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ECONOMIC & FINANCIAL ENVIRONMENT

DOSSIER: Potential GDP, a crucial but unclear concept

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"la Caixa"

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ECONOMIC AND FINANCIAL MARKET OUTLOOK
May 2013

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EDITORIAL

POTENTIAