economic and Monetary Affairs Commissioner: «Peer pressure has lacked teeth to ensure timely and effective action. Member states did not use the good times to reduce the public debt. Macroeconomic imbalances were neglected». Strengthening coordination of economic policies is an urgent task. Quite properly, the Commissioner stresses three key points.

The first is budget discipline. The Stability and Growth Pact, which sets a deficit limit of 3% of gross domestic product in normal times and allows higher deficits in the case of crisis, has not met its targets. The fiscal situation was not normalized in the good times and a serious recession has led to the loss of the advances made in the previous ten years. Even Germany, the supposed guardian of monetary orthodoxy, forced a relaxation of the Pact in 2003, when it failed to meet its targets. Now the Commission has suggested that budgets should be presented to an EU body before being approved by their national parliaments, certainly an unthinkable proposition at present but indicative of the urgent need to find a solution.

The second area to be reinforced is the surveillance of macroeconomic imbalances and divergent competitiveness. During the last expansionary stage some countries accumulated huge current account deficits and high losses of competitiveness. After the economic recession these divergences have narrowed to some extent but the problem persists. The endemically weak competitiveness of some economies might lead to problems as serious as public account imbalances. A coordinated response is required to tackle issues such as wage policy, the labour market, product and service markets and the financial sector.

The third point is crisis management. What to do when there is no responsive political mechanism to react? Financial assistance to Greece has been improvised ad hoc, forcing the Treaty to be interpreted due to the lack of suitable instruments. At present, we still don't know if it will be effective but there is no doubt that the crisis has revealed that there is still a long way to go in European governance. Within a Monetary Union, a country can't devalue to regain the competitiveness it has lost or to stop attacks by the markets. EU political leaders must therefore strive to agree a new institutional design that provides the stability and capacity for joint reaction that has been so lacking throughout this crisis.

## EXECUTIVE SUMMARY

### **The Greek crisis sparks off unrest in the markets...**

#### **The Greek debt crisis has relegated the recovery to second place**

Scarcely half a year after indicators certified the end of the recessive phase in which the world's economy had become immersed, the markets are once again getting the jitters. This time the focus is on Greece, or rather its government's ability to sort out its finances. The Greek economy has been starring in a show for the last few months that, as time goes on, seems to increasingly resemble previous crises in emerging countries, such as the one in Russia in 1998 or Argentina in 2001.

### **...in spite financial aid being approved for the country.**

Estimates of the imbalance of the Greek public accounts have been continuously raised due to the emergence of irregularities in its public accounting. Eurostat now estimates a public deficit of 13.6% of gross domestic product (GDP) in 2009 and a debt of no less than 115.1%. The new government has made numerous efforts, undertaking to implement a tough adjustment plan to reduce public expenditure and increase revenue. But the introduction of such a severe fiscal adjustment plan raises fears of the economy falling back into recession and thereby entering a spiral with no way out. A debt of 120%-130% of GDP is already being suggested for 2010.

### **The IMF upgrades its forecast for global growth for 2010.**

The markets have reacted, demanding a high risk premium for the Greek bonds issued. The differential with German 10-year bonds has increased non-stop and is already much wider than 700

basis points. Other countries have not been infected too much but the effects have been noticed. Portugal is the most severely affected but Ireland, Spain and Italy have also suffered rises in their risk premium. For the moment, Greece has formally asked the rest of the EU countries and the International Monetary Fund (IMF) to activate the financial aid approved recently. Nevertheless, the likelihood of default has continued to increase and Greek debt has been downgraded to the level of junk bonds by the rating agency S&P.

The Greek saga has taken audiences away from the good news regarding the recovery in the world economy that, in short, reflects a more positive underlying trend than initially expected. A good example is the improved IMF forecast in its six-monthly report. It has upgraded its growth forecast for the world economy in 2010 by 0.3 percentage points, up to 4.2%, while for 2011 it has kept this figure at 4.3%. According to the IMF, the emerging countries will continue to be the driving force of the recovery and their rate of growth will be above 6% in 2010 and 2011. For China, which grew spectacularly by 11.9% in the first quarter, its GDP is expected to grow by 10% over the whole year. The news for countries in central and eastern Europe is very positive, as their growth forecast for 2010 has increased by 0.8 percentage points, up to 2.8%.

There is also good news on the US economy. For 2010, the IMF has raised its growth forecast for GDP by

0.4 percentage points, placing it at 3.1%, while for 2011 the upgrade has been less, 0.2 percentage points, now at a rate of 2.4%. In general, it is expected that the vigour shown by the US economy in the fourth quarter of 2009 will continue throughout the year. The star of these first few months of 2010 is private consumption, which might be growing at a rate of around 3%. The expectation of robust growth is backed by optimistic business sentiment, suggesting that the advances made in capital goods investment will continue. However, there are still some elements of doubt. The upswing in consumption for the start of the year is due to a moderation in the savings rate, because of a lower aversion to risk, rather than higher income, which is conditioned by a labour market that is moving towards recovery very slowly. Consequently, although there may be vigorous growth in 2010, the medium-term outlook is still one of modestly-paced expansion.

The panorama in the euro area is somewhat weaker. Eurostat downgraded its GDP growth rate for the fourth quarter, leaving it at a dismal 0.0% quarter-on-quarter. The figures for the first quarter don't provide much joy either. The main culprit is private consumption. This was completely flat in the last quarter of 2009 and, in the first quarter of 2010, it might even post a slight decline. The foreign sector, boosted by the depreciation of the euro, continues to be the main support for the recovery. For 2010 as a whole, the IMF maintains its growth forecast of 1.0%, while for the coming year it has lowered this by 0.1 percentage points to 1.5%.

The world economy's recovery at different speeds is reflected in the trends in financial markets and particularly in the stock markets. While, in the United

States and in emerging countries, prices reflect the improvement in the economic cycle, European stock markets are closely following the ups and downs of the Greek case and prices reflect, with precaution, its collateral damage. In the middle of March, the campaign started in the United States for the quarterly results of firms listed on the S&P 500. To date, more than 80% of the companies that have published their profits have beaten the estimates of the consensus of analysts. In Europe, the trend in results is following in the wake of the North American companies, although at a greater distance due to the slower pace of economic recovery.

The recovery process in Spain is still slower than in the euro area as a whole and, according to forecasts by the IMF and the Bank of Spain, this situation will continue throughout the year. Both institutions revised their 2010 growth forecasts slightly, placing this at -0.4%. A somewhat higher rise is expected for 2011: the IMF places it at 0.9%, while the Bank of Spain has put it at 0.8%. In the medium term, the IMF growth forecasts are substantially lower than those contained in the Stability Programme produced by the Spanish government.

So far, the signs of recovery are starting to consolidate this year. Concerning demand, consumption indicators point to slight growth. On the one hand, automobile sales recorded the highest year-on-year rise in the series' history, 63.1% in March, while retail sales continued to improve, recording a year-on-year increase of 3.8% that month, the first positive rate since November 2007. However, the consumer confidence indicator for March continued to weaken, falling below the level of the fourth quarter.

**The recovery in consumption surprises in the United States and forecasts improve.**

**In the euro area, however, the tone is still very weak.**

**The IMF improves its growth forecast for the Spanish economy but is more pessimistic in the medium term.**

**The government approves more economic reforms and an extraordinary infrastructure plan.**

Industry is looking better from the point of view of supply. Although industrial production continued to fall in the first two months, both industrial confidence and entries of orders increased, driven by international trade. Within this context, the government passed a new package of twenty-six economic measures to boost economic recovery and employment. Of note is the support for renovating homes with various fiscal measures, the stimulus for business activity and encouragement for energy service firms. The government also presented an extraordinary infrastructure plan, which will involve 17 billion euros over the coming years. Thanks to public-private collaboration, investment in infrastructure will continue without affecting the public accounts until 2014.

**The labour market continues to be the Achilles heel to recovery.**

The financial sector is also starting to show early signs of what might be interpreted as a change in trend since, after six months of posting negative rates of annual change, loans to households recorded a slight year-on-year rise in February of 0.1%. This small increase was particularly due to housing, whose loans rose 0.4% compared with the same month the year before. The rest of loans to private individuals continued to fall, although the pace of this decline is slowing up.

The labour market is still the Achilles heel to economic recovery. In spite of the fact that the year-on-year rate of change in the number of Social Security registrations slowed up its decline in the month of March, a halt in job losses has yet to materialize. Moreover, it should be

noted that only temporary contracts saw an increase, while permanent contracts continue their downward slide. The disparate trends in both types of contract are in line with the dual model of employment contracts that is typical in Spain. This is stressed by the IMF biannual report, warning of the negative effects of a dual contract system on unemployment and training and recommending a single contract with scaled severance pay.

The weak demand produced by such a weakened job market continues to keep inflation at relatively low levels. The consumer price index rose to 1.4% in March relative to twelve months before, 0.6% more than in February, a bit more than expected. However, half the rise in inflation in March can be put down to fuels and oils, whose prices continued to rise, up 24.0% year-on-year. Nevertheless, the core inflation rate, which excludes energy products and unprocessed foods, stood at 0.2% year-on-year. Higher energy prices have also helped to slow up the improvement in the international trade imbalance.

The situation in which the Spanish economy finds itself is certainly complex. Although the exit from the recession is highly unlikely to be vigorous, in general the different indicators reflect a change in trend that suggests the economy is growing again. A piece of news that will undoubtedly help to calm the tense climate caused by the Greek troubles.

**Weak demand keeps inflation at low levels.**

28 April 2010



## CHRONOLOGY

### 2009

- May**
- 7** **European Central Bank** lowers official interest rate to 1.00% and announces measures to facilitate liquidity in banking system.
  - 12** Government announces **new economic policy measures**: partial removal of tax deduction for buying normal residence as of 2011, aids for buying cars, reduced taxes for some small and medium-size businesses and self-employed persons, etc.
- June**
- 12** Government **increases taxes** on tobacco, petrol and diesel fuel for motor vehicles.
  - 26** Government establishes **Fund for Orderly Restructuring of Banks**.
- September**
- 26** The Spanish government passes the **2010 State General Budget**, which eliminates the deduction of 400 euros from income tax, raises the duty on capital income and also the general and low VAT rates as from July 2010.
- November**
- 27** The central government presents its draft bill for the **Sustainable Economy Act**.
- December**
- 1** The **Lisbon Treaty** comes into force, reforming certain aspects of the European Union.

### 2010

- January**
- 29** The government passes a package of **budget austerity measures** and proposes to raise **the retirement age** to 67.
- February**
- 9** Agreement for employment and **collective bargaining 2010, 2011 and 2012** between representatives of employers and trade unions.
- April**
- 7** The government presents its **extraordinary Infrastructure Plan**, which will involve 17 billion euros in the coming two years.
  - 9** The government passes a **new package of measures to boost economic activity**.
  - 10** The Finance Ministers of the euro area announce the **conditions for helping Greece**.
  - 12** The government proposes a **new plan to reform the labour market**, to be discussed within the context of social dialogue.

## AGENDA

### May

- 4** Registration with Social Security and registered unemployment (April).  
EU industrial production index (March).
- 5** Industrial production index (March).
- 6** Governing Council of the Central European Bank.
- 12** GDP flash estimate (first quarter).  
EU GDP flash estimate (first quarter).
- 14** CPI (April).
- 18** International trade (March).  
EU inflation (April).
- 19** Quarterly national accounts (first quarter).
- 25** Producer prices (April).  
Government revenue and expenditure (April).
- 27** Retail sales (April).
- 28** HCPI flash estimate (May).
- 31** Balance of payments (March).

### June

- 2** Registration with Social Security and registered unemployment (May).  
EU industrial production index (March).
- 4** Industrial production index (April).  
EU GDP (first quarter).
- 10** Governing Council of the Central European Bank.
- 11** CPI (May).
- 16** Labour costs (first quarter).  
EU inflation (May).
- 22** International trade (April).  
Fed Open Market Committee.  
Government revenue and expenditure (May).
- 25** Producer prices (May).
- 29** Retail sales (May).  
HCPI flash estimate (June).
- 30** Balance of payments (April).

## INTERNATIONAL REVIEW

**The IMF expects 4.2% global growth for 2010, led by the emerging economies and the improved outlook in the United States...**

**...but Europe and Japan expect modest growth. Germany's expectations worsen while Spain undergoes a late recovery.**

### IMF forecasts: more recovery than expected

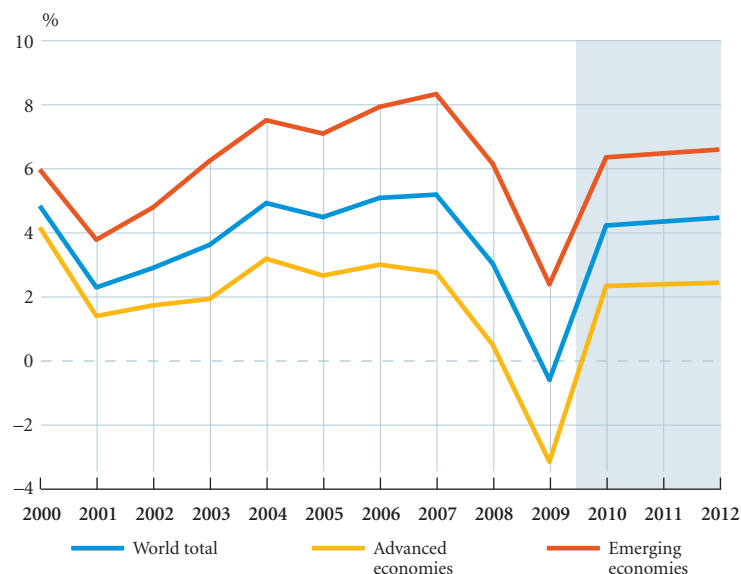
In its World Economic Outlook for April, the International Monetary Fund (IMF) upgraded its forecasts for 2010 and stated that recovery is stronger than expected. The reason for this lies in the improved financial conditions, although these are still worse than before the crisis. But the recovery will be at different speeds. Consequently, compared with January's forecast, the prospects have improved for Emerging Asia, which was already the main exponent of the global growth led by China in 2009. There are also improvements for Latin America and the

United States. 3.1% growth is expected in 2010 and 2.6% in 2011 for the planet's leading economy, very similar to our own forecasts.

In contrast with this upward tone, Europe and Japan seem to be exiting the recession less energetically. Japan's economy has improved its growth forecasts for 2010 but its prospects look worse for 2011. Albeit with the odd downgrade, the euro area maintains its modest growth expectations for 2010 and 2011, 1.0% and 1.5% respectively. By country, the main downgrade in forecasts has been for Germany that, according to the Fund, will grow by 1.2% in 2010 and by 1.7% in 2011. The

### THE EXIT FROM THE RECESSION

Year-on-year change in gross domestic product



NOTE: 2010, 2011 and 2012 are forecasts.  
SOURCE: International Monetary Fund.



forecasts are also worse for Italy and, to a lesser extent, for the United Kingdom. France, one of the countries that suffered least the repercussions of the crisis, is seeing some improvement in its expected rate of progress but this still does not exceed 2.0%. The Fund has also improved its forecasts for Spain, although still at the tail end of the recovery with an expected decline of 0.4% in 2010 and paltry growth of 0.9% for 2011.

In advanced economies, what still needs to be tackled in 2010 and 2011 is fiscal consolidation. Given the high deficits in government coffers, strategies will be required to make credible savings in the medium and long term. Notwithstanding these, and in the opinion of the IMF, the stimuli planned for 2010 in advanced

economies should still be kept in place, as they have yet to make a full recovery. In this respect, moderate inflationary tensions give the central banks some room to manoeuvre in order to carry out adaptable monetary policies.

The other risks to global recovery are high unemployment and trade imbalances. The excessively high proportion of long-term unemployed means that there is the danger of a large part of the unemployment generated during the crisis ending up as long-term. On the other hand, high trade imbalances had characterized the years before the crisis. In countries with a deficit, such as the United States and Spain, fiscal consolidation must be carried out, according to the IMF, in such a way as to limit the impact on growth

**Stimuli must remain for 2010 but fiscal consolidation is necessary.**

**The other risks are high unemployment and trade imbalances.**

## IMF FORECASTS

Annual change as percentage (\*)

	GDP		Consumer prices		Unemployment rate (**)	
	2010	2011	2010	2011	2010	2011
United States	3.1	2.6	2.1	1.7	9.4	8.3
Japan	1.9	2.0	-1.4	-0.5	5.1	4.9
China	10.0	9.9	3.1	2.4	...	...
Germany	1.2	1.7	0.9	1.0	8.6	9.3
France	1.5	1.8	1.2	1.5	10.0	9.9
Italy	0.8	1.2	1.4	1.7	8.7	8.6
United Kingdom	1.3	2.5	2.7	1.6	8.3	7.9
Spain	-0.4	0.9	1.2	1.0	19.4	18.7
<b>Euro Area</b>	<b>1.0</b>	<b>1.5</b>	<b>1.1</b>	<b>1.3</b>	<b>10.5</b>	<b>10.5</b>
<b>Advanced economies</b>	<b>2.3</b>	<b>2.4</b>	<b>1.5</b>	<b>1.4</b>	<b>8.4</b>	<b>7.9</b>
<b>Developing countries</b>	<b>6.3</b>	<b>6.5</b>	<b>6.2</b>	<b>4.7</b>	...	...
<i>Latin America</i>	4.0	4.0	6.2	5.9	...	...
<i>Eastern and Central Europe</i>	2.8	3.4	5.2	3.6	...	...
<i>Emerging Asia</i>	8.7	8.7	5.9	3.7	...	...
<b>World Total</b>	<b>4.2</b>	<b>4.3</b>	<b>3.7</b>	<b>3.0</b>	...	...
<b>World trade by volume (***)</b>	<b>7.0</b>	<b>6.1</b>				

NOTES: (\*) Forecasts at April 2010.

(\*\*) Percentage of labour force.

(\*\*\*) Goods and services.

SOURCE: International Monetary Fund.

**The United States is recovering thanks to consumption and capital goods investment.**

and domestic demand. In countries with a surplus, such as China, Japan and Germany, the biggest challenge is to stimulate domestic demand.

**The United States: consumers take a step forward**

The US economy looked vigorous in the fourth quarter and this positive tone is expected to continue in the first quarter of 2010. The star of these first few months of 2010 is private consumption, which could be growing at a rate of around 3%. The expectation of robust growth is backed by optimistic business sentiment, suggesting that the advances made in capital goods investment will continue. However, there are still some elements of doubt. The upswing in consumption for the start of the year is due to a more moderate savings rate, as a result of a lower aversion to risk, rather than to higher income, which is

conditioned by a labour market that is only very slowly moving towards recovery. The real estate market isn't very close to coming out of the tunnel either, while the deleveraging of household finances must continue. Household debt at the end of 2009 stood at 122.7% of disposable income, seven points below the record high of December 2007 but twenty above its long-term level. Consequently, although there may be vigorous growth in 2010, the medium-term outlook is still one of modestly-paced expansion.

The latest demand indicators are consistent with this recovery in private consumption. Retail sales, without cars or petrol, speeded up in March, up 4.4% year-on-year, the highest since the end of 2007. Consequently, after these three months of upswing, and having discounted the effect of price variations, retail consumption is close to its pre-crisis level of December 2007. Consumer

**Retail sales speed up.**

**UNITED STATES: MAIN ECONOMIC INDICATORS**

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009				2010		
			1 Q	2 Q	3 Q	4 Q	January	February	March
Real GDP	0.4	-2.4	-3.3	-3.8	-2.6	0.1	—	...	—
Retail sales	-0.8	-6.0	-9.2	-9.5	-6.7	2.0	4.5	4.4	7.6
Consumer confidence (1)	58.0	45.2	29.9	48.3	51.8	51.0	56.5	46.4	52.5
Industrial production	-2.2	-9.7	-11.6	-12.9	-9.4	-4.7	1.1	2.2	4.0
Manufacturing (ISM) (1)	45.5	46.2	35.9	43.0	51.4	54.6	58.4	56.5	59.6
Sales of single-family homes	-37.4	-22.9	-40.0	-27.1	-11.7	-5.6	-4.3	-13.0	...
Unemployment rate (2)	5.8	9.3	8.2	9.3	9.6	10.0	9.7	9.7	9.7
Consumer prices	3.8	-0.4	0.0	-1.2	-1.6	1.4	2.6	2.1	2.3
Trade balance (3)	-695.9	-378.6	-605.5	-503.7	-414.2	-378.6	-378.7	-391.9	...
3-month interbank interest rate (1)	2.8	0.7	1.2	0.8	0.4	0.3	0.2	0.3	0.3
Nominal effective exchange rate (4)	74.4	77.8	82.7	79.4	75.4	73.6	74.5	76.2	75.9

NOTES: (1) Value.

(2) Percentage of labour force.

(3) Cumulative figure for 12 months in goods and services balance. Billion dollars.

(4) Exchange rate index weighted for foreign trade movements. Higher values imply currency appreciation.

SOURCES: OECD, national statistical bodies and own calculations.

## THE UNITED STATES: CONSUMPTION'S COMING OUT THE HOLE

Real retail sales without vehicles or petrol, year-on-year change (\*)



NOTE: (\*) Data deflated by the consumer price index without energy or food.

SOURCES: Department of Trade and own calculations.

confidence was still quite far from the rise experienced in consumption, affected by base variables such as high debt and the continued high unemployment. Consequently, in spite of its increase in March, the Conference Board index was still at a low level, confirming its role as a delayed indicator in recoveries.

Business sentiment is still clearly more positive than consumer confidence. While, in principle, the fact that the non-financial sector is tackling the crisis with more moderate debt levels than that of banks and families has helped to boost business confidence, the good corporate results in the first quarter of the year have reinforced this optimistic perception. Consequently, the business sentiment index of the Institute for Supply Management for manufacturers in March rose to 59.6 points, a level befitting growth rates of more than 4% for the economy as a whole. For its part, industrial production continued to

recover in March, although slowing down somewhat compared with its dynamism at the beginning of the year. With a similar trend, industrial capacity utilization was still a little above 73%. In spite of the good tone at the start of the year, both indicators are still 10% below the levels of December 2007.

The real estate market will continue to be weak for most of 2010. The key still lies in the large number of foreclosed mortgages, leading to an excessive supply of housing. The Case-Shiller index for housing prices fell by more than 30% between the middle of 2006 and April 2009. Since then, we can talk more of stabilization than recovery. With these drops, the price of many homes has fallen below the outstanding debt, an incentive to stop meeting the mortgage payments and give up the property. These are the so-called walkaways since, in the United States, any outstanding debt on an unpaid mortgage is totally written off

**Entrepreneurs reinforce their increasingly optimistic view thanks to good corporate results.**

**Housing is still weak due to excessive supply that is being swollen by mortgage foreclosures.**

**The labour market bottoms out but recovery will take some time yet.**

once the property has been given over to the creditor. To stop this from happening, Obama's administration is working on legal provisions that reduce the outstanding capital in mortgages where this is more than 120% of the property's market value, but it is still not clear how these will be applied or the effect they'll have. The consequence is that activity continues to be below the minimum levels. The number of new homes started rose in March but these are still stuck at little more than a third of the average prior to the last real estate bubble.

The labour market showed encouraging signs in March with the net creation of 162,000 jobs, the best figure for the last three years. However, the unemployment rate was still 9.7% and it doesn't look like improving significantly until the end of 2010. The problem is that the job losses caused by this recession have been

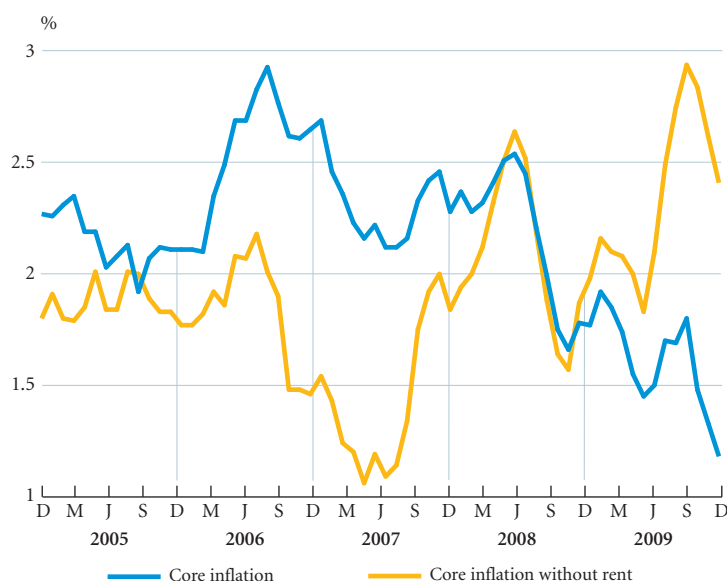
the highest since 1945, and by a long chalk. It will be difficult for the unemployment figures to fall for two reasons. First, the proportion of long-term unemployed, the most difficult people to relocate, is double that of the 1983 recession, when the unemployment rate was at similar levels to today. The other difficulty lies in the large number of discouraged workers and involuntary part-time workers, who might absorb any growth in the demand for labour as the recovery progresses.

The prolongation of the low utilization of production capacity for production is helping to keep prices stable, and substantial inflationary tensions are unlikely to appear in 2010. This gives the central banks some room for manoeuvre to maintain expansionary policies, even while draining the system of its liquidity. Consequently, the general consumer price index (CPI) rose 2.4% year-on-

**The CPI rises 2.4% and the core CPI a moderate 1.2% due to the low utilization of production capacity and rent.**

#### THE UNITED STATES: RENTAL HELPS TO MODERATE PRICES

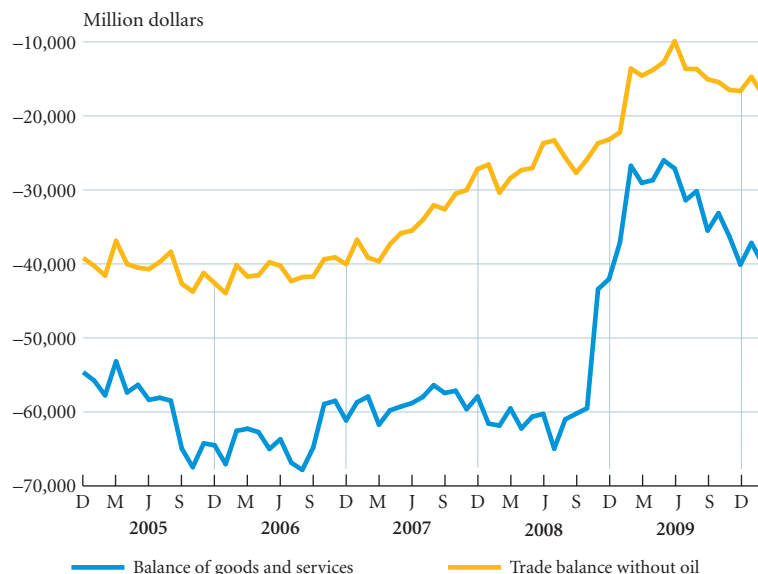
Year-on-year change in core consumer price index components (\*)



NOTE: (\*) Core inflation excludes food and energy.  
SOURCES: Department of Labor and own calculations.

## THE UNITED STATES: WITHOUT OIL, THE TREND IS ONE OF CORRECTION

Monthly balance of goods and services



SOURCES: Department of Trade and own calculations.

year in March, while the more significant core CPI, the general index without food or energy, continued to moderate its growth to 1.2% year-on-year. However, this slowdown is partly due to falling rental prices attributed to home owners. Without this component, core inflation rose by 2.4% year-on-year, somewhat more in line with the fundamental trend in prices.

The February trade deficit for goods and services was 39,704 million dollars, 2,752 million more than the previous month. Almost the whole decline occurred in the balance that excludes oil and its derivatives. The recovery in exports eased off while imports continued to advance thanks to lively domestic demand. If private consumption and investment continue to expand, the deficit should go on rising over the coming months, but without interrupting the slight corrective trend in the trade imbalance started at

the end of 2006, which can be seen if we exclude the effects of oil.

### Japan: cars and exports

Exports have been the stars of the Japanese recovery. Private consumption, however, still depends on government stimuli and is suffering from the effects of deflation. For its part, investment is starting to show signs of incipient reactivation.

The latest supply indicators continue to confirm that improvement is limited to the industrial and exporting sectors. In February, industrial production, which in Japan is closely related to how the economy performs overall, lost part of its energy of the last three months, although the general tone is still one of growth. Consequently, the general index has recovered three fifths of the 34.7% it lost during the crisis. The outlook for

**Japan recovers thanks to exports and state aid.**

**Industry and investment advance.**

## JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009				2010		
			1Q	2Q	3Q	4Q	January	February	March
Real GDP	-1.2	-5.2	-8.4	-6.0	-4.9	-1.4	—	...	—
Retail sales	0.3	-2.3	-3.9	-2.8	-1.9	-0.7	2.3	4.2	...
Industrial production	-3.4	-21.8	-32.2	-26.9	-20.5	-5.1	20.7	31.2	...
Tankan company Index (1)	-2.8	-40.8	-58.0	-48.0	-33.0	-24.0	—	-14.0	—
Housing construction	2.5	-27.6	-21.5	-31.9	-35.9	-20.7	-8.2	-9.1	...
Unemployment rate (2)	4.0	5.1	4.5	5.1	5.4	5.2	4.9	4.9	...
Consumer prices	1.4	-1.4	-0.1	-1.0	-2.2	-2.0	-1.3	-1.1	...
Trade balance (3)	4.1	4.0	1.2	0.9	1.7	4.0	5.3	5.8	...
3-month interbank interest rate (4)	0.8	0.6	0.7	0.6	0.5	0.5	0.5	0.4	0.4
Nominal effective exchange rate (5)	86.6	98.6	102.1	95.7	97.0	99.6	99.3	102.1	101.8

NOTES: (1) Index value.

(2) Percentage of labour force.

(3) Cumulative balance for 12 months. Trillion yen.

(4) Percentage.

(5) Index weighted for foreign trade movements. Higher values imply currency appreciation. Average in 2000 = 100.

SOURCES: OECD, national statistical bodies and own calculations.

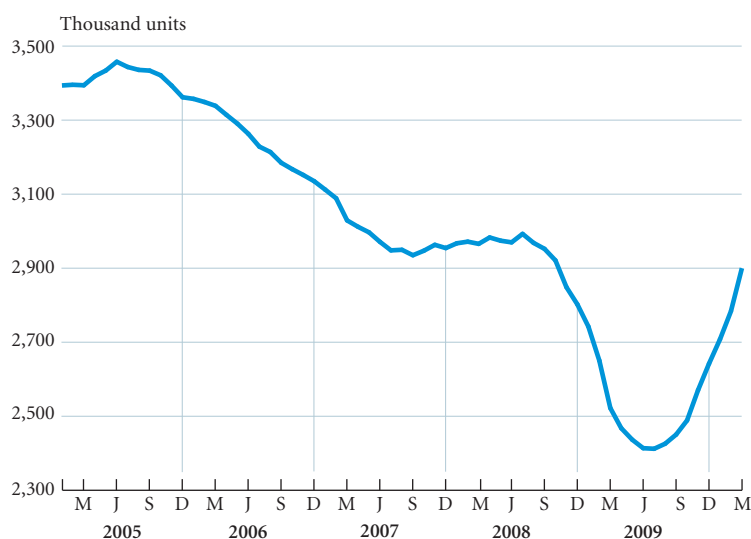
**Housing is still weak but unemployment remains at 4.9%.**

investment continued to improve in February, thanks to the upswing in machinery orders for foreign demand, although these were still 25% below the

average for 2008. The other half, orders for domestic demand, remained at 23% below the level for 2008.

## JAPAN: CARS COME OUT OF THE HOLE

Automobile sales. Total for the last twelve months

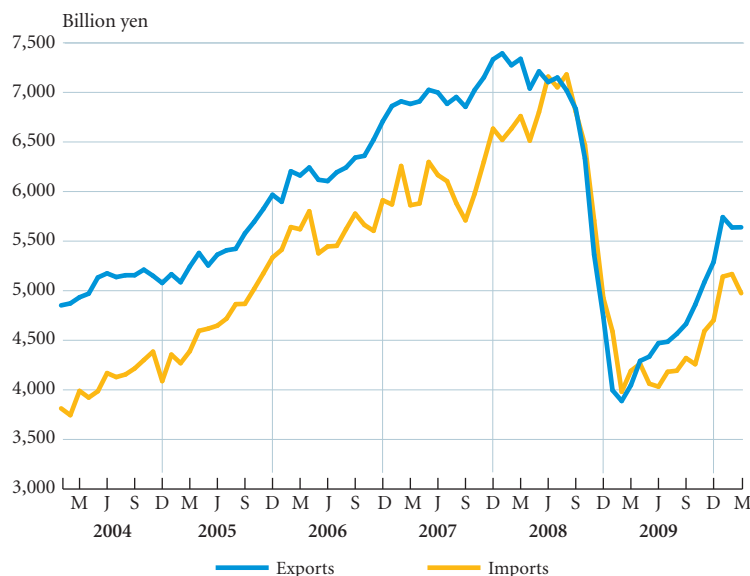


SOURCES: Japanese Ministry of Communications, National Statistics Office and own calculations.



## JAPAN: A RECOVERY THAT STILL HAS A LONG WAY TO GO

### Monthly exports and imports



SOURCES: Japanese Ministry of Communications and own calculations.

Retail sales for February were up 4.2% year-on-year, a very fast pace due to base effects, but the level remained close to that of 2003. The greatest recovery in consumption continued to be in automobile sales thanks to state aid. For its part, although the Tokyo housing market saw an upswing in March, new houses started in February were still 36% below the average for the last decade, already characterized by a low profile. On the positive side, the labour market maintained its gains, with an unemployment rate that remained unaltered in February at 4.9%.

Looking at prices, the underlying weaknesses in domestic demand will mean that deflationary trends will continue throughout 2010. January's CPI fell 1.1% year-on-year, as did core inflation, the general index without energy or food, already accumulating fourteen consecutive months of decreases. With regard to the foreign

sector, the trade surplus continued in March. Exports maintained their strong upswing from the period October 2009-January 2010, although they have been practically stagnant for the last two months. For their part, imports dropped off due to weak domestic demand.

### China: beating all expectations

China grew by a spectacular 11.9% year-on-year in the first quarter of 2010, and although this was partly due to the lows of a year ago, this figure is higher than even the most optimistic forecasts. Although inflation remained at a modest 2.2% year-on-year for the quarter as a whole, the pace of expansion has revived the risk of the economy overheating. The rise in housing prices, 11.7% year-on-year in March, also means there's a risk of a real estate bubble emerging.

**Core CPI falls 1.1%.**

**China grows by 11.9% in the first quarter...**

## CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2008	2009	2009			2010
			2Q	3Q	4Q	1Q
Real GDP	9.6	8.7	7.9	9.1	10.7	11.9
Industrial production	12.6	12.5	9.0	12.3	17.9	19.5
Electrical power generation	6.7	6.7	-0.4	8.0	24.3	22.6
Consumer prices (*)	5.9	-0.7	-1.5	-1.3	0.7	2.2
Trade balance (**)	298	198	296	251	198	150
Reference rate (***)	5.31	5.31	5.31	5.31	5.31	5.31
Renminbi to dollar (*)	6.9	6.8	6.8	6.8	6.8	6.8

NOTES: (\*) Average.

(\*\*) Cumulative balance for 12 months. Billion dollars.

(\*\*\*) Percentage at end of period.

SOURCES: National Statistics Office, Thomson Reuters Datastream and own calculations.

### ...and the risk of overheating reappears.

In order to alleviate the resurgent indications of reheating, the Chinese monetary authority seems willing to adopt a more flexible approach to its currency. This would be added to the various rises in the cash reserve ratio and the limitations imposed on granting credit. The words pronounced by the governor of the Chinese central bank during the National Popular Assembly, framing the exchange rate policy within a broader policy of a temporary nature aimed at combating the crisis, point to an imminent appreciation of the renminbi.

Domestic demand continued its upward trend, both in consumption and investment. In particular, retail sales grew by 15.5% year-on-year in the first quarter in real terms. Similarly, investment in fixed assets rose by a substantial 26.2% year-on-year in March, although a little less than the 26.6% of January and February. In spite of this, the forecasts for the next few months point towards a slowdown in the investment component once the measures have been implemented to restrict the approval of new investment

projects and given the credit limitations imposed for 2010. At present, new credit granted in March rose to 508 billion renminbi, compared with 702 billion in February, in line with the moderation announced.

On the supply side, industrial production in March grew by 18.1% year-on-year, lower than the 20.7% for January-February and coming close to the values of around 15% that were typical before the crisis. Meanwhile, the purchasing managers' index (PMI) rose to 55.1 points, a level indicative of strong expansion, after having weakened slightly for a couple of months.

Lastly, the data for international trade reveal a deficit of 7.2 billion dollars in March, the first monthly deficit in six years. This decline in the trade balance was caused by the large increase in imports, up 66% year-on-year, although exports were still strong and rose 24.3% year-on-year. Overall, the first quarter has ended with a trade surplus of 1.4 billion dollars, a surplus that might increase further thanks to the upswing in foreign demand and in spite

### Business indicators continue to show great vitality.

### China's trade balance in March reveals a deficit after six years of surplus.

of the more than likely appreciation of the renminbi.

Once again, China shows itself to be a vigorous economy that, for the time being, is capable of controlling inflationary tensions. However, there's no doubt that the risk of overheating is hovering over the Asian giant and that a more restrictive monetary policy that includes a more flexible exchange rate must be part of the central bank's agenda.

### Brazil: an imminent rise

As expected, Brazil's Monetary Policy Committee raised the reference rate at its meeting on 27 and 28 April. Although most analysts expected a rise of 50 basis points in the SELIC rate, it was actually raised by 75 points. In any case, the Brazilian monetary authority, led by Henrique Meirelles, who recently opted to remain at the head of the Central Bank, has earned e reputation of economic orthodoxy.

This therefore augurs a firm reaction to the marked inflationary upswing.

Throughout 2009, inflation was contained thanks to the wide output gap and weak commodity prices, but the 2010 panorama is very different. Adverse weather conditions, the annual rise in public tariffs and the lively Brazilian recovery all pushed inflation up to 5.2% in March. Part of this increase is expected to be temporary: on the one hand, the smaller crops due to strong rains is seasonal; on the other, the annual rise in transport and education prices will dissipate over time. However, even after these effects have been adjusted for, the inflationary pressures are evident in some sectors such as construction and household goods and, although the rate of inflation may soon stabilize, it is expected to do so far above the target set (4.5%).

The latest business data in Brazil support this suspicion, pointing to an economy in expansion that is very close to the full utilization of its production

**Brazil's Central Bank makes its move to keep inflationary surges in check.**

**Temporary effects and the recovery push the rate of inflation up to 5.2% in March, much higher than the target set.**

## BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009				2010		
			1Q	2Q	3Q	4Q	January	February	March
Real GDP	5.1	-0.2	-1.9	-1.7	-1.4	4.3	-	...	-
Industrial production	2.9	-7.2	-13.9	-11.3	-8.6	6.1	16.7	16.1	...
Consumer confidence (*)	140.4	138.3	128.5	128.4	141.9	154.2	158.7	159.0	156.7
Unemployment rate São Paulo (**)	13.0	12.8	12.6	13.9	13.1	11.8	11.7	...	...
Consumer prices	5.7	4.9	5.8	5.2	4.4	4.2	4.6	4.8	5.2
Trade balance (***)	24.8	25.3	25.1	27.5	26.4	25.3	25.7	24.3	23.3
Interest rate SELIC (%)	11.25	11.25	11.25	9.25	8.75	8.75	8.75	8.75	8.75
Reales to dollar (*)	1.8	2.3	2.3	2.0	1.8	1.7	1.9	1.8	1.8

NOTES: (\*) Value.

(\*\*) Percentage of labour force.

(\*\*\*) Cumulative balance for 12 months. Billion dollars.

SOURCES: Instituto Brasileiro de Geografia e Estatística, Banco Central do Brasil and own calculations.

**Domestic demand continues firm and appears able to withstand the withdrawal of fiscal stimuli.**

**The recovery in Mexico continues to benefit from the US drive.**

**Unemployment and weak credit and remittances are still hindering a domestic upswing in Mexico.**

**Promoting reforms, essential for growth.**

capacity. In March, the utilization of this capacity reached 83.5% and leading indicators suggest that this will go on rising. In spite of a moderate decline, the confidence of Brazilian consumers in their economy remained at historically high levels, as with credit, which continued to grow in February (1.5% year-on-year). This, and the good performance by the labour market with an unemployment rate that continues to fall (11.7% in January), explain the positive tone of retail sales that revealed surprising gains in February, up 12% year-on-year, once again confirming the strength of domestic spending. A strength that has been passed on to supply, with further rises year-on-year in double figures, both for industrial production (16% in February) and automobile sales (18% in March). The purchasing managers' index (PMI), in spite of a slight fall in March, continues to point towards strong expansion.

While domestic demand remains strong, foreign demand has not been able to slow up the drop in the trade balance. The renewed upswing in the real over the last few weeks has not helped the adjustment. Overall, the main requirement is to avoid the excessive overheating of an economy that, moreover, is not considering any far-reaching fiscal adjustment until at least after the elections in October.

### **Mexico: in the wake of the United States, a double-edged sword**

As 2010 advances, the Mexican economy gains in pace and optimism. An optimism that has caught on among many analysts, leading to more than one reconsidering their growth forecasts for the Mexican economy. Among the latest to rate the country more highly is the OECD, whose new estimate places GDP

growth for 2010 at around our forecast of 4.2% and above the growth expected for the rest of its member countries. Others, such as Miguel Messmacher, head of the Economic Planning Unit of the Mexican Treasury, even dare to predict higher advances if the foreign recovery is stronger than expected. And therein lies the key: «the foreign recovery». In other words: «the recovery of the United States».

Although 2010 commemorates the bicentenary of Mexican independence and is therefore already a year of celebration in Mexico, this optimism comes from no other source than the surprising energy of the US economy. The consolidation of the United States' recovery has once again been the major driving force behind a Mexican recovery whose renewed upswing is fundamentally due to exports that, in February, were up 31% year-on-year and boosted industry, which continued its growth, up 4.4% compared with the same month in 2009.

On the other hand, the still high unemployment (in historical terms), weak credit and the drop in remittances continue to hinder a domestic demand that is expected to recover much more cautiously. Nonetheless, leading indicators for economic activity still point towards a slow but gradual improvement. After the 1.8% year-on-year drop in retail sales in January, signs of improvement in employment have somewhat boosted the confidence of Mexican consumers in their economy, which should soon result in healthier domestic spending.

Domestic spending that should gradually become the main driving force in the Mexican economy and thereby reduce its overdependence on the economic performance of its neighbour to the

## MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009				2010		
			1Q	2Q	3Q	4Q	January	February	March
Real GDP	1.5	-6.6	-9.1	-8.5	-6.1	-2.4	—	...	—
Industrial production	-0.9	-7.0	-9.6	-9.6	-6.5	-2.0	4.8	4.4	...
Consumer confidence (*)	92.2	80.5	80.1	80.5	83.0	78.4	82.1	80.6	81.8
Leading business index	118.0	0.0	109.2	108.4	111.0	112.8	112.9	...	...
General unemployment rate (**)	4.0	5.5	5.0	5.2	6.3	5.3	5.9	5.4	...
Consumer prices	-11.8	0.0	6.2	6.0	5.1	4.0	4.5	4.8	5.0
Trade balance (***)	-17.3	-4.7	-17.6	-15.9	-12.6	-4.7	-3.5	-2.7	...
Official Banxico rate (%)	7.50	6.75	6.75	4.75	4.50	4.50	4.50	4.50	4.50
Mexican pesos to dollar (*)	10.6	14.2	14.2	13.2	13.5	13.1	13.0	12.8	12.3

NOTES: (\*) Value.

(\*\*) Percentage of labour force.

(\*\*\*) Cumulative balance for 12 months. Billion dollars.

SOURCES: Banco de México and own calculations.

north of the Río Grande. In this respect, the fiscal reform, the recent proposal by Calderón's government to promote competition and reinforce anti-trust laws, or any other measure aimed at strengthening the internal pillars of growth, if fulfilled, will be highly positive and, in any case, will be essential to ensure growth sustainability in the long run.

### Oil continues to rise and metals speed up

Oil prices are still on the up, at over 85 dollars in spite of the dollar remaining strong. Between 20 March 2010 and 20 April 2010, crude rose 6.9%, reaching 85.37 dollars per barrel (Brent quality, for one-month deliveries). This means that crude has gained 9.7% this year while the dollar has gained 7.7% compared with the euro.

The expected economic recovery, particularly that of emerging economies, has driven up oil prices and, in the short

term, these are likely to exceed the top end of the reference band of 75-85 dollars per barrel. These rises might continue but no sharp changes are expected over the coming months, with a volatility that is very far from the levels of 2008.

With regard to the rest of commodities, the Economist index rose 4.2% between 20 March and 20 April due to metals, which continued to climb. Most of the gains were in base metals, influenced by the withdrawal of the annual reference system to set the price of iron and by the Chinese limiting imports of low grade iron ore. Iron and nickel were up 25% while aluminium and copper rose more moderately, after enjoying strong upswings in previous months. In precious metals, palladium was up 23.1% and platinum 9.4% due to the recovery in the car industry. Gold remained stable although hinting at an upswing, close to the barrier of 1,150 dollars an ounce. Foods performed more irregularly, with drops in the price of rice and sugar and rises in tea.

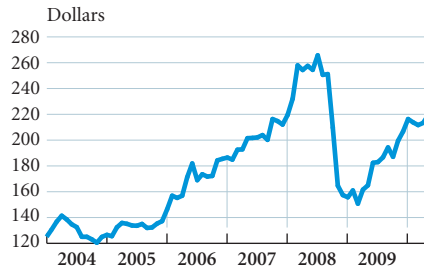
**Crude crosses the barrier of 85 dollars per barrel, boosted by the expected recovery.**

**The recovery pushes up oil prices.**

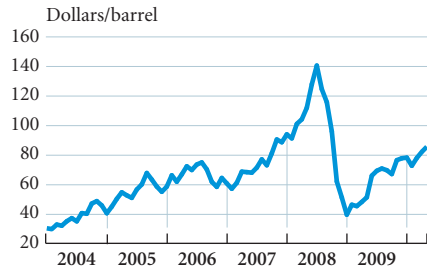
**Metals continue to rise due to changes in how iron prices are set.**

## TREND IN VARIOUS COMMODITIES (\*)

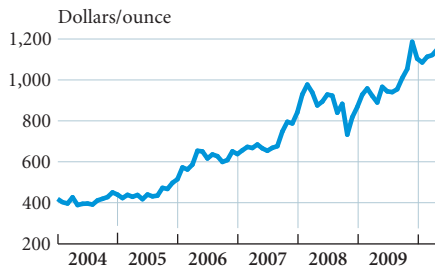
«The Economist» index



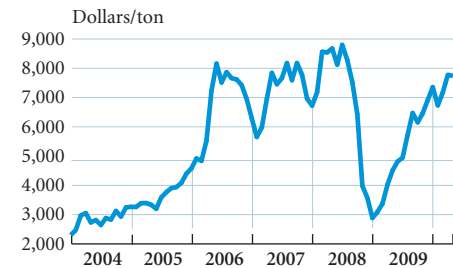
Brent oil



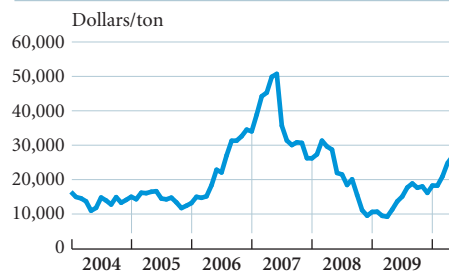
Gold



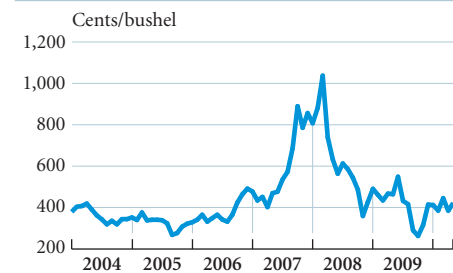
Copper



Nickel



Wheat



NOTE: (\*) Figures for last day of month (last date April 21).

SOURCES: «The Economist», Thomson Reuters Datastream and own calculations.

## Times of crisis - the chance for economic reform?

Are bad times (economic crises) opportunities to promote structural reforms? Indeed, it would seem that the more acute the crisis, the more urgent it is to reform the economy. However, the assumption of a direct relationship between economic crisis and carrying out reforms is not as immediate as we might think. The issue of structural reform, and its determining factors, also seems to largely depend on the political, social and even cultural context in which it occurs.

Because of this, in order to improve our understanding of the keys to success, our starting point is to analyze three examples of structural reform carried out within the euro area: the labour market reforms undertaken by



Germany between 2002 and 2005, the 2003 pension reform in France and the 1999-2007 reform of business hours, once again in Germany.<sup>(1)</sup>

The so-called «Hartz reforms» led to the adoption of four labour acts in Germany in 2002-2005. Although the content of the reform is wide-ranging and diverse, the basic strategy was to change a culture that protected workers based on passive policies to one of active policies. Key aspects in this culture were the establishment of «Personnel Service Agencies», with the same functions as temporary employment firms, along with more traditional functions of public intermediation between job seekers and employers, the reform of the Federal Employment Office in order to improve job placement and the toughening up of conditions for receiving unemployment benefit.

For their part, the French pension reforms in 2003 aimed to achieve three ambitious goals: to bring the pension systems of civil servants and salaried workers closer together, to improve the financial stability of both systems and to cut back on the generous incentives for early retirement. These reforms aroused strong opposition but the government ended up imposing a series of measures that toughened up the conditions for public employee pensions, increased the period required for social security contributions to access the maximum pension and encouraged people to go on working once they had reached retirement age.

Lastly, the German reform of retail opening hours was carried out in two stages. The first, promoted by the federal government between 1999 and 2003, resulted in a modest reform, one of whose main innovations was

#### FACTORS THAT EXPLAIN THE ADOPTION OF REFORMS

Case	Political cycle	Macroeconomic cycle	Interaction with other policies	Adoption process
<b>Germany (labour)</b>	Clear electoral mandate Taking advantage of the first two years of legislature	Reform started in time of little growth		Strong government commitment to the reform (threat of unilateral action)
<b>France (pensions)</b>	Clear electoral mandate Taking advantage of the first two years of legislature			Careful process of analysis, consultation and communication Strong government commitment to the reform (threat of unilateral action)
<b>Germany (services, business hours)</b>		Reform started in time of little growth	International pressure, that means the retail trade must be made more competitive	

SOURCES: OECD and own calculations.

(1) These reform processes have been the object of several studies by the OECD, among which we would particularly recommend the following publications: *The Political Economy of Reform. Lessons from pensions, product markets and labour markets in ten OECD countries* 2009 and *Going for Growth*, 2009 and 2010 editions.

the possibility to remain open until 8 pm on Saturdays. After a ruling by the constitutional court, the *Länder* were able regulate this issue, generally opting for a widely liberalized system that practically eliminated any restriction to business hours from Monday to Saturday.

What general conclusions can be drawn from these three cases? As can be seen from the above table, one initial lesson is how successful reforms require a clear electoral mandate. This might be related to taking advantage of the initial years in a legislature to avoid any possible negative effects on future elections. The importance of this electoral factor would vary, however, depending on the issue in question. While it seems critical in areas perceived by citizens as central to their social charter (pensions and the labour market, for example), in those aspects perceived as more technical or sector-specific, such as reforms of product and service markets, the predominant role is played by pressure groups.

Another relevant aspect concerns the macroeconomic cycle. In the case of the German reforms, there is a relationship between the cyclic position and the reform attempted, as both were launched at a time of economic weakness. The French pension reform, however, escapes this relationship, undoubtedly because the debate regarding its benefits and costs is projected over the long term due to its nature.

However, it would be valid to ask to what extent these conclusions, based on just three cases, can be generalized. The answer is that, when the OECD studies 20 cases of reform in advanced countries in different areas, the general lesson remains that the labour market and product and service markets are more likely to be reformed at a time of crisis. Nevertheless, the issue of labour reform is packed with nuances. In line with the political economic literature on labour reform, the OECD states that a high unemployment rate tends to pressurize in favour of reform, although the most organized part of the market tends to oppose measures that involve reducing protection. This means that the most frequent outcome of labour reform in difficult times focuses on liberalizing less organized segments (newcomers to the market, the unemployed, etc.).

A third conclusion of interest concerns the relationship of reforms with other similar initiatives or global trends. The evidence available suggests that reforms of product and service markets are more likely to succeed if they take place within international liberalization trends (e.g. related to the liberalization of the domestic market) or when there is greater international competition. Among the cases in question, that of liberalizing retail opening hours would reflect this influence, as the *Länder* were concerned about the growing phenomenon of cross-border shopping.

Lastly, a fourth area of interest when studying the determining factors of reforms is how these are implemented. In this area, the main conclusion resulting from the above cases, and confirmed in other studies by the OECD devoted to other reforms, is that the processes involved in adopting structural reforms are long and require significant preparation, including notable effort dedicated to analysis, consultation and communication. For example, the preparation for the French pension reform took over one year and, in other similar cases, two years of work prior to launching the reform are not exceptional. Similarly, the communication policy was designed with care, including consultation processes with economic players. This strategy meant that the need for this reform was never in doubt, although it met with opposition in society.

Another aspect of the process that leads to successful reform is what the OECD calls «government leadership». Although, as has already been mentioned, accord is key, the cases studied suggest that what is fundamental is strong government commitment to the reform (whose most typical exponent is the credible announcement

that the government will act unilaterally if no agreement is reached). The German labour reforms and French pension reforms fall into this category.

Given the experience of the abovementioned reforms, can we expect the current crisis to trigger new initiatives for structural change in the euro area? Studies by the OECD, both those mentioned above as well as other similar examples, highlight the fact that the political and procedural dimension is critical, and that the economic situation might actually play a less decisive role than sometimes publicly assumed. In particular, and taking up the conclusions of the OECD, only if the electoral mandates are clearly favourable to tackling structural reform, and if the governments apply their political capital to a process of slow preparation, complex agreement and strong leadership, are we likely to witness a new generation of structural reforms.

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## EUROPEAN UNION

### Eurostat upgrades Greece's public deficit again and the risk premium soars.

### The next few months will be critical in determining the real scope of the crisis.

#### Euro area: the Greek tragedy comes to the fore

The main focus of attention for the euro area in the month of April has been Greece. For the last few months the Greek economy has been starring in a series that, as time goes on, seems to resemble more what was offered by Russia in 1998 or Argentina in 2001. It all started in autumn, when the recently elected Greek prime minister, Y. Papandreu, was forced to substantially raise the public deficit forecasts for 2009. This led to a huge lack of confidence in the quality of the macroeconomic figures published and doubts arose as to the Greek economy's capacity to pay back its debt. In fact, in April, Eurostat once again slightly upgraded its public

deficit estimate for 2009, from 12.7% of gross domestic product (GDP) to 13.6%, putting all investors back on the alert.

The new government has made numerous efforts. It has improved its communication of the economic situation with the markets and has promised to carry out an adjustment plan to reduce public spending and increase revenue. But the need to introduce such a tough fiscal adjustment plan has created a new fear: that it might send the economy back into recession and thereby make it enter a spiral with no way out.

For the moment, the different countries in the euro area and the International Monetary Fund (IMF) have promised

#### EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009				2010		
			1Q	2Q	3Q	4Q	January	February	March
GDP	0.5	-4.0	-5.0	-4.9	-4.1	-2.2	-	...	-
Retail sales	-0.7	-2.2	-3.3	-2.6	-2.2	-1.0	-0.6	-1.2	...
Consumer confidence (1)	-18.1	-24.7	-32.5	-27.9	-21.4	-17.0	-15.8	-17.4	-17.3
Industrial production	-1.7	...	-18.6	-18.8	-14.5	-7.6	1.0	4.2	...
Economic sentiment indicator (1)	93.5	80.8	71.5	75.6	84.1	91.9	96.0	95.9	97.7
Unemployment rate (2)	7.5	9.4	8.8	9.3	9.7	9.9	9.9	10.0	...
Consumer prices	3.3	0.3	1.0	0.2	-0.4	0.4	1.0	0.9	1.4
Trade balance (3)	-1.2	-13.5	-35.8	-30.1	-4.1	16.0	25.8	29.7	...
3-month Euribor interest rate	4.6	1.2	2.0	1.3	0.9	0.7	0.7	0.7	0.7
Nominal effective euro exchange rate (4)	110.6	111.7	109.9	111.0	112.1	113.8	110.8	108.0	107.4

NOTES: (1) Value.

(2) Percentage of labour force.

(3) Cumulative balance for 12 months. Billion euros.

(4) Change weighted for foreign trade flows. Higher values imply currency appreciation.

SOURCES: Eurostat, European Central Bank, European Commission and own calculations.

to help Greece if it ultimately ends up being necessary. But this has not been enough to make the markets confident again. Greece's risk premium has risen non-stop and continues to hit record highs. The coming months, or even weeks, will be decisive in seeing whether the bailout plan orchestrated is enough, and particularly in determining the risk of other countries being infected. To date, Portugal, Ireland and Spain have been the most affected by the significant rise in sovereign risk premia.

This panorama has pushed the recovery of the euro area as a whole into the background and, moreover, has tarnished the interpretation of the new indicators with some pessimism. This was also due to the downgrade in the growth rate for the fourth quarter of 2009. Although the initial figure was hardly that good, initially Eurostat published 0.1% quarter-on-quarter

growth but it lowered it in April by one tenth of a percentage point, so that it's now at a dismal 0.0%. Moreover, the first quarter is unlikely to offer much joy either. The main guilty party: consumption. This was completely flat in the last quarter of 2009 and, in the first quarter of 2010, it might even post a slight decline. This is indicated both by retail sales and the consumer confidence index. Both indicators have slowed up their recovery and retail sales actually fell again in the month of February.

The trend in consumer prices (CPI) is also heading in the same direction, albeit more indirectly. The year-on-year change in the CPI rose substantially in the month of March, going from 0.9% in February to 1.4%. This was due to the rise in fuels, however. The component related to the trend in energy product prices rose 7.2%. However, the underlying component of the index,

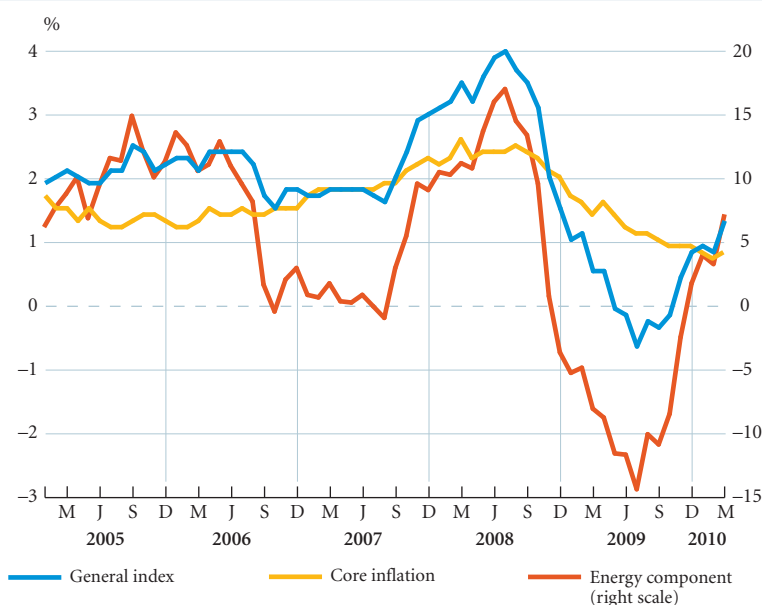
**The euro area's growth in the last quarter of 2009 is downgraded...**

**...and the first quarter of 2010 won't offer much joy either.**

**Weak consumption continues to be the main reason.**

## INFLATION RISES ENERGETICALLY

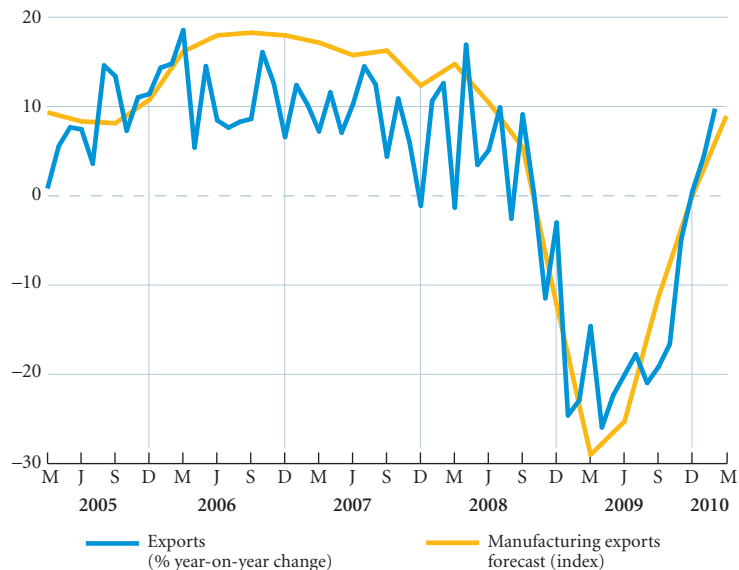
Year-on-year change in harmonized CPI



SOURCE: Eurostat.

## EXPORTS ARE THE DRIVING FORCE

Indicators of goods exports



SOURCES: Eurostat and own calculations.

### Activity and the foreign sector are acting as counterweights and underpinning the recovery.

which better reflects the state of demand, remained at very low levels, only rising 0.1% compared with February and standing at 0.9%.

But it's not all bad news. As in previous months, activity and the foreign sector are acting as a counterweight. The prime example of the recovery in activity is provided by the industrial production index which, far from getting weaker, continues to rise strongly. In the month of February, the year-on-year rate of change rose by 3.2 percentage points and stood at 4.2%. It's worth remembering that this index fell by 21.6% in the month of April last year and, in fact, in December 2009 it was still posting a drop of 3.9%. And this indicator's not the only one showing a good pace of recovery in activity. The PMI index of purchase managers and industrial orders, with data available from April and March,

respectively, also show a clearly positive trend.

Given the poor trend in consumption, this all points towards the recovery in activity being due to improvements in stock, which was used up throughout last year, and to the improvement in the foreign sector. In this respect, exports continued to perform well in February and advanced by 9.6% in year-on-year terms. In just two months they have risen 9.2 percentage points. Moreover, this trend is expected to continue over the coming months. This is indicated by the survey of expectations regarding manufacturing exports produced by the European Commission. Without doubt, this partly reflects the benefits entailed for this sector by the euro depreciating. At present, the exchange rate against the dollar is remaining stable around 1.35 and the bulk of the evidence



available suggests that it will continue to fall. The speed with which it does so will ultimately depend to a large extent on the next few episodes in the Greek crisis.

With regard to imports, it's true that they are also recovering quite fast, as in the month of February they rose 5.7%, 4.8 percentage points more than in January. However, a large part of this increase is due to the base effect and the general recovery process in trade at a global level. Given the weak demand, they're unlikely to increase much more in the month of March, so that the foreign sector's contribution to growth will once again be clearly positive in the first quarter of 2010. This trend will certainly continue

throughout the year, although it will lose force as demand starts to pick up.

In spite of the pessimism generated by the Greek saga and the poor growth figures for the fourth quarter, there are reasons to think that the recovery of the euro area will continue throughout 2010. Growth will be somewhat weak for the year as a whole, as it will probably be around 1%. In fact, if we compare it with the growth figures for the United States, which is expected to grow by 3%, the European figures look pretty low. But we must not forget that the potential growth rate for the euro area is significantly lower, between 1.5% and 2%.

**The weak euro will help exports to grow.**

## Thou shalt not bail out thy neighbour's country (or should you?)

During the second half of the 1980s, the construction of Europe went through what has probably been the most fertile and dynamic period in its history. A favourable economic climate, the successful adoption of the Single European Act (the first great step towards integration since the treaties of the 1950s), the enlargement to the south and the apparent stability of the European Monetary System, combined with Jacques Delors at the helm of the Commission, an enthusiastic supporter of the European project. Delors, former minister of the Economy and Finance in France, guessed that now was the time to take a decisive step forward in integrating Europe, complementing the already almost accomplished internal market with a single currency. This undertaking had already been attempted in the 1970s but was disrupted by the monetary instability of the time. This time it seemed possible and, in Madrid in 1989, the idea was formally accepted by the Council. Thus started the drawing up of the document that became known as the Maastricht Treaty, which would introduce the single currency and which came into force in 1993, albeit after a complicated journey.

Those drawing up the single currency project were aware of its complexity. Comparable experiences in history were not very encouraging (the Latin Union of 1865, the Scandinavian Monetary Union of 1873, etc.) and suggested that, if it wasn't supported by true political union, the life expectancy of monetary union would not be very long. Academia didn't help much either: Mundell's theory of optimum currency areas revealed that, without labour mobility, with little price and wage flexibility and without a shared fiscal system, the project would run the risk of failure. But the decision was political and a suitable formula had to be found. A new currency was conceived that was provided with the utmost protective mechanisms to guarantee its solidity, a kind of seven commandments of monetary union. These are: a central bank that is federal in nature but totally independent of European governments and institutions; restrictive conditions for joining the monetary union; a monetary policy whose aim would be price stability; strict control of the members' public accounts; a ban on

central banks financing governments; a ban on a member state taking on the debt of another member state; and close coordination of national economic policies.

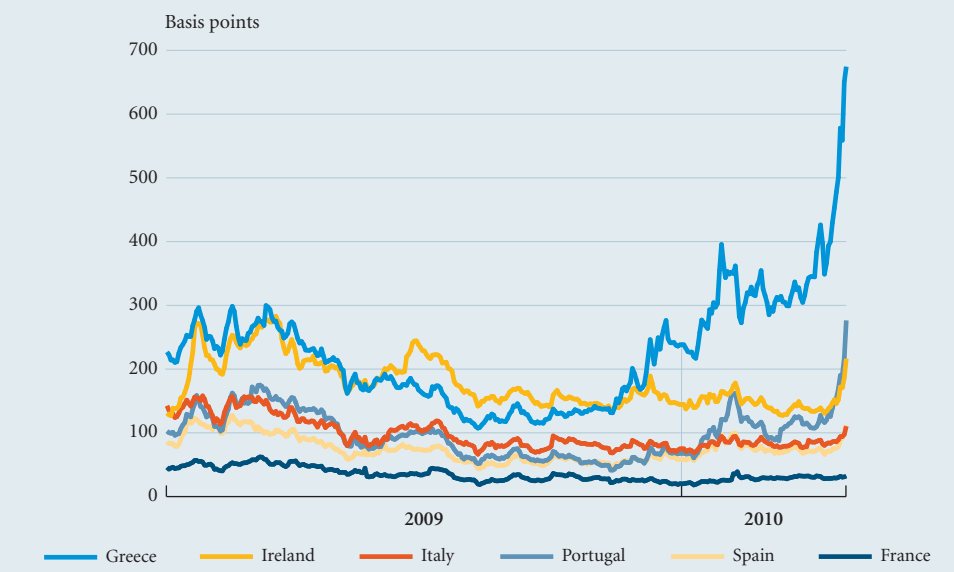
Armed with this protection, the euro has been successful in its first eleven years of life. Even in the midst of the financial storm, many countries regretted not being part of a currency that was acting as a safe haven against external turmoil and are now working on getting the green light to join. In some respects, the euro area has emerged from the global financial crisis in better shape than the rest of the large economies. Compared with the United States or United Kingdom, its public deficit is much smaller (6%-7% of GDP, compared with double digit figures), its currency has remained relatively strong against the dollar and pound, if we adopt a historical view, and its foreign accounts are more balanced.

However, the Greek crisis has suddenly disturbed this set-up, raising doubts as to the solidity of the euro's design. Greece has been hit by the crisis like the other member states. But it had previously falsified its public accounts, so that it has finally had to admit an unexpected and huge public deficit (around 13% of GDP) that leaves a public debt in excess of 120% of GDP. A very heavy burden made worse by the mistrust of the financial markets, forcing the Greek government to pay a high premium to finance its profligacy. After a lot of hesitation, the Greek government implemented a series of adjustment measures aimed at sorting out its accounts. But the markets are still wary and the financial situation is critical. Sovereign debt default has become a real possibility.

Default by a state involved in the single currency was not on the euro's radar. The initial reaction by political leaders was one of solidarity: bailing out a neighbouring country to help them out of a tight spot. But they

#### GREECE IS BEING PUNISHED BY THE MARKETS

Sovereign bond differential compared with German bonds



SOURCE: Bloomberg.

soon realised that this violated one of the euro's commandments mentioned above. The prose of Maastricht, now reconverted into the Lisbon Treaty, makes this very clear: «A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State» (article 125). Of course, as the saying goes, laws were made to be broken. Someone suggested invoking article 122, which allows the Council to approve financial aid for a member state's central government when it «is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control». But using this provision would clearly contravene the spirit of the Treaty. And there was also the German objection. The German constitution also prohibits the central government from taking on the debt of third parties. Moreover, German public opinion does not like the idea of having to pay for the wastefulness of its southern neighbours. The euro was contaminated by the Greek crisis and fell against the dollar, while other periphery countries, including Spain, were unexpectedly punished. What to do?

One option was for Greece to call at the door of the International Monetary Fund (IMF). The most fervently pro-Europe sectors were indignant at such a possibility. The European Central Bank and the Bundesbank flatly rejected it. Some economists put forward the idea of a European Monetary Fund, capable of tackling problems like the one in hand. A plausible proposal but there wasn't enough time to set up a new institution to resolve the Greek crisis. Others suggested the possibility or expediency of Greece leaving the euro. Finally, EU leaders, on the eve of the European Council in March, decided to take the middle way and approved giving Greece funding partly from the IMF and partly – mostly – from the member states, in the form of «coordinated bilateral loans», whose payment was to be approved unanimously should Greece request it. In mid-April, and seeing as all the turmoil surrounding the Greek debt had not abated, it was agreed that the member states would give a total of 30 billion euros at an interest rate of around 5%, a high level but lower than the 7% demanded by the markets at that time for Greek debt. Greece has already asked to activate this mechanism.

In short, European leaders have decided to get around the no bail-out clause with the excuse that these are bilateral loans at a non-discounted interest rate. Leaving Greece to collapse is certainly too risky a solution. And, with the current decision, attacks on the euro and other troubled sovereign debt are expected to be defused. But the crisis has highlighted one of the defects in the conception of the single currency, namely the difficulty of managing monetary union that is not supported by political and fiscal union. The multilateral supervision of economic policy has failed spectacularly and greater strictness is needed when establishing and respecting budgetary discipline. Integrating national budget policies even further is still taboo but it's probably the only way to stop any state from being tempted to take advantage of the cover provided by the euro in order to act negligently or irresponsibly.

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**German GDP is still stagnant in the first quarter of 2010.**

## The good weather enlivens Germany

The recent forecasts published by the main institutions place the German economy's growth between 1.2% and 1.5% in 2010, leaving behind its biggest recession in years. However, this recovery will not stop the German economy's growth from being close to zero or even negative in the first quarter of 2010, starting the year the same way as it ended 2009. The cold winter and the gradual reduction in government measures to stimulate growth have been the reasons behind this stagnation. However, the first rays of spring are expected to reactivate activity, with greater dynamism being forecast as from the second quarter.

Demand indicators point in this direction. Consequently, retail sales in February were up 1.1% on the previous month. In this period, German unemployment fell again by 0.1 percentage points in March, standing at 8.0%. Consumer confidence also noticeably improved in the same month, so that private consumption is expected to keep to this

trend in the short term. Given this increase, and the significant rise in oil prices, the German rate of inflation increased by half a percentage point in March, standing at 1.1% after a year of being below 1%.

In spite of these signs of recovery in demand, private consumption will remain at low levels for the coming quarters. This will be the result of the decline in the unemployment rate which, in spite of prolonging the short-time working scheme (Kurzarbeit) until March 2012, is expected to peak in 2011, above 9%. A similar pattern is likely to occur with the end of the government's measures to stimulate consumption. This can be seen in vehicle registrations that, after rising by 23.2% throughout 2009 thanks to state aid, fell by 22.7% year-on-year in the first quarter of this year.

Given the impossibility of consumption, both public and private, taking over the reins of the German economy, the foreign sector is once again driving growth. February's figures support this statement, with a month-on-month rise

**Private consumption will remain at low levels.**

## GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009				2010		
			1Q	2Q	3Q	4Q	January	February	March
GDP	1.0	-4.9	-6.7	-5.8	-4.8	-2.4	-	-	
Retail sales	0.0	-2.2	-2.9	-1.9	-2.4	-1.8	-1.6	-0.3	...
Industrial production	-0.1	-15.9	-20.0	-19.2	-15.6	-8.5	2.1	5.4	...
Industrial activity index (IFO) (*)	96.8	87.7	82.6	84.8	89.9	93.5	95.8	95.2	98.1
Unemployment rate (**)	7.8	8.1	8.0	8.3	8.2	8.1	8.1	8.1	8.0
Consumer prices	2.6	0.4	0.9	0.3	-0.3	0.4	0.8	0.6	1.1
Trade balance (***)	195.0	140.2	160.2	140.4	131.0	129.5	136.8	140.5	...

NOTES: (\*) Value.

(\*\*) Percentage of labour force.

(\*\*\*) Cumulative balance for 12 months. Billion euros.

SOURCES: Eurostat, European Central Bank, European Commission, national statistical bodies and own calculations.

in exports of 5.1%, much higher than imports, namely 0.2%, once again increasing the balance of trade. The expected depreciation of the euro and the country's significant penetration in Asian markets, with greater development potential, will consolidate this upswing throughout the year.

Because of this recovery in foreign demand, German production is expected to liven up in the short term, a knock-on effect that did not occur during the first two months of 2010 because of the tough weather conditions in this period, which particularly hit the transport and construction industries. Consequently, industrial production did not grow in February, after increasing a meagre 0.1% month-on-month the previous month. Similarly, industrial orders only rose by 0.4% month-on-month in the second month of the year. All this confirms the estimate for weak economic growth in the first quarter.

However, the arrival of spring has coincided with confidence indicators picking up strongly for the main economic agents. Both the IFO business climate index and consumer confidence recorded significant increases in March, recovering half the ground lost since the maximum reached in May 2007. Economic activity can therefore be expected to reactivate substantially as from the second quarter of the year.

Consequently, everything points to the medium term growth in the German economy once again being supported by the foreign sector. A pillar that, as already observed in the last crisis, may become a double-edged sword if the country's domestic demand is not solid enough to counteract any slump in the flow of global trade. That's why, within a context

of deleveraging and reduction in current imbalances by its main trading partners, several voices have been heard demanding policies aimed at strengthening domestic demand in order to avoid such dependency on international trade.

However, this requirement is far from the priorities of the German government. Given that the imbalance in the public accounts is expected to be above 5% of GDP in 2010, the government's efforts are focused on reducing the public deficit in the coming years. This will require significant spending cuts to get the deficit below 3.0% by 2013, in order to comply with European commitments, and at levels close to zero by 2016, as contained in the constitutional amendment introduced in September 2009.

### **France's pace of recovery slows up a little**

The figures for real activity and leading indicators suggest a slight stagnation in the recovery process of the French economy for the first quarter of 2010. From the point of view of supply, industrial production remained flat in February after six months of ups and downs, due mainly to the stagnation in construction and, to a lesser extent, in transport and energy materials. On the other hand, the manufacturing component of production grew by 0.4% during the month. Overall, the year-on-year rate of growth for industrial production stood at 3.3% in February, higher than the 2.6% in the previous month, and much higher than the drop of 15.7% recorded in February 2009.

The rest of the available indicators provide a mixed bag of trends in French

**The foreign sector is once again the driving force of the economy.**

**The German government must contain spending as from 2011.**

**February's industrial production remains flat in France.**

## FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009				2010		
			1Q	2Q	3Q	4Q	January	February	March
GDP	0.3	-2.2	-3.4	-2.8	-2.3	-0.3	–	...	–
Domestic consumption	-0.6	1.0	-0.8	0.6	-0.1	4.3	1.5	1.6	2.5
Industrial production	-2.4	-11.8	-15.5	-15.2	-11.3	-4.6	2.6	3.3	...
Unemployment rate (*)	7.8	9.5	8.9	9.4	9.7	10.0	10.0	10.1	...
Consumer prices	2.8	0.1	0.6	-0.2	-0.4	0.4	1.1	1.3	1.6
Trade balance (**)	-50.3	-48.8	-55.8	-52.9	-45.2	-41.4	-42.2	-41.8	...

NOTES: (\*) Percentage of labour force.

(\*\*) Cumulative balance for 12 months. Billion euros.

SOURCES: OECD, Eurostat, INSEE, European Commission and own calculations.

### The Bank of France predicts 0.4% growth in GDP for the first quarter of 2010.

economic activity, in general this being more favourable in March than February. Both economic sentiment indicators and the industrial orders index for March continued their upward trend started a few months ago, after a small relapse noted in February, related largely to adverse weather conditions. Similarly, the creation of firms was positive in March, up 3.8% month-on-month.

According to the Bank of France's Annual Report published 9 April 2010, the industrial business climate index increased slightly in March, reaching 103 points. The equivalent index for the services sector also rose by one point. Based on the trend in its activity indicator, the same report predicts moderate progress in activity in the coming months and estimates a growth in French GDP of 0.4% for the first quarter of 2010 compared with the previous period.

Concerning demand, it's estimated that household spending will not be such a great help towards the French GDP flash estimate this quarter. Household consumption fell by 2.5% and 1.4% month-on-month in January and

February. However, this indicator picked up 1.2% in March.

For its part, the deterioration in the labour market, with unemployment at 10.1% in February compared with 8.9% the same month a year ago, once again led to a fall in consumer confidence. Consequently, this index fell two and a half points, standing at 19 negative points.

On the other hand, domestic demand is unlikely to be strongly boosted by its other two components, public consumption and investment. Over the coming months, the government is expected to reduce public expenditure in order to fulfil its stability plan, which stipulates that the deficit must not exceed 3% of GDP by 2013. That's why the government needs to withdraw its aid to stimulate economic activity. In fact, according to INSEE data, the French public deficit doubled in 2009, standing at 7.5% of GDP after being at 3.3% in 2008. Public debt therefore rose more than 10 points, up to 77.6% of GDP.

The public deficit soared both because of the sharp fall in revenue, namely



4.3%, and also due to the 3.8% increase in public expenditure. With regard to expenditure, the stimulus plan contributed significantly to the 5.1% rise in intermediate consumption. Similarly, the crisis also led to rising benefit payments, up 5.7%, to a large part due to unemployment benefit.

With regard to investment, the index of production capacity utilization published by the Bank of France increased 0.6 points in March, totalling 75.3. Although the index did not reach 80 points, the level as from which investment starts to contribute positively to the economy, it is gradually getting closer. In fact, this indicator reached its record low last April, at 69.6 points, and has been growing since then.

Lastly, weaker domestic demand might be partially offset by the foreign sector, boosted by the euro's depreciation. So French exports recorded an increase of 0.6% in February month-on-month, accumulating four months of rises, and the year-on-year rate stood at 6.5%. However, imports posted higher growth of 0.8%, widening the trade balance deficit.

In summary, supply and demand indicators for February predict a very moderate rise in French GDP for the first quarter of 2010. However, March's figures outline a more optimistic panorama and this suggests that the adverse weather conditions in February may have played quite an important role. The recovery in French economic activity might therefore gain in strength during the second quarter of 2010.

### Italy: beyond recovery

After the squeeze in Italian gross domestic product (GDP) at the end of 2009, 0.3% quarter-on-quarter, the main economic institutions expect its economy to grow again at the beginning of the year. However, the data available for the first quarter do not show any significant improvement, particularly in terms of private consumption, which still shows signs of weakness.

The main demand indicators point in this direction. The expected deterioration in the labour market in the first quarter will continue to decimate household disposable income, which fell

**The French public deficit doubles in 2009, standing at 7.5% of GDP.**

**Italian GDP grows again in the first quarter.**

## ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009				2010		
			1Q	2Q	3Q	4Q	January	February	March
GDP	-1.3	-5.1	-6.2	-6.1	-4.8	-3.0	—	—	—
Retail sales	-0.3	-1.6	-3.1	-1.2	-2.3	-0.1	-2.6	...	...
Industrial production	-3.8	-18.2	-22.1	-23.0	-17.4	-9.2	-0.6	2.8	...
Unemployment rate (*)	6.7	7.7	7.3	7.6	7.9	8.2	—	—	—
Consumer prices	3.3	0.8	1.5	0.8	0.1	0.7	1.3	1.2	1.4
Trade balance (**)	-10.0	-9.1	-12.8	-11.2	-7.4	-4.9	-3.9	-5.3	...

NOTES: (\*) Percentage of labour force.

(\*\*) Cumulative balance for 12 months. Billion euros.

SOURCES: OECD, national statistical bodies and own calculations.

## Upswing in industrial production in February.

2.8% year-on-year in 2009, weakening private consumption. It's no surprise that, within this context, consumer confidence has fallen in the first quarter of 2010, neutralizing the slight improvement recorded in the second half of last year. There's no good news from the international trade figures either. Exports grew by 4.5% year-on-year during the first two months of the year, below the rise in imports of 6.6%. This stopped the foreign sector from contributing positively to growth in the first quarter.

## Structural reforms are vital in Italy.

On the supply side, industrial production picked up in the month of February, with a rise of 2.8% year-on-year, the first positive figure since the beginning of 2008. The improvement in industrial confidence in March suggests this trend will continue over the next few months. This upswing in activity coincides with the improved conditions for granting credit to firms in the first quarter of the year. Consequently, investment is expected to revive in the medium term,

once industrial capacity utilization attains levels closer to those of the past.

However, the exit of the Italian recession will lead to old structural problems reappearing, particularly low competitiveness and heavy public borrowing. It's therefore a good time for Berlusconi's government to tackle significant reforms, taking advantage of the long time before the next elections.

## The United Kingdom: a slow, costly but gradual recovery

After six quarters in deep recession with GDP falling by 6.2%, the British economy started to recover in the last quarter of 2009. The 0.2% rise in GDP in the first quarter of 2010 compared with the previous period confirms this change in trend.

Household consumption at the end of the year largely helped the return

## British GDP grows 0.2% quarter-on-quarter.

### UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009				2010		
			1Q	2Q	3Q	4Q	January	February	March
GDP	0.5	-4.9	-5.3	-5.9	-5.3	-3.1	-	-0.3	-
Retail sales	2.2	1.4	-0.4	0.4	2.5	3.1	-1.3	3.2	2.2
Industrial production	-3.1	-10.2	-12.4	-11.7	-10.7	-5.9	-1.6	-0.1	...
Unemployment rate (1)	2.8	4.7	4.2	4.7	4.9	5.0	5.0	4.9	4.8
Consumer prices	3.6	2.2	3.0	2.1	1.5	2.1	3.4	3.0	3.4
Trade balance (2)	-93.7	-86.7	-91.9	-88.7	-84.0	-82.2	-82.3	-81.8	...
3-month Libor interest rate (3)	5.5	1.2	2.1	1.4	0.8	0.6	0.6	0.6	0.6
Nominal effective pound exchange rate (4)	97.6	73.9	73.9	77.0	83.7	79.0	80.4	80.5	76.9

NOTES: (1) Percentage of labour force.

(2) Cumulative balance for 12 months. Billion pounds.

(3) Average for the period.

(4) Index weighted for foreign trade flows (January 2005 = 100). Higher values imply currency appreciation.

SOURCES: OECD, Bank of England, ONS, European Commission and own calculations.

to positive quarter-on-quarter growth in GDP. However, the withdrawal of significant measures of fiscal stimulus in 2010 creates doubts as to the strength of the British stabilization process. In particular, it is feared that raising value added tax (VAT) to 17.5% in January, after 13 months at 15%, will influence consumer spending, although for the moment indicators point to a small impact. In fact, January's retail sales fell 1.3% year-on-year but picked up again in February and March, at 3.2% and 2.2% year-on-year, respectively. Similarly, another element that reduces the risk of a slump in private consumption is the strength shown by the labour market, with unemployment falling by 0.1 percentage points in March for the second consecutive month.

This higher consumption may have influenced prices. The rate of inflation therefore advanced 0.4 percentage points to 3.4% year-on-year in March, due to oil prices but also to other items, as shown by the 0.1% rise in core inflation. There have therefore been three consecutive months of rises above 3%. This places inflation at a somewhat uncomfortable level for managing the Bank of England's monetary policy, which has to balance helping the economy to recover and preserving the credibility of its price stability target. For the present, the bank considers this rise in inflation to be temporary but, if it persists, it might be forced to raise interest rates earlier than expected.

On the other hand, public consumption and investment are highly unlikely to boost domestic demand significantly. After years of very high spending, the government that comes out of the next elections will have to take serious

measures to contain the public deficit. According to the general budget for 2010-2011, the deficit is expected to reach a maximum of 11.8% of GDP this year, afterwards falling to 4.0% in 2014-2015. The accounts have been drawn up based on the assumption that economic activity in the United Kingdom will grow by 1%-1.5%, 3%-3.5% and 3.25%-3.75% in 2010, 2011 and 2012, respectively. However, it should be pointed out that, although the rate for 2010 is reasonable, the growth expected for 2011 seems quite optimistic. To date, it hasn't been difficult to finance these deficits, although we should remember the sharp depreciation in the pound over the last few months.

From the point of view of supply, indicators point to a certain improvement in activity, in spite of its quite erratic behaviour. Industrial production grew 0.9% in February, reducing the drop to 0.1% year-on-year. The industrial and service confidence indices present a similar profile, as both increased in March.

So the British economy continues its improvement, which started later than other countries and is somewhat weak and especially costly in terms of public borrowing. However, the United Kingdom is known for its flexible labour market with the capacity to adjust wages, a relatively low general level of taxation with the ability to raise taxes should it be necessary, and an independent monetary policy. These factors will help it out of its slump. Moreover, if the new government chosen in the elections of 6 May manages the public accounts properly, confidence will return, thereby laying the foundations for a definitive exit from the crisis.

**Consumption has maintained its tone in spite of the VAT hikes, thanks largely to good labour market performance.**

**The general budget predicts a deficit of 11.8% of GDP in 2009-2010.**

**In emerging Europe, concerns for the budget situation, Baltic weakness and the bank situation have eased.**

## Emerging Europe: a more favourable balance of risks

On Renaissance maps, the unknown areas of the globe were marked with the fearful phrase: *hic sunt dracones*, in other words, «here be dragons»! The dragon symbolized any unknown risk and therefore clearly warned people to avoid such inclement waters. Five centuries on, economic cartography is more precise. All told, the risks that might be hidden beyond the near horizon continue to require unceasing attention. Over the last few months emerging Europe has, fortunately, seen some of the dragons lose part of their ability to instil fear, although others are certainly still ready to pounce and are a cause for concern. Among the dragons, i.e. the risks that seem to have lost their bite early in 2010 are the state of public finances, the general economic situation of the Baltic countries and the state of banking.

Budget concern was dressed up in two different ways but had the same

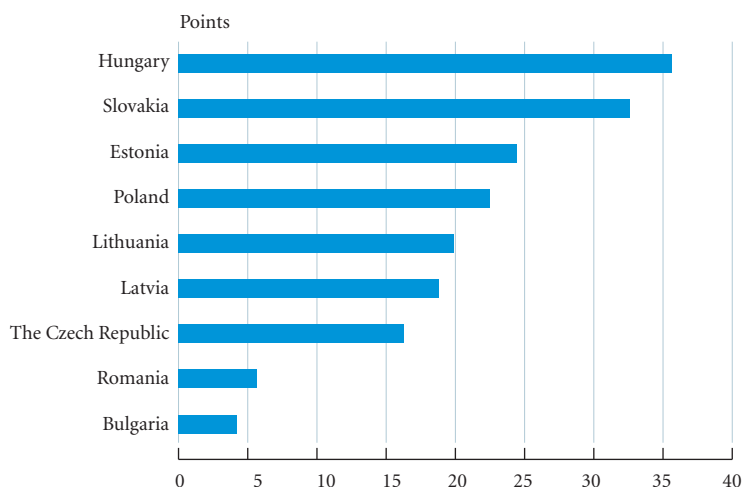
common base: might the need to sort out public accounts affect a still weak recovery? The first of these variants affected those countries being helped financially by the International Monetary Fund and other institutions. Here attention focused on whether the public adjustment agreed with the Fund could be carried out within a context of strong recession. Fortunately, the halt in economic decline has allowed public revenue and spending to move along the planned coordinates and Hungary, Romania and Latvia are all fulfilling their commitments.

Poland was experiencing a second, different situation, a country whose better economic performance has, paradoxically, helped its fiscal adjustment to be postponed. Here concern focused on when fiscal consolidation would take place and what effects it would have on activity. The fiscal plans announced in its Stability and Growth Programme of last February have served to calm the mood, as they reasonably combine a well-balanced

**Estonia might adopt the euro in 2011.**

### BALTIC COUNTRIES CLEARLY IMPROVE

Differential between current values and minimum of the economic sentiment index



SOURCES: European Commission and own calculations.

package of measures to take advantage of growth but also implement the necessary cuts in spending.

The dragon of budget adjustment being under control, another cause for concern that has eased is the Baltic flank of the European Union. For months, the fear of unwelcome devaluation in Latvia has been the object of extreme tension due to the effects this might have had on other currencies in the zone and, in more general terms, on the aversion to regional risk. The clearly improved health of activity in Estonia, Latvia and Lithuania, in line with that experienced by more advanced countries in the region that are also recovering (see graph above), has lessened these fears. The imminent upgrade in the public debt rating of the Baltic trio by Moody's and the EU's probable decision in June that Estonia will be the next member of the single currency as from January 2011 endorse this improvement.

Lastly, the situation of banking, a critical aspect in the current economic crisis, seems to have moved away from the more pessimistic scenarios viewed at certain times. The figures for default and profits recorded by the sector point to the 2009 crisis as better than other preceding episodes occurring in the same region. Although the expected development is not without uncertainty, should the expected upward trend in activity continue, bank risk will be notably diverted during 2010.

As can be deduced from the explanation above, the three risks mentioned (public budgets, Baltic imbalances and the bank situation) are perceived as less threatening largely because the cyclic weakness has been left behind and the economies are gaining ground (once again, see the graph above). That's why any event that directly threatens the recovery will be a

candidate to be the «great dragon» on the region's economic map.

The two obvious candidates come from the economic and political domains. Starting with the latter, it should be noted that 2010 is a year full of elections. The electoral calendar started in April with the Hungarian legislative elections and will continue in May with parliamentary elections in the Czech Republic, in June with the sudden presidential elections in Poland and in October with the legislative elections for Latvia. These are elections within a complicated economic context, as citizens still can't clearly see the cycle picking up. Overall, most analysts believe that economic policy will not change much even though the governments may change in the region. In this respect, the radical victory of the Hungarian opposition has served to confirm that the country's economic policy will be maintained in general, this probably being an example of what will be repeated in other countries in the coming months.

If the future follows the expected political course, the main risk is economic and, more particularly, the risk resulting from the very nature of the recovery itself. This economic reactivation has largely been due to improvements in international trade and, in particular, to the improvement in key export markets (mainly the euro area). This means that domestic drive has not had much to do with the recovery (the well-known exception being Poland, which has benefitted from its dynamic consumption) and, by extension, if the external boost weakens, there are no signs on the horizon of what might make up for the role played by foreign demand. Is this risk very likely? Certainly not but, given its importance, it should be clearly marked on all navigation charts.

**The busy election schedule in 2010...**

**...should not make the region's economic policy vary too much.**

**The great risk for emerging Europe is still a slump in the international situation.**

# FINANCIAL MARKETS

## Monetary and capital markets

**The economy will set the pace for the Fed and ECB's exit strategies.**

**In Europe, the rise in interest rates and change in collateral policy will wait until 2011.**

**The Fed has a somewhat more positive economic view but repeats that the challenges of high unemployment remain.**

### **The economic situation will set the pace for the Fed and ECB**

At its monetary policy meeting on 8 April, the European Central Bank (ECB) decided to keep its official rate at 1% for the eleventh month in a row. The ECB's communiqué suggests that the institution's economic outlook has not changed. With regard to activity, it repeats that the trends in different countries in the area will be disparate. With regard to inflation, this is expected to remain moderate in the short and medium term. As regards the fiscal situation, the ECB President believes it's essential that governments manage to reduce their budget imbalances, focusing on spending, in order to correct the excessive deficits occurring in many countries.

At the press conference after the meeting, attention did not focus on the official rate or its prospects but centred on details concerning how the financial aid to Greece would function, if it is finally requested. In this respect, Jean-Claude Trichet, the ECB President, stressed that the desire to help shown by the different leaders in the euro area, in conjunction with the International Monetary Fund, was welcome. Moreover, he underlined that this aid would always be carried out under the «non-subsidy» principle.

Another point that generated interest was related to non-standard monetary policy, more specifically the announcement of changes in collateral

policy. At all times Trichet made it crystal clear that the new criteria were not at all related to the specific situation of Greece. However, there is absolutely no doubt that the main beneficiaries are Greek banks and buyers of Greek sovereign debt, particularly German and French banks.

Specifically, the ECB announced that it will keep the minimum threshold for eligible collateral at investment-grade level (i.e. BBB-/Baa3) until the end of 2010, except in the case of ABS (Asset-Backed Securities). In addition, as from January 2011, a schedule of graduated valuation haircuts will be applied to assets rated in the BBB+ to BBB- range. This schedule will replace the uniform haircut add-on of 5% that is currently applied to these assets.

Continuing with non-standard monetary policy, the ECB is most likely to watch the development of 3-month LTRO liquidity auctions very carefully since, as from 28 April, they will once again be at a variable rate and without full allotment. Given that the amount of money inserted into the system via these operations would be copious, it can be interpreted that the ECB will use them to gradually push the EONIA rate upwards. Once this goal has been reached, and with the situation back to normal, the ECB will prepare a rise in rates for the main (weekly) operations, perhaps for the first quarter of 2011.

In the United States, the Federal Reserve (Fed) kept its official interest rate at

0.25%, the level established in December 2008. The reserve bank's economic view is more positive but still cautious due to the risks. The monetary authority once again repeated that, given the economic conditions, exceptionally low interest rates should be kept for a prolonged period. In this respect, in mid-April Elizabeth Duke, member of the Board of Governors, maintained that the economy had improved «considerably», although noting that there were still challenges due to high unemployment.

In spite of caution, the trends in activity are not only showing signs of greater drive but are doing so within a context of low inflation and well anchored

inflation expectations. This scenario will consolidate further during this year, which means that a change in the cycle in standard monetary policy might come about at the end of the third quarter of 2010. In this respect, James Bullard, President of the Saint Louis Fed, indicated that the next restrictive phase will not be as predictable as previous ones, since it will depend on the sequence of economic data offered by the atypical economic cycle we are going through.

No new announcements have been made with regard to non-standard monetary policy. The Fed hinted that the trends in activity and inflation would allow the institution to keep to the same

**Interbank rates reflect the disparity in economic trends in the United States and the euro area.**

## SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5)		Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
		3-month	1-year						
<b>2009</b>									
May	1.00	1.27	1.63	0.25	0.66	0.52	0.50	1.28	0.60
June	1.00	1.10	1.50	0.25	0.60	0.46	0.50	1.19	0.33
July	1.00	0.89	1.36	0.25	0.48	0.41	0.50	0.89	0.41
August	1.00	0.82	1.30	0.25	0.35	0.39	0.50	0.69	0.30
September	1.00	0.75	1.24	0.25	0.29	0.35	0.50	0.54	0.31
October	1.00	0.72	1.24	0.25	0.28	0.33	0.50	0.59	0.34
November	1.00	0.72	1.23	0.25	0.26	0.30	0.50	0.61	0.32
December	1.00	0.70	1.25	0.25	0.25	0.28	0.50	0.61	0.35
<b>2010</b>									
January	1.00	0.67	1.23	0.25	0.25	0.26	0.50	0.62	0.34
February	1.00	0.66	1.22	0.25	0.25	0.25	0.50	0.64	0.36
March	1.00	0.64	1.21	0.25	0.28	0.24	0.50	0.65	0.16
April (1)	1.00	0.64	1.22	0.25	0.31	0.24	0.50	0.66	0.28

NOTES: (1) April 22.

(2) Marginal interest rate. Latest dates showing change in minimum rate: 8-10-08 (3.75%), 6-11-08 (3.25%), 4-12-08 (2.50%), 5-03-09 (1.50%), 2-04-09 (1.25%), 7-05-09 (1.00%).

(3) Latest dates showing change: 11-12-07 (4.25%), 22-01-08 (3.50%), 30-01-08 (3.00%), 18-03-08 (2.25%), 30-04-08 (2.00%), 8-10-08 (1.5%), 29-10-08 (1%), 16-12-08 (0%-0.25%).

(4) Latest dates showing change: 10-04-08 (5.00%), 8-10-08 (4.5%), 6-11-08 (3.0%), 4-12-08 (2.0%), 7-01-09 (1.5%), 5-02-09 (1.0%), 5-03-09 (0.50%).

(5) Interbank rate.

SOURCES: National central banks, Bloomberg and own calculations.



**The IMF and European Union warn of the risks posed by high fiscal deficits to consolidating economic recovery.**

route map designed to withdraw surplus reserves as from the third quarter.

The disparity in economic prospects between the United States and the euro area has started to appear in interbank market interest rates. While interbank rates did not record any movement in the euro area (suggesting they have bottomed out), the curve is moving slightly upwards in the United States. The long part of the curve (6-12 months) in the United States rose again by 4 basis points. This slight upward trend in the US market will remain throughout 2010.

**Public debt continues to attract attention**

Public debt forecasts continue to be one of the focuses of attention in financial markets. Two reports, one by the IMF

and another by the European Union, focused investor interest on this issue. The IMF's Financial Stability Review for April noted excessive fiscal deficits and the rise in public debt as one of the main risks that might destabilize and prolong economic weakness. On 22 April, the European Union, through the statistics office Eurostat, published a report on the levels of deficit and surplus of public debt of member countries at year-end 2009. The report also highlights the rise in debt from 69.4% to 78.7% of GDP in the euro area in the period 2008-2009.

In spite of the fact that both the United States and the euro area are facing the problem of high fiscal deficit, two factors have meant that public debt interest rates can be maintained in these regions. Firstly, the strength of demand for public debt, with investors from emerging countries playing a leading

**Interest rate differentials remain between the United States and the euro area.**

## LONG-TERM INTEREST RATES IN NATIONAL MARKETS

10-year government bonds at end of period as annual percentage

	Germany	France	Spain	Italy	United States	Japan	United Kingdom	Switzerland
<b>2009</b>								
April	3.18	3.59	3.92	4.28	3.12	1.43	3.50	2.14
May	3.59	3.95	4.29	4.48	3.46	1.49	3.75	2.41
June	3.39	3.73	4.13	4.43	3.53	1.36	3.69	2.32
July	3.30	3.57	3.85	4.16	3.48	1.42	3.80	1.97
August	3.26	3.54	3.78	4.08	3.40	1.31	3.56	2.03
September	3.22	3.54	3.81	4.02	3.31	1.30	3.59	1.99
October	3.23	3.53	3.79	4.07	3.38	1.42	3.62	2.02
November	3.16	3.42	3.75	4.02	3.20	1.27	3.52	1.84
December	3.39	3.59	3.98	4.14	3.84	1.30	4.02	1.90
<b>2010</b>								
January	3.20	3.46	4.12	4.12	3.58	1.33	3.91	2.00
February	3.10	3.40	3.86	4.00	3.61	1.31	4.03	1.90
March	3.09	3.42	3.82	3.98	3.83	1.40	3.94	1.88
April (*)	3.09	3.40	3.92	3.99	3.78	1.32	4.03	1.86

NOTE: (\*) April 23.

SOURCE: Bloomberg.

role, as well as banks. In fact, the acid test resulting from the end of the Fed's treasury purchase programme has been passed with flying colours as this has only led to momentary tensions in the market, at least for the present. For example, 10-year bonds in the United States managed to achieve a yield of close to 4%, although later falling to levels around 3.80%.

There are likely to be more turbulent episodes in US debt but, in the medium term, the forecasts for growth and inflation will encourage a slight upswing in the yields offered by public bonds.

On the other hand, sovereign debt differentials have widened slightly between Germany and the countries on the periphery of the euro area, mainly because the yield from German bonds has been driven down by two factors. The first is the downgrade in the economic growth expected by the consensus of analysts. The second factor has been the run on quality caused by the Greek crisis. In other words, given the uncertainty, investors prefer to take refuge in German debt. This shift has been more significant in 2-year German bonds, which reached a minimum yield of 0.865% on 22 April.

With regard to the Greek crisis, this has got worse and the differential of its debt with German debt at 10 years' maturity reached a record high of 365 basis points. In absolute terms, the return required from Greek 10-year bonds reached 8.84%. Pressurized by this situation, on 23 April the Greek prime minister, Georgios Papandreou, formally asked for the aid package to be activated that had been designed by the European Union and the IMF. This decision should encourage a reduction in

differentials not only for Greece but also for the public debt from the rest of the periphery countries.

### **The dollar acts as a safe haven**

Since mid-March, the euro-dollar exchange rate has fluctuated within a narrow band between 1.33 and 1.37 dollars per euro. Towards the end of April, the euro weakened and returned to the lower end of this band, pressurized by the Greek crisis. In the medium term, the disparity in growth between the euro area and the United States, together with the trend in the interest rate differential, will weaken the euro against the dollar. Consequently, the tendency for the euro to depreciate, which started in December last year, should continue.

In the short term we cannot rule out a slight recovery in the euro due to the expected improvement in the Greek situation and, moreover, to the dollar's excessive speed of appreciation of the last few months, as it has appreciated 12.3% since 25 November 2009.

On the other hand, the same doubts as last month continue to hover over the pound sterling. Firstly, the economic growth data published for the first quarter are worse than expected by the consensus. Moreover, the result of the elections of 6 May and the likelihood of a hung parliament in the United Kingdom might make it difficult for any party to govern alone and therefore to take decisions.

Another element worth noting in the currency market is the appreciation of most Asian currencies against the dollar. This trend, which started at the beginning of the year, is due to the high

**The downgrade in EU growth and the run on quality widen the differentials between Germany and periphery countries.**

**The upward trend in the dollar should continue in the medium term.**

**Uncertainty regarding growth and the new government in the United Kingdom are affecting the pound sterling.**

## EXCHANGE RATES OF MAIN CURRENCIES

April 23, 2010

	Exchange rate	% change (*)		
		Monthly	Over December 2009	Annual
Against US dollar				
Japanese yen	93.4	3.2	0.4	−4.8
Pound sterling	0.651	−2.0	5.0	−4.3
Swiss franc	1.076	1.7	3.8	−6.9
Canadian dollar	0.998	−1.8	−5.5	−22.5
Mexican peso	12.206	−2.2	−7.3	−8.0
Against euro				
US dollar	1.333	−1.3	−7.5	1.4
Japanese yen	124.5	2.0	−7.0	−3.4
Swiss franc	1.434	0.5	−3.5	−5.5
Pound sterling	0.868	−3.4	−2.2	−2.9
Swedish krona	9.603	−1.0	−6.8	−13.2
Danish krone	7.442	0.0	0.0	−0.1
Polish zloty	3.883	0.0	−5.6	−15.4
Czech crown	25.39	−0.3	−4.2	−6.2
Hungarian forint	265.1	0.3	−2.0	−12.5

NOTE: (\*) Plus sign indicates appreciation of dollar (first group) or euro (second group).

SOURCE: Bloomberg.

### Asian currencies appreciate against the dollar, with the exception of the Chinese renminbi.

growth in the area's countries and the crucial need to control inflation. The only exception has been China, although there's strong consensus in the market that the renminbi will soon start to gradually appreciate against the dollar again.

### Corporate bonds are still in high demand

In January, and during the first few days of February, the first shock due to the Greek debt crisis occurred. This episode gave rise to wider credit spreads, a fall in corporate bond prices (particularly financial) and a drastic reduction in volumes traded in the markets. Consequently, primary issues slowed up, as companies decided to

shelve new operations until there is less uncertainty.

A second episode has occurred in the last few weeks in which investors see a high risk of default for Greek debt. On this occasion, the corporate bond market appears to be maintaining a calmer tone in general, at least for the present, although there is the risk of this spreading to different sectors, firms and countries.

The fundamental factors behind this stability are the continued improvement in growth expectations at a global level and the expansion in activity in almost all production sectors.

The recovery in activity brings with it a strong recovery in corporate profits and

### The Greek crisis calls for caution, although corporate bonds remain stable.

a change in trend in the labour market. This improvement in the situation has also led to a slight fall in default risk. In the United States, where the recovery is more advanced, these effects have already been seen in the last two quarters. The euro area is expected to improve gradually throughout the coming quarters. In line with this situation, rating agencies are substantially upgrading the debt rating of firms, especially in the small and medium-sized sector.

Given this macroeconomic environment, investors are increasing their appetite for higher risk assets, in particular private bonds, which still offer high yields. For this reason, managers are buying more bonds from small and medium-sized companies, which are slightly riskier but have a higher rate of return.

On the other hand, the low yield for monetary mutual funds means that resources are constantly moving towards private bond funds. Given the high inflows, the managers of these funds are forced to take advantage of the investment opportunities offered by high risk corporate bonds.

This situation is helping to improve the financing of firms in general and, most particularly, that of small and medium-sized firms, which are taking advantage of the favourable situation in the financial markets to issue large numbers of bonds. Consequently, in the year to date, small and medium-sized firms have issued a record number of high yield bonds.

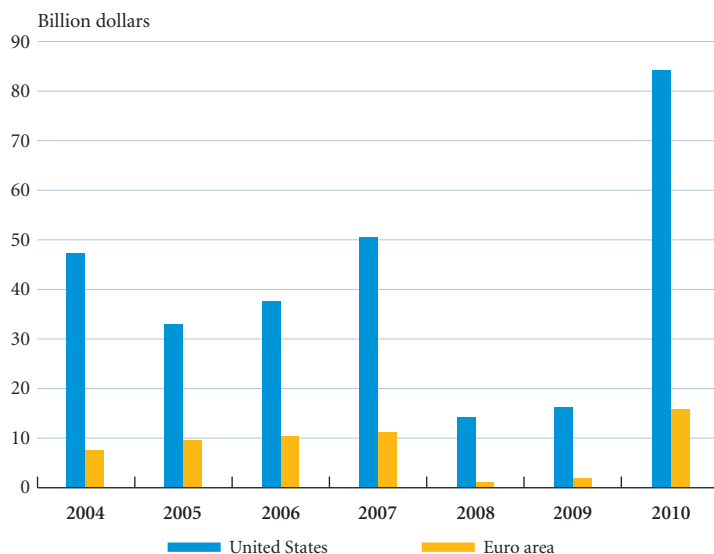
Although the improvement in issue volumes is centred on the United States, this surge has also spread to the euro

**The economic recovery sustains investors' appetite, to the detriment of low yield monetary assets.**

**Spectacular rise in the flow of funds to high yield assets in the private bond market.**

## RECOVERY IN VOLUMES OF PRIVATE BONDS ISSUED

High yield corporate bond issuance (\*)

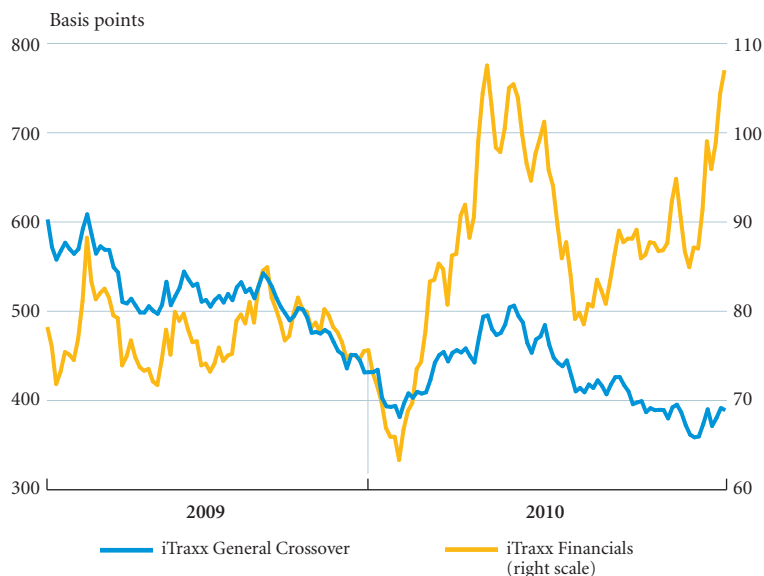


NOTE: (\*) The data for all the years correspond to the period January-April.

SOURCE: Bloomberg.

## TENSIONS IN FINANCIAL SECTOR BONDS

Credit spreads in the euro area



SOURCE: Bloomberg.

**However, the market is penalizing the role of financial institutions for their exposure to Greece.**

area and south-east Asia. The most recent data show that the spread of this market is reaching emerging countries such as China and Brazil.

However, such a benign environment in corporate bond markets has some notable exceptions that are related to the Greek debt crisis. This is the case of bonds from financial institutions, which are being severely affected by the tensions in the public debt of periphery countries, especially those with a high direct exposure to Greece. Other countries have started to be infected in the last few sessions, such as Portugal, Spain and Ireland. The financial sector and the sector of firms with regulatory risk are the most affected.

Notwithstanding the caution imposed by developments in the Greek sovereign debt crisis, the outlook for private bond markets continues positive. Firstly, due to the consolidation of the economic recovery and, additionally, to the

structural change in corporate financing. Firms are being forced to look for alternative sources of funding apart from bank loans, at least while the banks' balance sheets are being brought in line with the new regulations for the financial system.

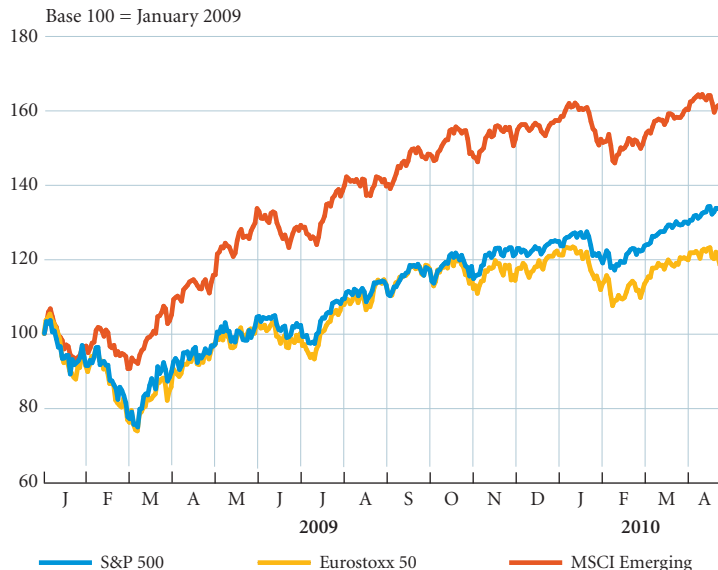
### Good corporate results boost the stock markets

In April, equity markets continued to recover part of the losses recorded in January-February due to the crisis in some countries of the euro area. This is precisely the main reason why there's a disparity in the pace of rises in the stock markets between the United States and emerging economies on the one hand, and the European indices on the other. While the former's performance is linked to the improvement in the economic cycle, the latter are associated with the resolution of the Greek situation and are cautiously paying the

**Widespread recovery in international stock market indices.**

## TRENDS IN THE MAIN INTERNATIONAL STOCK MARKETS

### Stock market indices



SOURCE: Bloomberg.

price for its direct and indirect consequences.

In spite of the events happening in Greece, in April the indicators for volatility and risk premia recorded slight variations, a situation that has led to a greater tendency to invest in equity on the part of portfolio managers.

Of note among the factors that have encouraged stock market movement, among others, are the favourable trend in economic data at a global level, as well as the good corporate results published in the campaign for the first quarter of the year in the United States and Europe.

The campaign to present the quarterly results of firms listed on the S&P 500 started mid-April in the United States and, to date, more than 80% of the companies publishing their profits have beaten the estimates of the consensus of analysts. One significant factor that helps to gauge the solidity of this recovery

is the gradual improvement in sales revenue. It is estimated that, out of the 500 companies listed on this index, approximately one third will have increased their sales by more than 10% in the first quarter. Moreover, the return per share of companies that have already published their results is around 19.50 dollars, above the estimate by the consensus of analysts, namely 18.26 dollars, and a long way from the figure for the first quarter of 2009 (which was 12.83 dollars per share).

For its part, although corporate results in Europe are tending to follow in the wake of US companies, they are at some distance due to the slower pace of economic recovery.

Another issue catching the attention of investors are the proposals to regulate the financial system. At its weekly meeting, the IMF repeated the need to establish a new regulation in the world financial system as a whole in order to avoid

**Investors continue to watch how the Greek deficit situation is resolved.**

**Positive outcome from the corporate results campaign for the first quarter.**

**Financial reform is one of the main focuses of attention for equity markets.**

future crises. As part of the actions taken to encourage and coordinate reform carried out by the IMF, the BIS and the G-20, significant progress is being made in this area in the United States and in the European Union. Of note among the proposals made is the increase in capital and liquidity requirements for financial institutions, the separation of investment and retail banking activities and the imposition of new rates to limit banks' exposure to high risk assets.

Regarding the medium term outlook for stock markets, those factors that support continued improvement in the economy at a global level seem to be increasingly more solid, of note being the recovery in corporate results and the lively flows of investment towards high risk assets. Nevertheless, in the short term the possible risks posed by the Greek situation, as well as the possibility of excessively strict financial regulations, might encourage adjustments in the stock markets.

## INDICES OF MAIN WORLD STOCK EXCHANGES

April 28, 2010

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
<i>Dow Jones</i>	11,204.3	3.3	7.4	38.7
<i>Standard &amp; Poor's</i>	1,217.3	4.3	9.2	40.5
<i>Nasdaq</i>	2,530.2	5.6	11.5	49.3
Tokyo	11,165.8	1.5	5.9	28.2
London	5,778.8	1.3	6.8	39.0
Euro area	2,958.1	0.6	-0.2	27.5
<i>Frankfurt</i>	6,321.1	3.3	6.1	35.2
<i>Paris</i>	4,011.4	0.6	1.9	29.3
<i>Amsterdam</i>	357.4	3.9	6.6	49.3
<i>Milan</i>	22,994.8	-0.3	-1.1	23.3
<i>Madrid</i>	11,068.6	0.0	-7.3	24.5
Zurich	6,815.8	-0.3	4.1	33.3
Hong Kong	21,603.0	2.6	-1.2	41.6
Buenos Aires	2,447.0	1.9	5.4	94.3
São Paulo	69,509.5	1.2	1.3	48.6

NOTE: (\*) New York: Dow Jones Industrials, Standard & Poor's Composite, Nasdaq Composite; Tokyo: Nikkei 225; euro area: DJ Eurostoxx 50; London: Financial Times 100; Frankfurt: DAX; Paris: CAC 40; Amsterdam: AEX; Milan: MIBTEL; Madrid: Ibex 35 for Spanish stock exchanges; Zurich: Swiss Market Index; Hong Kong: Hang Seng; Buenos Aires: Merval; São Paulo: Bovespa.

SOURCE: Bloomberg.



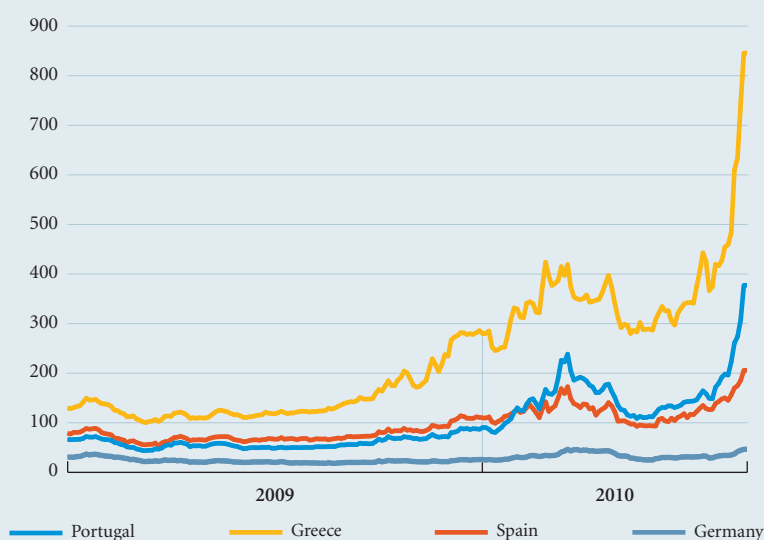
## A common euro area bond

The European Union is standing at a historic crossroads because of Greece's severe financial crisis. The origin of this situation fundamentally dates back to the weakness in the current coordination framework for fiscal policy between the member states. Although the decision to modify this framework is ultimately a political matter, related to the project of European integration, there are some important elements to this debate from a technical point of view, in particular those regarding the creation of a European Monetary Fund and a common euro area bond. We will focus on the latter.

Politicians, economists, tax experts and supranational institutions have all made different proposals to improve fiscal coordination. They all agree on the first goal, which is to maintain budget discipline in each country in the medium and long term but with enough flexibility to handle cyclical adjustments in the short term. Should this not be achieved, or should it fail for any reason, many believe that it would be useful to have the appropriate mechanisms in place to resolve the corresponding crisis. Among the different proposals formulated with this dual aim of preventing and resolving fiscal crises, there is one element that frequently appears, albeit under different guises: the creation of a common or centralized public debt instrument; in other words, a common euro area bond. Those who propose the implementation of this instrument argue that, in addition to contributing to fiscal stability, if it is appropriately designed it will also provide significant advantages in terms of efficiency for those taking part in government bond markets, particularly issuing governments but also brokers and end investors.

### CDS TRENDS FOR EURO AREA COUNTRIES

In basis points



SOURCE: Bloomberg.

Each member country of the euro area currently meets its financing needs by resorting, on its own account and with full autonomy, to the capital markets. But the smallness of some countries means that their government bond markets lack any great liquidity or depth. This fragmentation into several different small-scale sovereign issuers is a factor that, in the case of a negative shock affecting a country and making it difficult for it to refinance, contributes to situations of extreme financial fragility. These cases often give rise to controversial debate concerning hypothetical speculative action by some agents. Less debatable is the effect of the herd behaviour of most investors, who usually cause the prices of financial assets to overreact, so that an initially solvent central bank can end up bankrupt.

What are the possible solutions to avoid a central government not being able to get financing? Partial and emergency proposals do not seem significant and might even be harmful, such as the proposal to restrict the speculative use of derivatives, such as Credit Default Swaps (CDS). Another type of more global focus<sup>(1)</sup> proposes quite far-reaching reforms of the institutional framework to improve prevention (by modifying the Stability and Growth Pact) and resolve crises (e.g. by setting up a European Monetary Fund). One crucial aspect to such proposals is the interpretation or even the degree of respect for the current prohibition to bail out or subsidize another member government, which seems to depend on the political position underlying the different proposals.<sup>(2)</sup> In this respect, the creation of a common bond is a key element in proposals from those areas more in favour of pushing forward with European political integration.<sup>(3)</sup> When all is said and done, the full implementation of the changes needed for member countries of the euro area to set up a single sovereign issuer of public debt would be the pinnacle of fiscal policy coordination. Evidently, in designing this new institutional and operational system, suitable incentives must also be created to stop any country from going off, under the umbrella of the euro area, along an unsustainable fiscal path; this is possibly the main technical challenge to designing a common issuing mechanism.

If the project of a common bond finally gets underway, what would be the benefits (and also the costs) for member countries of the euro area and for the rest of the markets' participants? In the middle of 2008 (i.e. before the present-day tensions started), the European Primary Dealers Association (EPDA) produced a study<sup>(4)</sup> of this issue based on surveys on bond market brokers, rating agencies, institutional investors and academic specialists.

The most outstanding conclusion was related to the expected reduction in financing costs for member states as a whole. This would be possible thanks to the phenomenal increase in the volume of issues, making room for a significant reduction in liquidity premia. Logically, the biggest advantage would be for small or medium-sized countries, but large countries might also benefit. The euro area's government bond market would compete with that of the United States, currently the unquestionable world leader in terms of depth and liquidity. Moreover, it would help to develop the euro as an international reserve currency.

(1) For example, the proposal by D. Gros and T. Mayer, «How to deal with sovereign default in Europe: Towards a Euro(pean) Monetary Fund», VoxEU.Org (2010), or that by the German finance minister, W. Schäuble, in an article published in the *Financial Times* on 11-03-10.

(2) See the box «Thou shalt not bail out thy neighbour's country (or should you?)» on page 25.

(3) Note, for example, the contrast between the positions of Otmar Issing («Why a Common Eurozone Bond isn't Such a Good Idea», Center for Financial Studies, 2009) and of Romano Prodi («Fight the crisis with the eurozone bond market», *Financial Times* of 25-02-09).

(4) «A Common European Government Bond», September 2008.

A more open question is the effect on risk premia. In principle, the risk premia of those countries with the worst credit profiles would be expected to fall significantly, while they would increase slightly for central countries such as France and Germany. However, if the start-up of the common bond was part of a series of credible institutional reforms to ensure the Union's fiscal correctness, there might be a widespread fall in the risk premium.

For example,<sup>(5)</sup> and according to the aforementioned report by the EPDA, an initial change that would be advisable is to set up an independent agency to handle the issuing of the public debt. In accordance with the Lisbon Treaty, each participating country would be responsible for its corresponding percentage of debt issued. But in order to raise the credit rating of the common euro area bond, it would be better to create a Guarantee Fund to ensure the debt is paid should any member participating in the scheme become insolvent.

International rating agencies would look at different aspects to assign a rating to the new common European bond. Firstly, the seniority of the common euro area bond. In other words, there must be a legal obligation to repay the common euro area bond before any other debt issued individually by any member state. Secondly, whether there is an issuing agency that is independent of any political interference. Thirdly, it would be important for all member countries to be responsible for a proportional share of the debt for each maturity. And, lastly, the existence of a possible Guarantee Fund to contribute enough liquidity for the regular payment of coupons and redemptions planned for the debt in question.

With regard to the consequences for financial brokers, in principle there would be a series of costs. Firstly, they would lose some investment options and possibilities for arbitrage after a common euro area bond is created. The banks distributing public debt would also lose some business in syndicating bond issues and advising national public treasuries. However, in the medium term the volume of business would increase. A good example from history is the disappearance of national currencies with the advent of the euro. Although, currency trading desks were downsized for financial brokers in the short term, today we can safely say that the volume of business in the currency market is higher than it was before the euro was introduced. In any case, a common euro area bond would provide these agents with new business opportunities. Not only due to the increase in derivative markets (futures and options) for the common euro area bond, but also because of the possibility of creating a deeper, more liquid repo markets, increasing the possibility of taking short positions and boosting liquidity in the money markets. In a nutshell, the futures, repo and money markets would create a virtuous circle, each one increasing the liquidity of the others, so that the cost of getting finance would fall.

Ultimately, if there is enough political will, viable and efficient technical options can be found, such as the common euro area bond, to improve the operational framework for fiscal coordination that is currently employed in the euro area.

(5) As has been mentioned, the proposals presented regarding the common bond are varied and assume different institutional frameworks. Consequently, another alternative would be to enhance the European Commission's budget and its capacity to take on debt.

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## SPAIN: OVERALL ANALYSIS

### Economic activity

**The Bank of Spain upgrades its growth forecast for the Spanish economy for 2010 to -0.4%.**

**Consumption shows signs of livening up...**

#### Highs and lows at the start of 2010

As a whole, the economic indicators available for the first quarter point towards a similar trend in the overall situation as in the previous quarter, albeit with a clear improvement in the year-on-year rates. Given this situation, towards the middle of March the Bank of Spain slightly upgraded its economic growth forecast to -0.4% compared with its forecast in March 2009, a prediction that coincides with that of the International Monetary Fund and our own.

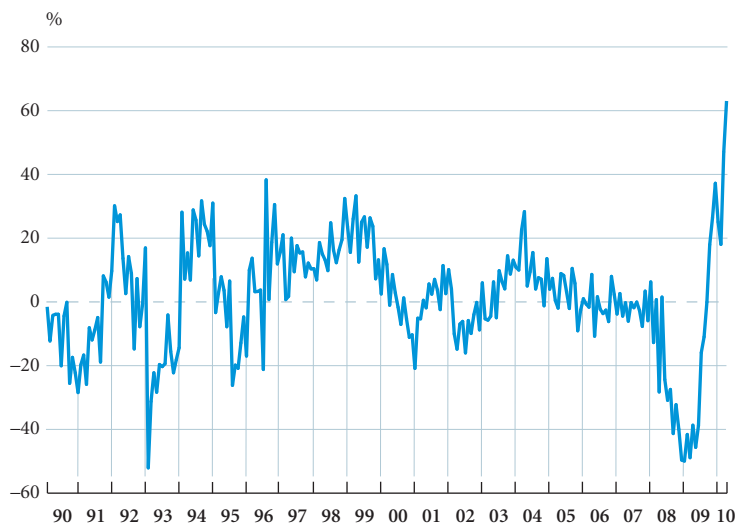
Concerning demand, indicators for consumption as a whole point to moderate growth, although they are

disparate. On the one hand, vehicle sales recorded their highest ever year-on-year increase, namely 63.1% in March. However, this is partly due to its comparison with the very low level twelve months before, as well as sales being brought forward due to the limited subsidies from the 2000-E plan and the expected hike in value added tax in July, as well as Easter being earlier in 2010. Retail sales continued to improve, recording a 0.2% year-on-year decrease in February compared with a 2.7% drop in the fourth quarter.

But, on the other hand, the production of consumer goods in the first two months fell 2.7% year-on-year, one point more than in the fourth quarter.

#### CAR SALES POST A SHARP RISE

Year-on-year change in vehicle registrations



SOURCES: ANFAC and own calculations.

Moreover, domestic sales in large service companies, after having picked up with a year-on-year rise of 1.5% in January, decreased 2.3% in February compared with the same month the year before. Meanwhile, the consumer confidence indicator continued to weaken in March, falling below the level of the fourth quarter.

Savings constitute the opposite to the moderation in consumer spending. The latest figures published for household savings, referring to 2009, show that, in the last year, the savings rate relative to gross disposable income rose to 18.8%, 5.9 points more than the previous year, the highest figure for the last few decades. This rise in savings is precautionary in nature, due to the high unemployment, greater economic uncertainty and the correction of the high level of debt reached previously. However, we believe that the household savings rate is likely to fall during 2010.

Investment continues to improve, albeit within the low levels reached. The production of capital goods fell by 4.1% in February compared with the same month the year before but this compares favourably with the 10.3% year-on-year drop for the fourth quarter. The decline in imports of capital goods also slowed up in the first two months. Similarly, registrations of load-bearing vehicles were still energetic in March. Moreover, domestic sales of capital goods and software in large firms grew by 1.6% year-on-year in the first two months, compared with an annual fall of 17.0% in the fourth quarter. With regard to investment in construction, a leading indicator such as apparent cement consumption dropped year-on-year by 20.2% in the first two months, 3.5 points more than in the fourth quarter of 2009.

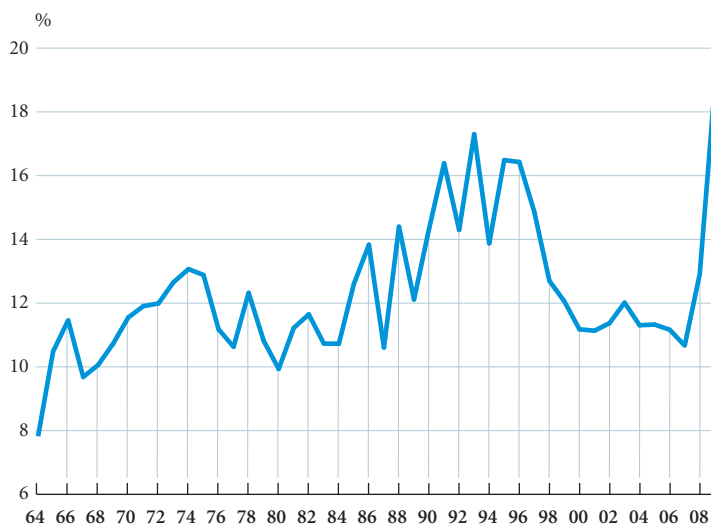
Industry is looking more positive from the point of view of supply. Although

**...but consumer confidence declines.**

**The savings rate is likely to fall slightly in 2010.**

#### THE HOUSEHOLD SAVINGS RATE HITS A RECORD HIGH FOR THE LAST FEW DECADES

Gross savings out of the disposable income of families and not-for-profit institutions serving households (\*)



NOTE: (\*) Four-quarter moving average.

SOURCES: Ministry of the Economy, INE and own calculations.

**Improved outlook  
for industry, boosted  
by foreign business.**

industrial production continued to decline in the first two months, both industrial confidence and new orders rose, boosted by foreign business. The confidence index for construction also rose in March, after a slump in January and February. For its part, the year-on-year rate in turnover for the market services industry was –0.9% in February, 3 points more than in January.

Within this context, on 9 April the government passed a new package of twenty-six economic measures to boost economic recovery and employment. Home renovations are being supported by various fiscal measures. Among other reforms to stimulate business, the unrestricted depreciation for investments in Corporate Tax was extended to 2011 and 2012, if employment is maintained. Energy services firms will also be encouraged.

**New package of measures  
by the government  
to boost economic recovery  
and employment.**

In the second week of April the extraordinary infrastructure Plan was

also presented, comprising 17 billion euros over the next two years. Thanks to public-private collaboration, investment will continue in infrastructures but won't affect the public accounts until 2014. In this way, the Plan does not compromise the government's aim to reduce its public deficit by 2013.

**The decline in net operating  
profits for firms eases in 2009**

The latest data published by the Central Balance Sheet Data Office of the Bank of Spain for the fourth quarter of 2009 provide an overall view of the last year. These figures confirm the sharp and widespread shrinkage in business, estimated at an annual change of –9.5% in value added for the firms in the sample.

Companies tackled the fall in demand by cutting costs. Consequently, staff costs

**PROFIT AND LOSS ACCOUNT OF NON-FINANCIAL COMPANIES**

Annual percentage rate of change

	2007	2008	2009
Value of output	6.4	0.7	–14.2
Inputs	7.1	2.7	–16.6
<b>Gross value added (GVA)</b>	<b>5.0</b>	<b>–3.1</b>	<b>–9.5</b>
Personnel costs	4.7	3.5	–1.6
<b>Gross operating profit</b>	<b>5.2</b>	<b>–7.9</b>	<b>–15.9</b>
Financial revenue	34.6	11.7	–10.4
Financial costs	37.8	18.7	–28.7
Depreciation and provisions	–0.9	16.6	–5.4
<b>Ordinary net profit</b>	<b>9.0</b>	<b>–24.2</b>	<b>–10.3</b>
Disposals and impairment	–5.9	–	–
Changes in fair value and other gains (losses)	–15.9	–	–
Corporate income tax	–29.0	–88.8	–2.6
<b>Net profit</b>	<b>12.3</b>	<b>–50.8</b>	<b>11.9</b>

SOURCE: Bank of Spain (Quarterly Central Balance Sheet Data Office).

decreased 1.6% in 2009, carried out particularly by reducing the workforce, since average wages rose 1.1%. Overall, the gross operating profit fell further than at any other time in the series' history, by -15.9%.

This adjustment also affected financial expenditure by restricting debt. As a result, and thanks also to the fall in interest rates, financial costs decreased by 28.7%, while financial income didn't fall so far. For their part, amortization and net operating provisions were down 5.4%. Consequently, the slump in net operating profits eased back to 10.3%, compared with 24.2% in 2008. It should be noted that, in the fourth quarter of 2009, net operating profits achieved positive rates of change in a large number of the sectors analyzed.

Lastly, both the reduction in extraordinary costs, due to the amortization of financial assets, as well as the rise in capital gains, led to a turnaround in profits for the year, up 11.9%. However, it should be noted that, in spite of the rise, this figure was significantly lower than the record high recorded in 2007 in relation to gross value added, and moreover the increase was concentrated in a few large firms from the sample. With regard to profitability, the return on net assets was 6.1%, more than one point lower than a year earlier. The return on equity was 8.4%, 0.7 points less than in 2008.

## **The gross domestic product fell in all autonomous communities in 2009**

The recession affected all autonomous communities last year, leading to a greater spread in the rates of change for gross domestic product (GDP). In general, the communities that suffered the highest declines in GDP were those with the greatest weight in the market economy. Consequently, the highest falls in GDP were in Aragon (-4.4%), the Community of Valencia (-4.3%) and the Canary Islands (-4.2%). These three were the only communities with a higher annual fall in GDP than the average for the twenty-seven countries in the European Union (-4.2%). The smallest falls in GDP occurred in Extremadura (-2.0%) and Navarre (-2.5%).

Looking at the trends for the period 2000-2009, the autonomous communities with the greatest expansion were Extremadura and Murcia, with an average annual growth of 2.8%, almost half a point more than the national average (2.3%). At the other end of the scale, the Balearic Islands (1.7%), Asturias (2.0%) and Catalonia (2.1%) recorded the lowest rises in overall activity.

On the other hand, the Basque Country was the autonomous community with the highest per capita GDP in 2009, namely 30,703 euros, followed by Madrid, with 30,029 euros. A further five communities posted figures higher than the average for the European Union (23,600 euros): Navarre, Catalonia, La Rioja, Aragon and the Balearic Islands, while Extremadura, Castile-La Mancha and Andalusia were at the bottom of the list.

**Cost cutting and non-trading income salvage the profits of the firms analyzed by the Central Balance Sheet Data Office.**

**Seven autonomous communities have a higher per capita GDP than the European Union average for 2009.**



## GROSS DOMESTIC PRODUCT BY AUTONOMOUS COMMUNITY

Year 2009

	Gross domestic product (*)		% real change		GDP per person
	Million current euros	% of total	2009	2000-2009	Current euros
Andalusia	142,874	13.6	-3.6	2.5	17,485
Aragon	32,473	3.1	-4.4	2.3	24,639
Asturias	22,736	2.2	-3.7	2.0	21,523
Balearic Islands	26,327	2.5	-3.8	1.7	24,510
Canary Islands	41,411	3.9	-4.2	2.2	19,867
Cantabria	13,480	1.3	-3.5	2.4	23,343
Castile-La Mancha	35,040	3.3	-3.3	2.5	17,208
Castile-Leon	55,982	5.3	-3.4	2.2	22,314
Catalonia	195,403	18.6	-4.1	2.1	26,831
Valencian Community	101,608	9.7	-4.3	2.2	20,259
Extremadura	17,609	1.7	-2.0	2.8	16,301
Galicia	54,686	5.2	-3.0	2.4	19,995
Madrid Community	189,060	18.0	-3.2	2.5	30,029
Murcia	27,018	2.6	-3.4	2.8	18,619
Navarre	18,246	1.7	-2.5	2.5	29,598
Basque Country	65,493	6.2	-3.5	2.3	30,703
La Rioja	7,825	0.7	-3.6	2.2	24,754
Ceuta	1,611	0.2	-1.7	2.5	22,208
Melilla	1,496	0.1	-1.4	2.7	21,250
<b>Total</b>	<b>1,051,151</b>	<b>100.0</b>	<b>-3.6</b>	<b>2.3</b>	<b>22,886</b>

NOTES: (\*) Total does not coincide with sum of all Autonomous Communities because it includes GDP figures which cannot be broken down by region.

SOURCE: National Institute of Statistics.

## Labour market

### Job losses slow up but don't cease

In March, the average monthly number of new registrations as employed with Social Security increased by 22,457, standing at 17,594,808. However, once corrected for seasonal factors, this figure drops by almost 30,000 people, a very similar level to the one seen in the last two months. Consequently, in spite of March's year-on-year rate slowing up its decline to 2.6%, compared with 6.5% recorded in the same month of 2009, the deterioration in the job market is still continuing.

By sector, only services generated employment in March, up by 54,272

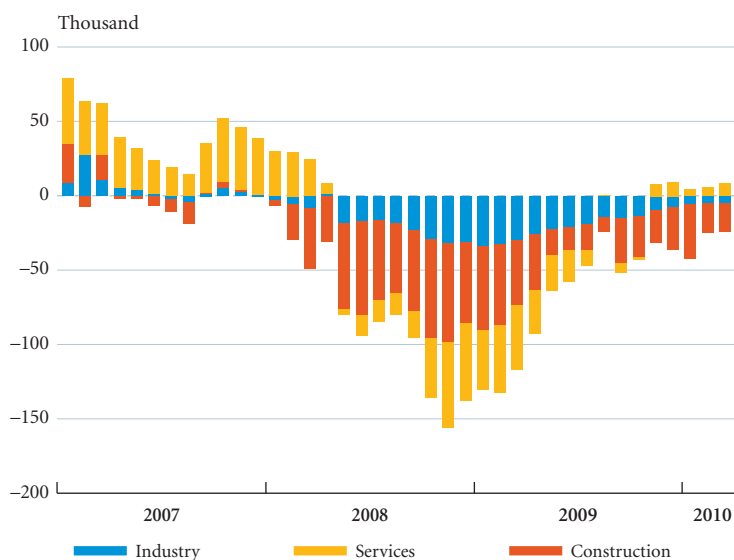
jobs. However, this rise is significantly lower when we take into account the fact that this month includes the Easter holiday period. Consequently, once corrected for seasonal factors, those registered as working in the service sector rose by close to 9,000. Overall, it should be noted that only the service sector shows a slight recovery, as it has created jobs over the last five months. On the other hand, both construction and industry have posted a drop in their total number of employed.

By gender, the number of women employed increased by 30,306 in the month of March and the rate of decline stood at 0.7% year-on-year, close to

**Job losses are coming to an end in the service industry.**

### ONLY THE SERVICE SECTOR IS CREATING EMPLOYMENT

Monthly change in the number of employed people registered with Social Security



NOTE: Series corrected for seasonal factors.

SOURCES: Ministry of Labour and Social Affairs and own calculations.

## EMPLOYMENT INDICATORS

Percentage rate of change over same period year before

	2008	2009	2009				2010		
			1Q	2Q	3Q	4Q	January	February	March
Persons registered with Social Security (1)									
Sectors of activity									
Industry	-2.1	-10.6	-9.3	-11.5	-11.5	-10.0	-8.2	-7.2	-6.3
Construction	-10.3	-23.1	-25.2	-25.4	-22.0	-18.9	-17.6	-16.2	-15.4
Services	1.7	-2.6	-2.1	-3.1	-3.0	-2.1	-1.2	-0.8	-0.4
Job situation									
Wage-earners	-0.7	-6.0	-6.3	-7.0	-6.2	-4.6	-3.3	-2.8	-2.3
Non-wage-earners	0.4	-4.8	-3.9	-5.0	-5.3	-4.9	-4.3	-4.0	-3.6
Total	-0.5	-5.8	-5.9	-6.7	-6.0	-4.6	-3.5	-3.0	-2.6
Persons employed (2)	-0.5	-6.8	-6.4	-7.2	-7.3	-6.1	-	-	-
Jobs (3)	-0.6	-6.7	-6.3	-7.2	-7.2	-6.1	-	-	-
Hiring contracts registered (4)									
Permanent	-14.3	-31.0	-35.4	-35.3	-28.6	-22.5	-20.6	-12.5	-2.7
Temporary	-10.4	-13.5	-23.9	-17.8	-9.4	-2.1	-5.1	2.9	14.0
Total	-10.9	-15.5	-25.4	-19.9	-11.4	-4.3	-6.7	1.1	12.1

NOTES: (1) Average monthly figures.

(2) Estimate by Labour Force Survey.

(3) Equivalent to full-time work. National Accounting estimate; data adjusted for seasons and public holidays.

(4) At the Spanish Employment Institute (INEM).

SOURCES: National Institute of Statistics, Ministry of Labour and Social Services, Public State Employment Service and own calculations.

### Only temporary contracts grow, in line with the dual employment model.

positive figures. Men registered as employed fell by 7,849 compared with last month, slowing up the decline in the year-on-year rate to 4.0%.

However, it should also be noted that, for the first time in almost two years, self-employment remained stable in March and moderated its year-on-year drop to 3.6%. For their part, the total number of salaried workers increased by 22,000 this month, with the annual fall standing at 2.3%, lower than the 2.8% recorded the previous month.

In March, the number of contracts recorded increased by 12.1% year-on-year, a higher rate than the 1.1% increase of February. This rise points to a certain deceleration in the intensity of the recession. However, it should be noted

that only temporary contracts saw a rise, namely 14.0% year-on-year. For their part, permanent contracts continued to fall, although substantially more moderately, down 2.7% in March after their 12.5% annual fall in February.

The disparity of the trends in both contract types is in line with the dual contract model typical of the Spanish labour market. This is actually emphasized in the International Monetary Fund's report on the World Economic Outlook, of April 2010. In particular, it warns of the negative effect of a dual contract system on unemployment and training, recommending a single contract with a scaled severance pay. Within this context, in its document «Social Dialogue on actions in the labour market» of 12 April

2010, the government recognises the need to reduce this dualism and the temporary nature of the job market.

### **The rise in unemployment continues to slacken**

As expected, the number of unemployed registered with the state employment service continued to grow in the month of March, almost 36,000 more people and totalling 4,166,613. Consequently, the year-on-year rate of change stood at 15.6% in March, lower than the 18.6% posted the previous month. Seasonally adjusted, the rise in unemployment was greater, around 55,000 people, and this suggests that the number of unemployed has yet to reach its peak. These data show a certain slowdown in the pace of improvement in the labour market.

By sector, unemployment increased in all industries except construction, which saw a slight drop of 1,103 people. The sector with the highest increase in unemployment was for those with no previous job, 16,761 more people registered, although this group only accounts for 7.8% of all unemployed.

By gender, the number of unemployed has grown more among women in the last month. Although the start of the recession was marked by greater job losses among men, in the last few months female workers have seen relatively higher rises in unemployment. This has placed the annual growth rates in unemployment for men and women on an equal footing, namely 16.1% and 15.1%, respectively.

On the other hand, unemployment has generally increased in almost all autonomous communities, led by Catalonia and the Community of Valencia. Of note is the fall in the number of unemployed in the Balearic Islands, thanks to the seasonal effect of the Easter holidays.

For its part, of note was the rise in the number of foreigners registered with the state employment service. Registered foreign unemployed workers rose by 24.1% in the last twelve months up to March, compared with 14.2% year-on-year for Spanish nationals. Accordingly, the number of foreign people unemployed now accounts for 14.8% of the total. Given this situation, the government, through the Department of Integration for Immigrants, approved in March a new regulation of aid to economically reward foreign citizens who voluntarily decide to leave Spain.

Lastly, it should also be noted that the rise in registered unemployment has been comparable to the increase in the number of people receiving unemployment benefit. Not only has the rate of cover not fallen since the recession started but it has actually increased. In February 2007 the rate of cover was 68.5%, whereas it was 77.5% in February 2010. The rise in the number of people receiving benefit has led to a 10.9% increase in this item of expenditure in the last twelve months, totalling 2,894 million euros in February.

**The government recognises the need to reduce the dualism in the labour market.**

**Registered unemployment reaches 4.2 million in March.**

**Foreigners account for 14.8% of all unemployment.**

## REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

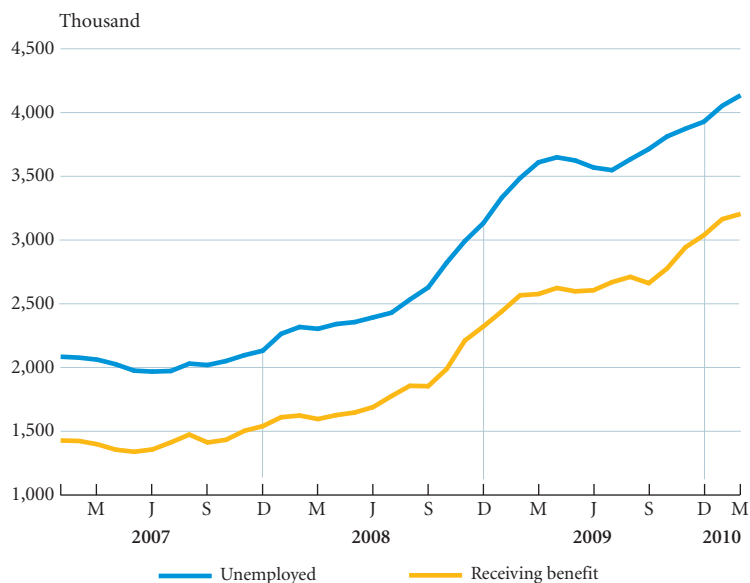
March 2010

	No. of unemployed	Change over December 2009		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	120,679	14,546	13.7	26,964	28.8	2.9
Industry	525,886	17,084	3.4	36,991	7.6	12.6
Construction	797,572	15,848	2.0	74,225	10.3	19.1
Services	2,398,741	157,676	7.0	323,706	15.6	57.6
First job	323,735	37,856	13.2	99,325	44.3	7.8
By sex						
Males	2,113,565	101,029	5.0	292,415	16.1	50.7
Females	2,053,048	141,981	7.4	268,796	15.1	49.3
By age						
Under 25 years	483,040	36,271	8.1	40,537	9.2	11.6
All other ages	3,683,573	206,739	5.9	520,674	16.5	88.4
TOTAL	4,166,613	243,010	6.2	561,211	15.6	100.0

SOURCES: Public State Employment Service and own calculations.

## THOSE RECEIVING BENEFIT FOLLOW RISING UNEMPLOYMENT

Registered unemployed and people receiving benefit



SOURCES: Public Employment Offices and own calculations.

## Prices

### Inflation rises to 1.4% in March

The general consumer price index (CPI) rose to 1.4% in March relative to twelve months before, 0.6 points more than in February, a little more than expected. This notable increase was due particularly to energy products, as a result of the trend in oil prices. Overall, inflation is at a very low level, although it is 1.5 points higher than in March 2009, when it was negative in the midst of recession.

Half the increase in inflation in March can be put down to fuel and oil, whose prices continued to rise, up by 24.0% year-on-year. Fuels contributed 0.05

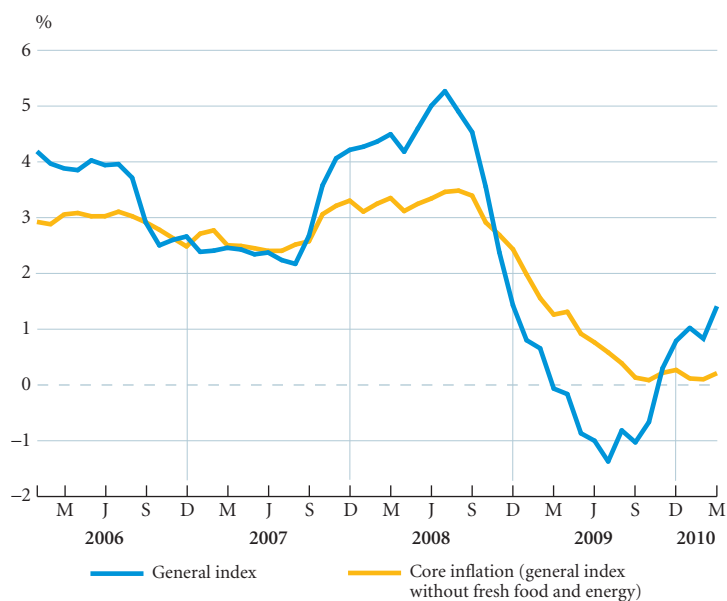
points to the rise in inflation and the other volatile component, fresh foods, contributed a further 0.10 points. Fresh food prices actually rose 0.4 points during the month, although their year-on-year rate of change was still negative, namely -2.2%, but 1.6 points more than one month earlier. There were notable upswings in the prices of fresh fish and chicken.

March's rise in inflation does not suppose any substantial change in price trends. The most stable core of inflation, also known as underlying inflation, which excludes energy products and unprocessed foods, was just 0.2% year-on-year. Although it rose 0.10 points, this

**The rate of inflation rises 0.6 points in March due to energy products and unprocessed foods.**

### THE GAP WIDENS BETWEEN GENERAL AND CORE INFLATION

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

## CONSUMER PRICE INDEX

	2009			2010		
	% monthly change	% change over December 2008	% annual change	% monthly change	% change over December 2009	% annual change
January	-1.2	-1.2	0.8	-1.0	-1.0	1.0
February	0.0	-1.2	0.7	-0.2	-1.2	0.8
March	0.2	-1.1	-0.1	0.7	-0.5	1.4
April	1.0	-0.1	-0.2			
May	0.0	-0.1	-0.9			
June	0.4	0.3	-1.0			
July	-0.9	-0.5	-1.4			
August	0.3	-0.2	-0.8			
September	-0.2	-0.4	-1.0			
October	0.7	0.3	-0.7			
November	0.5	0.8	0.3			
December	0.0	0.8	0.8			

SOURCE: National Institute of Statistics.

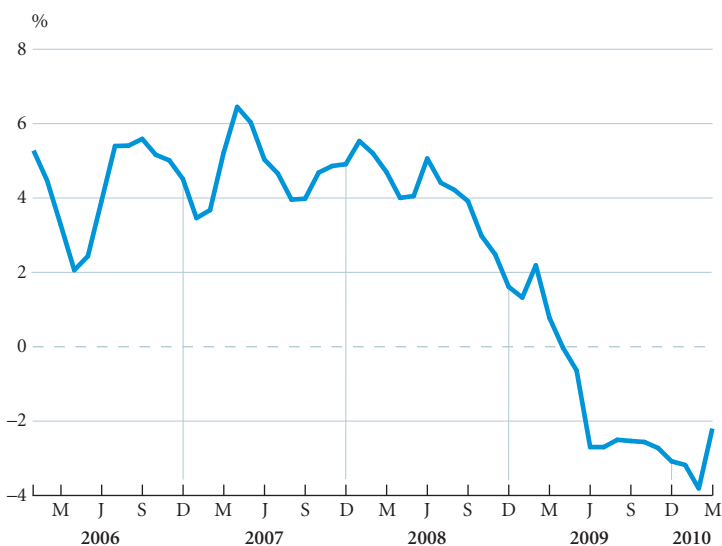
**Core inflation is up 0.10 points to 0.2% due to the effect of Easter...**

increase can be put down almost entirely to package travel, whose prices rose mostly because of Easter being earlier this year than in 2009.

In effect, non-energy industrial goods kept their year-on-year drop at 1.5% within a context of strong competition in international markets. For its part, the

## UPSWING IN FRESH FOODS

Year-on-year change in the price index for unprocessed food



SOURCE: National Institute of Statistics.



annual rate of change of processed food rose very slightly to 0.6%.

Services picked up after being at their lowest level for the last few decades, rising by 0.2 points to 1.3% year-on-year. However, this upswing does not seem to be driven by demand but can be explained by the rise in packaged travel, due to Easter being at a different position in the calendar. In fact, the annual rate

for restaurants, bars and cafeterias continued to fall, standing at 1.0%, the lowest since August 1986.

The rate of inflation for the harmonised consumer price index with the European Union stood at 1.5%, also 0.6 points above the rate for February. The differential with the euro area therefore changed direction again, with 1.4% inflation in the euro area, very slightly in positive terrain. However,

**...but is still lower than the figure for the euro area.**

## CONSUMER PRICE INDEX BY COMPONENT GROUP

March

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2009	2010	2009	2010	2009	2010
By type of spending							
Food and non-alcoholic beverages	107.2	−0.7	0.0	−1.1	−0.8	0.6	−2.1
Alcoholic beverages and tobacco	129.7	0.1	0.0	3.5	2.9	4.1	12.1
Clothing and footwear	94.7	3.4	3.6	−12.2	−12.3	−1.8	−1.0
Housing	114.0	0.0	0.4	0.9	1.3	4.0	1.2
Furnishings and household equipment	106.8	0.3	0.3	−0.2	−0.6	2.0	0.4
Health	97.7	−0.1	−0.1	0.2	0.1	0.9	−1.4
Transport	106.8	−0.5	1.7	−0.7	3.4	−8.2	8.1
Communications	99.2	0.0	0.0	0.1	−0.1	−0.5	−0.5
Recreation and culture	97.6	0.2	1.2	−1.0	−1.0	−0.8	−1.0
Education	114.5	0.1	0.0	0.2	0.1	4.0	2.6
Restaurants and hotels	112.3	0.2	0.2	0.6	0.4	2.4	1.0
Other goods and services	111.3	0.3	0.4	1.5	1.3	3.0	1.9
By group							
Processed food, beverages and tobacco	111.7	−0.2	−0.1	0.0	−0.1	1.2	0.6
Unprocessed food	105.9	−1.3	0.4	−1.7	−0.8	0.8	−2.2
Non-food products	106.3	0.4	0.9	−1.2	−0.5	−0.4	1.9
Industrial goods	101.7	0.5	1.4	−3.1	−1.5	−3.4	2.4
Energy products	113.0	−1.1	2.5	−0.6	5.3	−11.6	13.9
Fuels and oils	109.2	−1.4	3.4	−2.0	6.7	−18.4	17.4
Industrial goods excluding energy products	97.6	1.0	1.1	−4.0	−3.8	−0.6	−1.5
Services	111.3	0.3	0.4	0.8	0.5	2.7	1.3
Underlying inflation (**)	106.5	0.4	0.5	−1.1	−1.1	1.3	0.2
GENERAL INDEX	107.3	0.2	0.7	−1.1	−0.5	−0.1	1.4

NOTES: (\*) Base 2006 = 100.

(\*\*) General index excluding energy products and unprocessed food.

SOURCE: National Institute of Statistics.

### Weak consumption will tend to contain prices.

the core inflation differential continued to be favourable to Spain by more than half a point. This difference is basically due to the large rise in fuels because of oil prices and their greater weight in the Spanish basket of goods.

In April inflation will probably be around its current rate. Although the planned rise by 2 points in the general value added tax (VAT) from 16% to 18% and in the reduced rate from 7% to 8% in July will noticeably impact inflation, weak consumption will tend to contain prices. Consequently, year-end inflation will probably be close to the European Central Bank's target, which has set the limit at 2%.

### Raw materials are behind the rise in wholesale prices.

### Wholesale prices continue their upswing

Industrial prices continued to rise in the month of February, basically driven by the increase in raw materials over the last few months. Consequently, the general index for producer prices rose 1.1% in the last twelve months up to February, 0.2 points more than in January. This boost came particularly from intermediate goods, such as chemical products, and from energy products, recording a 6.8% year-on-year rise, 0.5 points more than in January. The increase was even higher in import prices, helped by the euro's depreciation, and the general price index for imports rose 4.7% in February compared with the same month last year.

## INFLATION INDICATORS

Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflator (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods (**)	
2008											
December	-10.3	0.4	1.6	2.3	1.0	-3.4	-3.9	2.6	1.6	2.0	-
2009											
January	-7.2	-0.5	0.9	1.9	-1.6	-2.2	-4.9	2.8	2.0	0.4	-
February	-5.4	-1.1	0.4	1.6	-3.2	-1.9	-5.6	3.0	2.6	-1.2	1.5
March	-7.1	-2.5	-0.4	1.3	-4.3	-5.0	-6.9	2.6	3.1	-2.7	-
April	-7.7	-3.4	-0.8	1.2	-5.5	-6.8	-7.4	2.5	3.1	-3.7	-
May	-15.1	-4.4	-1.1	1.1	-6.3	-9.8	-9.9	1.8	2.5	-5.5	0.2
June	-17.2	-4.9	-1.3	0.9	-6.9	-10.1	-10.8	1.3	2.4	-6.0	-
July	-17.9	-6.7	-1.3	0.5	-7.8	-16.0	-11.4	2.0	2.3	-7.1	-
August	-14.8	-5.5	-0.9	0.3	-7.7	-11.5	-9.8	0.6	2.1	-7.4	-0.6
September	-14.0	-5.4	-0.7	0.4	-7.6	-11.5	-9.2	-0.5	1.7	-7.6	-
October	-12.2	-4.3	-0.7	0.2	-6.3	-8.4	-7.2	-2.1	1.0	-6.7	-
November	-9.3	-1.8	-0.6	0.2	-4.6	-0.7	-3.1	-3.1	0.5	-5.4	-0.2
December	-5.5	0.4	-0.5	0.1	-2.7	6.3	1.9	-1.1	0.8	-1.9	-
2010											
January	...	0.9	-0.5	-0.3	-0.9	6.3	3.4	-0.9	0.2	0.2	-
February	...	1.1	-0.7	0.0	-0.4	6.8	4.7	-0.4	-0.2	1.4	...

NOTES: (\*) Seasonal and calendar effects adjusted data.

(\*\*) Except energy.

SOURCES: National Institute of Statistics, Ministry of Economy and own calculations.

## Foreign sector

### The trade deficit starts to adjust again

After eighteen months of falls in succession, January's trade deficit rose 0.4% year-on-year, suggesting that there might be a change in trend in its adjustment. However, February's figures have momentarily wiped out this suspicion with another reduction in the deficit of 39.3% compared with the same month in 2009. An analysis of the accumulated data for the last twelve months, which removes any monthly volatility, placed February's deficit at 47,888 million euros, 45.1% lower than the same period last year.

This reduction, however, was not homogeneous across the different components in the balance of trade. As can be seen in the graph, since June 2009 the energy component has accounted for most of the trade deficit (close to 60%), with a much slighter rate of adjustment than the rest of the products. The shape of this series shows the evident influence of oil prices on the total energy deficit. Consequently, the continued rise in the cost of crude represents a significant brake on future corrections in the trade deficit, reducing its rate of adjustment.

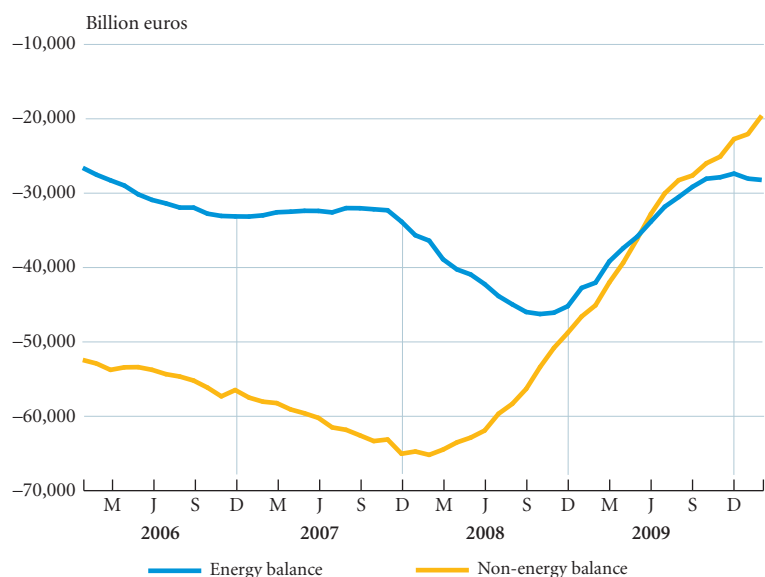
With regard to trade flows as a whole, an analysis of their behaviour over the last

**Trade deficit lessens by 39% in February.**

**The reduction in the energy deficit slows up.**

### THE ENERGY COMPONENT IS BEHIND MOST OF THE TRADE DEFICIT

Accumulated balance of trade over the last twelve months



SOURCES: Ministry of the Economy and own calculations.

## FOREIGN TRADE

January-February 2010

	Imports			Exports			Balance	Export/ Import rate (%)
	Million euros	% annual change by value	% share	Million euros	% annual change by value	% share	Million euros	
By product group								
Energy products	6,291	11.2	18.4	878	−19.9	3.4	−5,413	14.0
Consumer goods	8,645	−23.6	25.3	9,875	3.6	37.9	1,230	114.2
Food	2,030	−8.4	5.9	3,740	2.2	14.3	1,710	184.2
Non-foods	6,615	−27.3	19.4	6,135	4.5	23.5	−480	92.8
Capital goods	2,501	−7.8	7.3	2,099	3.0	8.0	−402	83.9
Non-energy intermediate goods	16,713	17.9	48.9	13,227	22.1	50.7	−3,487	79.1
By geographical area								
European Union	19,089	−1.4	55.9	18,206	10.3	69.8	−882	95.4
Euro area	15,338	−7.1	44.9	15,031	10.1	57.6	−306	98.0
Other countries	15,061	3.8	44.1	7,872	12.7	30.2	−7,189	52.3
Russia	880	33.0	2.6	203	−5.1	0.8	−677	23.1
United States	1,289	−23.0	3.8	801	−14.2	3.1	−488	62.2
Japan	561	19.3	1.6	217	21.1	0.8	−344	38.7
Latin America	1,627	4.5	4.8	1,232	11.9	4.7	−395	75.7
OPEC	3,294	17.7	9.6	816	−16.5	3.1	−2,478	24.8
Rest	7,410	0.9	21.7	4,602	28.5	17.6	−2,808	62.1
TOTAL	34,149	0.9	100.0	26,078	11.0	100.0	−8,071	76.4

SOURCES: Ministry of the Economy and own calculations.

### Demand increases from the main trading partners.

few months reveals significant differences. The correction in the trade imbalance during first two months of the year occurred within a context of growing international trade. The value of exports increased by 11.0% compared with the same period in 2009, while imports were up 0.9%. The squeeze in prices in January and February led to even higher growth in trade volumes, with rises of 13.6% and 2.0% respectively.

A breakdown by geographical area shows that this significant upswing in Spanish exports was mainly due to the European and Asian markets. Of note is the rise in sales of Spanish products to France and Italy, 14.6% and 17.1%

respectively, during the first two months of the year.

On the other hand, exports to China rose by 44.1% in the same period. The recovery of Spain's main trading partners, the depreciation of the euro and the low starting level of exports after the decline in 2009 all suggest that this trend will continue over the coming months.

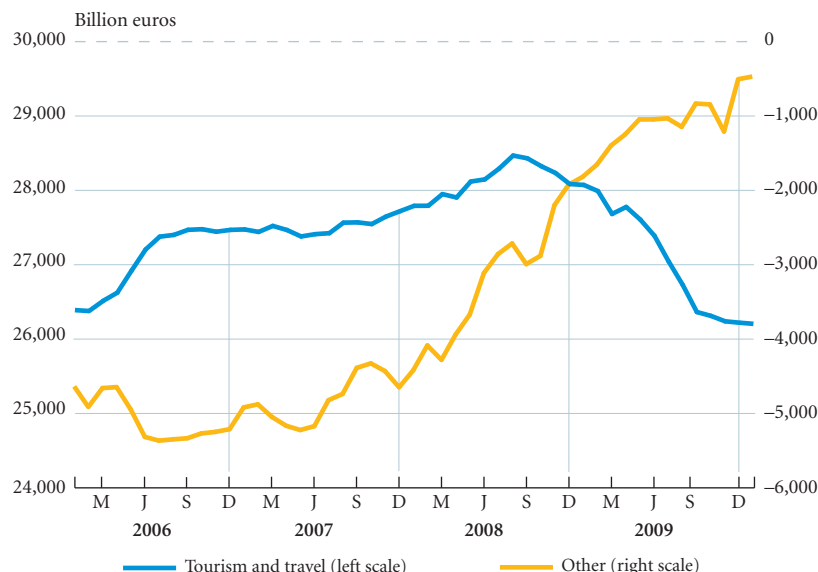
### The current deficit rises 6% in January.

### The current deficit slows up its decline

The latest data available for current accounts show, in January, a 6.0% year-on-year increase in the deficit, the first

## THE SERVICE SURPLUS SHOWS SIGNS OF RECOVERING

Accumulated balance over the last twelve months



SOURCE: Bank of Spain and own calculations.

in the last ten months. The rise in the trade deficit mentioned above and the enlargement of the current transfer deficit by 1,287 million euros were the main reasons behind this decline. This could not be offset by the further reduction in the income deficit or the slight increase in the service surplus.

In the case of the services balance, as can be seen in the graph, the fall in the tourism surplus shows signs of easing after a year of continual reductions. These were partially offset by the improvement in other services, whose deficit was reduced. This suggests that the slump in the services surplus is coming to an end, due to the significant reduction in foreign payments.

The higher deficit in January led to a slight increase in the current account deficit accumulated since February 2009,

which reached 57,520 million euros, 42.3% lower than the same period a year ago. However, the higher surplus in the capital account for January led to a 44.8% fall in financing needs in the same period.

With regard to financial flows, the main sources of foreign funds over the last twelve months were direct and portfolio investment. Both account for a net inflow of 50,633 million euros in this period, compared with the outflows recorded a year ago of 5,893 million euros. Direct investment is particularly significant since, due to the divestments carried out over the last year, it put an end to six years of net outflows to other countries. Meanwhile, short-term financing fell overall, with a net outflow of 3,686 million euros in the last twelve months, the first for more than two years.

**Financing needs fall in February.**

**The main sources of inflows are direct and portfolio investment.**

## BALANCE OF PAYMENTS

January 2010

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	-4,133	1.3	-45,090	36,878	-45.0
Services					
<i>Tourism</i>	1,616	-0.9	26,185	-1,869	-6.7
<i>Other services</i>	-112	-23.9	-468	1,349	-74.3
Total	1,504	1.3	25,717	-520	-2.0
Income	-2,196	-30.3	-28,889	6,610	-18.6
Transfers	-1,701	310.3	-9,258	-769	9.1
Total	-6,526	6.0	-57,520	42,199	-42.3
Capital account	1,295	273.0	5,016	434	9.5
Financial balance					
Direct investment	2,776	-	6,583	23,191	-
Portfolio investment	8,870	-4.9	44,050	37,303	-
Other investment	-2,751	-	-3,686	-80,895	-
Total	8,895	-2.2	46,947	-20,400	-30.3
Errors and omissions	-345	-13.9	-3,818	1,260	-24.8
Change in assets of Bank of Spain	-3,319	15.1	10,029	-21,235	-67.9

NOTE: The figure resulting from the sum of current account balance, capital account balance and financial balance is compensated by the change in assets of Bank of Spain plus errors and omissions.

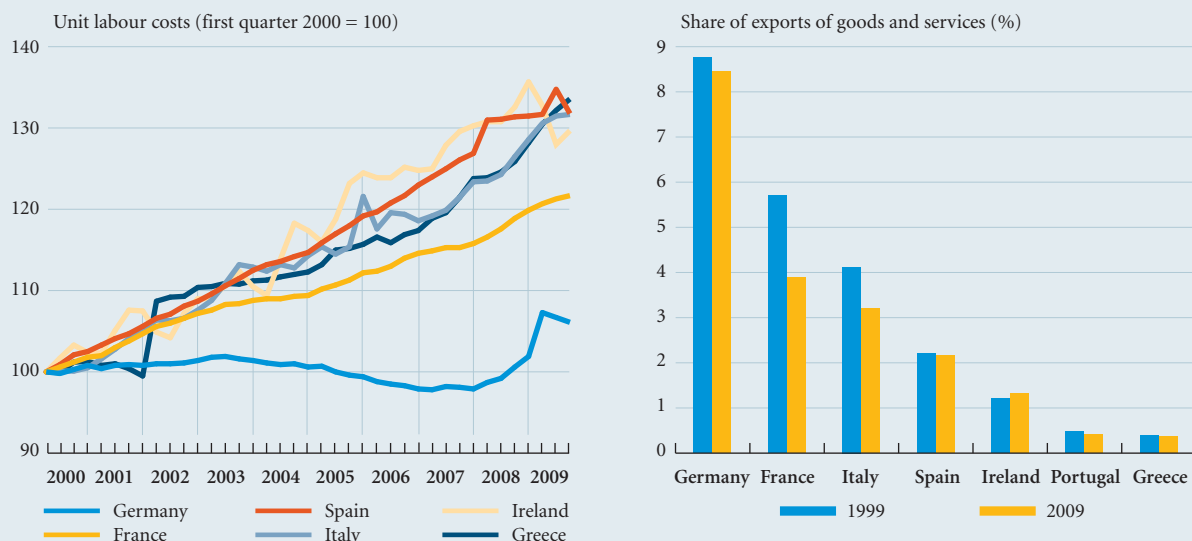
SOURCES: Bank of Spain and own calculations.

## External imbalances within the euro area

The rise in global current account imbalances throughout most of this century's first decade has been at the centre of a heated debate. Although the euro area as a whole remained close to balance, some countries in the area have also been involved in this phenomenon. So while Germany posted positive balances higher than 5% of GDP for several years, four countries (Ireland, Spain, Portugal and Greece) reached deficits above 5% of GDP. Two hypotheses have been proposed as the reason for these imbalances: the loss of price competitiveness in countries that have suffered the greatest declines in current account terms, and the strong growth in domestic demand in countries with a deficit, caused mostly by real interest rates being too low.

Invariably, the loss of price competitiveness has been postulated as one of the determining factors of the imbalances within the area. Unit labour costs (ULC), an indicator of price competitiveness, have grown at a higher rate in the Mediterranean countries and Ireland than in other euro area countries. Specifically, while ULC rose by 6% in Germany in the last decade, this increase was 5 times greater in those countries with the highest deficits (see graph below). An indicator based on the CPI in the different countries paints a very similar picture, reflecting the significant differences between countries in their levels of inflation. It's very likely that this slump in price competitiveness has made it difficult for exports to grow and has stimulated imports.

## COUNTRIES WITH THE GREATEST PRICE COMPETITIVENESS LOSSES HAVE NOT SUFFERED THE HIGHEST DECLINES IN EXPORT SHARE



SOURCES: OECD, WTO and own calculations.

However, in spite of deficit countries losing price competitiveness, the changes in their export shares offers a new perspective in price competitiveness losses. Ireland, for example, is one of the countries whose price competitiveness indicators declined, but it is also the only country in the euro area to improve its share of exports during the first decade (in its case because a rise in domestic prices was accompanied by significant improvements in productivity in its export sector). For its part, Spain's loss of share was not very different from that of Germany (see graph above). In short, a loss of competitiveness surely explains part of the current account declines but not completely, and not to the same extent for all countries.

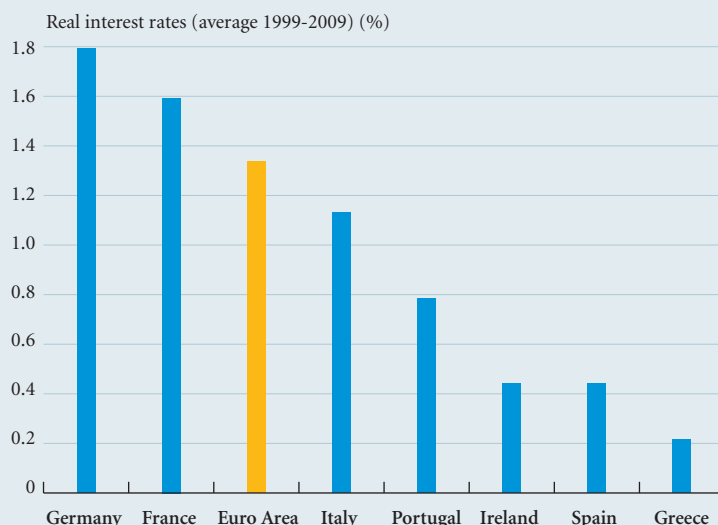
One clearly common factor in all countries with soaring deficits was the strength of domestic demand. Germany, on the other hand, stood out precisely for the opposite. Several studies point to low real interest rates as the cause of strong domestic demand, although fiscal and idiosyncratic factors may have also been relevant to a certain extent.<sup>(1)</sup>

The process of convergence prior to introducing the euro led to a notable reduction in nominal and real interest rates in those countries that went on to have large deficits. Similarly, after the euro area was formed, inflation differentials meant that real interest rates were highly heterogeneous in the different countries (see graph below). The higher the inflation, the more likely a loss in competitiveness and also the more likely that the low real interest rate would boost domestic demand. Low interest rates encouraged demand through various channels: directly, by stimulating consumption and investment in detriment to savings. Cheaper money might also have encouraged the formation of real estate bubbles and attracted significant flows of investment in this sector. The revaluation of house prices also helped, through the so-called «wealth effect», to boost consumption and reduce savings. Within a context of strong growth in domestic demand, the inflation

(1) Charles Wyplosz, «Ten Years of EMU: Successes and Puzzles», *Working paper* presented at the «Conferencia 10º Aniversario del Ingreso de España en la UEM» held in February 2009 at the Bank of Spain.



## THE SAME NOMINAL RATE, DIFFERENT REAL RATES



NOTE: The real interest rate has been calculated by subtracting average annual inflation from the annual average for the 12-month Euribor rate.

SOURCES: Thomson Reuters Datastream and own calculations.

differentials existing at the time the Union was formed, far from being corrected, continued and even increased throughout the first decade of the century.

A second possible cause of vigorous domestic demand might have been expansionary fiscal policy. This does not seem to have been the case of Ireland or Spain, which posted fiscal surpluses, although some argue that the structural surplus generated during these years was not enough. The experience of Greece, however, fits better with this hypothesis, as it repeatedly incurred fiscal deficits in spite of its high rates of economic growth. Other idiosyncratic factors, such as the rising population in Spain, might also have contributed to strong domestic demand in certain countries, but these reasons seem to have played a secondary role in comparison with real interest rates.

In short, a certain loss in price competitiveness in deficit economies and, in particular, strong domestic demand seem to explain the increase in current account imbalances within the euro area. Imbalances that, given the fluctuating flows of international funds, constitute a significant macroeconomic risk. How can they be avoided? One of the keys lies in reducing inflation differentials between countries, which requires institutional changes, far-reaching in some cases. Consequently, the same monetary policy would not be too lax in some countries and too restrictive in others, with the risks this entails. Moreover, these institutional changes would lead to improvements in price competitiveness and would allow EMU countries to continue in the system without generating excessive foreign imbalances.

*This box was prepared by Clàudia Canals  
International Unit, "la Caixa" Research Department*

## Public sector

### More effort to reduce the public deficit

According to the latest official figures published, the public deficit stood at 11.2% of gross domestic product (GDP) in 2009. This is 0.2 points lower than the previous rise. However, it is still a record figure and the government is determined, in line with the 2010-2013 Stability and Growth Programme it presented to the European Commission, to reduce this to 3% of GDP by 2013.

Within this context, at the Fiscal and Financial Policy Council on 22 March 2010, the central and autonomous governments approved a Framework Agreement for the sustainability of the

public accounts for 2010-2013.

Autonomous communities undertook to draw up rationalization and efficiency plans for public spending within a period of three months. The agreement includes the commitment to implement a staff cost containment policy, which will result in more limited wages, and a restrictive strategy when preparing job offers for the public sector.

At the meeting of the National Commission for Local Authorities on 7 April, the administration of the central government and the Spanish Federation of Municipalities and Provinces also passed a Framework Agreement for the sustainability of the public accounts for 2010-2013. In this way, the aggregate

**Autonomous communities and local authorities undertake to draw up, within three months, plans to rationalize public spending.**

### CENTRAL GOVERNMENT BUDGETARY IMPLEMENTATION

February 2010

	Month		Cumulative for year	
	Million euros	% change over same month year before	Million euros	% change over same month year before
<b>Non-financial revenue</b>	<b>16,804</b>	<b>-8.1</b>	<b>27,529</b>	<b>-3.9</b>
<b>Non-financial revenue adjusted (*)</b>				
Personal income tax	4,426	0.0	14,797	-0.3
Corporate tax	846	7.0	1,238	-7.8
VAT	12,354	-7.3	12,838	-8.9
Special taxes	1,602	9.4	3,277	1.7
Other	1,551	-48.9	3,329	-28.7
<b>Total</b>	<b>20,779</b>	<b>-9.8</b>	<b>35,479</b>	<b>-7.1</b>
<b>Non-financial spending</b>	<b>20,973</b>	<b>31.1</b>	<b>35,288</b>	<b>22.8</b>
<b>Treasury balance</b>	<b>-4,169</b>	<b>-</b>	<b>-7,759</b>	<b>-</b>
<b>Surplus (+) or deficit (-) (**)</b>	<b>3,983</b>	<b>-8.5</b>	<b>3,277</b>	<b>-35.4</b>

NOTES: (\*) Includes tax segments ceded to regional and local governments under current financing system.

(\*\*) On a national accounts basis.

SOURCES: Ministry of Economy and Finance and own calculations.

**The partial withdrawal of the 400-euro deduction helps to stabilize revenue from personal income tax.**

**Tax hikes for tobacco and hydrocarbons in June 2009 lead to a rise in revenue from special taxes.**

**The extraordinary infrastructure Plan will not affect public accounts until 2014.**

local authority deficit will go from the figure of 0.5% of GDP recorded in 2009 to the 0.2% forecast for 2013.

With regard to the trends this year, data for the central government up to February show that the weak economic situation overall continues to have a negative effect, although it's true that results from the first two months are not representative of a general trend. Up to February, accumulated non-financial income for the central government, before assignments to territorial governments according to the current financing system, totalled 35,479 million euros, representing a drop of 7.1% compared with the same period the previous year. However, this decrease falls to 5.8% when it is adjusted for time differences in tax returns.

Revenue from personal income tax fell 0.3% year-on-year in the first two months. Employment withholdings recorded an annual rise of 1.5%, helped by the partial withdrawal of the deduction of up to 400 euros. For its part, corporate tax fell 7.8%.

Value added tax (VAT) fell 8.9% compared with the same period a year ago, affected by the impact of extending the entitlement to monthly refunds, not in effect during the first few months of last year. However, special taxes rose 1.7% thanks mostly to tobacco which, in turn, reflects the tax hike in effect as from June 2009. However, we should also remember that the general tax rate and the reduced VAT rate are expected to rise in July the latter affecting new housing. On the other hand, in the package of

economic measures of 9 April, it was decided to apply a reduced VAT rate for all kinds of renovation and repair work on homes up to 31 December 2012 in order to boost home improvements. Similarly, an extra low VAT rate was established of 4% for dependent care services.

On the other side of the balance sheet, non-financial payments by the central government totalled 35,288 million euros in the period January-February 2010. This figure represents an annual rise of 22.8%. Although all expenditure items rose compared with the first two months of 2009, of note is the 26.3% increase in current transfers, accounting for almost half the budget.

The expansion in capital payments was considerable, namely 11.4%, although less than in current transfers. It should be noted that, in an effort not to compromise budget stability, the extraordinary infrastructure Plan presented on 7 April, which includes public tenders totalling 17 billion euros between 2010 and 2011, will not affect the public accounts until 2014.

As a result of the trends in revenue and payments, net lending (on a national accounts basis) totalled 3,277 million euros. However, this was 35.4% lower than the figure for the first two months of 2009.

Lastly, it should also be noted that Spain is involved in the euro area's plan to offer Greece loans to alleviate its public accounts crisis.

## Savings and financing

### The adjustment in private sector debt slows up

Private sector financing posted a year-on-year decrease of 1.0% in February, the same rate as the month before. It therefore seems that the correction of excessive debt, which went from annual growth rates higher than 24% in 2006 to slight falls at the end of 2009, is losing strength. The continued downslide in interest rates for loans, at 3.29% on average in February, 121 basis points below the rate of a year earlier, as well as a certain improvement in demand might

have contributed to easing the decline in financing.

However, financing to non-financial firms fell 1.8% in the last twelve months up to February, 0.3 points more than in January. This difference was due to the slowdown in bonds issued by large firms, posting a year-on-year rise of 29.4%, 3.8 points less than in January, as well as in foreign loans, which rose 1.3%, 0.6 points less than the previous month.

Loans and credit to resident financial institutions kept their rate of year-on-

**The excessive leveraging in the private sector achieved during the cycle's boom phase is being corrected.**

### FINANCING OF NON-FINANCIAL SECTORS (1)

February 2010

	Balance	Change this year	Change over 12 months		% share
	Million euros	Million euros	Million euros	% (2)	
Private sector	2,205,596	-9,382	-12,007	-1.0	79.7
Non-financial corporations	1,304,853	-7,102	-7,904	-1.8	47.2
<i>Resident credit institution loans (3)</i>	908,043	-8,338	-45,365	-4.3	32.8
<i>Securities other than shares</i>	57,815	1,560	13,135	29.4	2.1
<i>External loans</i>	338,995	-324	24,327	1.3	12.3
Households (4)	900,743	-2,280	-4,103	0.1	32.6
<i>Housing loans (3)</i>	678,997	1,090	1,252	0.4	24.5
<i>Other (3)</i>	219,067	-3,413	-5,512	-0.8	7.9
<i>External loans</i>	2,680	43	157	6.2	0.1
General government (5)	560,519	869	110,233	24.5	20.3
<b>TOTAL</b>	<b>2,766,114</b>	<b>-8,513</b>	<b>98,226</b>	<b>3.3</b>	<b>100.0</b>

NOTES: (1) Resident in Spain.

(2) Year-on-year rates of change calculated as effective flow/stock at beginning of period.

(3) Include bank off-balance-sheet securitized loans.

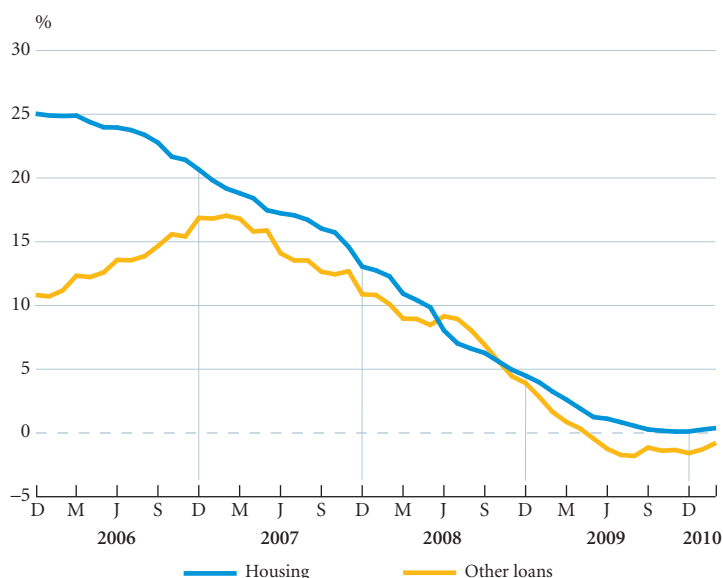
(4) Include those non-profit institutions serving households.

(5) Total liabilities (consolidated). Liabilities among public administrations are deducted.

SOURCES: Bank of Spain and own calculations.

## THE DECLINE IN HOUSEHOLD FINANCING FOR HOUSING SLOWS UP

Year-on-year change in household financing (\*)



NOTE: (\*) Includes not-for-profit institutions serving households.  
SOURCE: Bank of Spain.

### The decline in trade credit slows up.

year decline at 4.3% while trade credit, aimed at financing firms' working capital, continued to ease back on its decrease but presented an annual fall of 22.7%. Finance leases, related to investment, also showed a slight reduction in their annual rate of decline, standing at 15.7%. However, new credit operations to non-financial firms totalled more than 57 billion euros in February.

After six months of posting negative annual variation rates, loans to families recorded a slight rise year-on-year in February of 0.1%. This small increase was particularly due to housing, whose loans rose 0.4% compared with the same month the year before, 0.3 points more than in December. The record lows for the one-year Euribor, to which most mortgage loans are indexed, contributed to this turning point. In March, the 12-month Euribor posted a new record

by falling to 1.215% as a monthly average, one basis point less than its record low in February. In the first few weeks of April, the one-year Euribor has fluctuated close to its minimum level.

The rest of loans to individuals continued to fall, although the pace of decline eased up. Consequently, their balance fell by 0.8% compared with twelve months before, half a point less than the month before.

On the other hand, non-performing loans, whose trends usually follow after those of the economic cycle, continued to rise slightly in the month of February. They therefore stood at 5.4% at the end of the month, 0.1 points more than in January and 1.2 points more than in February 2009.

Public sector financing has slowed up considerably in the last few months,

### The 12-month Euribor sets a new record low.

although it continues to advance at a strong pace. In February, its balance grew by 24.5% compared with the same month the year before, but 10.7 points less than in October 2009.

In February, the monthly change in public debt, totalling 5,845 million euros, was mostly due to medium and long term net issues of 7,852 million euros, while the balance of bonds and Treasury bills rose 23.5% since February 2009.

In fact, in the last few months the differential for Spanish sovereign bonds compared with German debt for the same period has stabilized around 75 basis points, which is even a little lower than the level a year ago, in spite of the nasty surprises caused by the crisis in Greek finances.

Consequently, financing for resident sectors as a whole continued to slow up, with total financing showing 3.3% year-on-year growth in February.

Within this context, part of the package of political and economic measures approved by the government on 9 April to boost growth and employment included new direct loans that can be granted by the Official Credit Institute (ICO) to SMEs and self-employed workers under market conditions as from the month of June, assuming all the risk, with a maximum of 200,000 euros per client and valid until the end of 2011. Moreover, the reguarantee of mutual guarantee companies was also reinforced through the ICO, which provide financing for SMEs, and the financing will be extended for developing subsidized housing for sale.

## **The gap between credits and deposits narrows**

Returns on bank deposits continued to fall in February to 1.19% on average, in line with the Bank of Spain's figures. This represented a monthly fall of 5 basis points and of 82 compared with twelve months before. However, this return is higher than both the official European Central Bank interest rate, at 1% since May 2009, and inflation.

Within this context, and given the sluggish economy, the balance of bank deposits continued to slow up, achieving 1.0% year-on-year growth in February. Although slight, this increase contrasted with the fall in credits, so that the gap between credits and deposits continued to narrow, another factor of the adjustment underway, which limits dependence on foreign savings.

In general, the fall in growth rates affected all kinds of deposits. However, the annual growth for on demand and savings deposits was in contrast to the drop in term deposits and those in foreign currencies. This was fundamentally due to a greater preference for liquidity, given the economic uncertainties and rising unemployment.

The competition between bank deposits meant that, for the fifth consecutive month, net withdrawals were recorded of mutual fund shares. In March these totalled 1,177 million euros, concentrated in mixed short-term Euro bonds and in the money market. However, fixed return guaranteed funds and global funds accumulated the highest net subscriptions. Overall, and thanks to gains from the good performance of the financial markets, mutual fund assets rose 0.3%,

**The differential for ten-year Spanish government bonds compared with German bonds stabilizes at around 75 basis points.**

**New government measures to boost SME financing.**

**Preference for liquidity boosts savings deposits.**

## BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

February 2010

	Balance	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	259,922	-2,813	-1.1	15,421	6.3	18.6
Savings deposits	206,672	-1,120	-0.5	26,106	14.5	14.8
Term deposits	707,045	-12,966	-1.8	-22,048	-3.0	50.6
Deposits in foreign currency	22,480	465	2.1	-7,261	-24.4	1.6
<b>Total deposits</b>	<b>1,196,118</b>	<b>-16,435</b>	<b>-1.4</b>	<b>12,218</b>	<b>1.0</b>	<b>85.7</b>
<b>Other liabilities (*)</b>	<b>200,368</b>	<b>-12,761</b>	<b>-6.0</b>	<b>-32,488</b>	<b>-14.0</b>	<b>14.3</b>
<b>TOTAL</b>	<b>1,396,486</b>	<b>-29,196</b>	<b>-2.0</b>	<b>-20,270</b>	<b>-1.4</b>	<b>100.0</b>

NOTE: (\*) Aggregate balance according to supervision statements. Includes asset transfers, hybrid financial liabilities, repos and subordinated deposits.

SOURCES: Bank of Spain and own calculations.

### Improvement in the annual return of mutual funds to 6.0%.

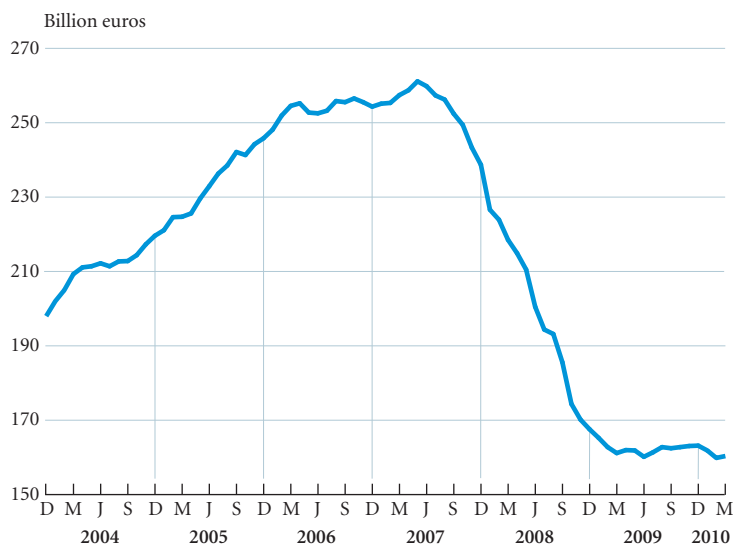
interrupting a negative run of five months.

In spite of the volatility caused by the Greek crisis, the yield for mutual funds improved during the first quarter and ended March at 6.0% annual on average.

All categories posted annual gains with the highest returns coming from equity funds. Of these, those from emerging countries reached 75.5%. At the tail of the ranking, monetary funds posted an average return of 1.0%.

## SLIGHT INCREASE IN MUTUAL FUND ASSETS IN MARCH

Total assets in mutual funds



SOURCE: Inverco.





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**"la Caixa" GROUP: KEY FIGURES**

As of December 31, 2009

FINANCIAL ACTIVITY	Million euros
Total customer funds	237,799
Receivable from customers	178,026
Profit attributable to Group	1,510

STAFF, BRANCHES AND MEANS OF PAYMENT	
Staff	27,505
Branches	5,326
Self-service terminals	7,951
Cards (million)	10.3

COMMUNITY PROJECTS: BUDGET FOR ACTIVITIES IN 2010	Million euros
Social	356
Science and environmental	62
Cultural	55
Educational and research	27
<b>TOTAL BUDGET</b>	<b>500</b>



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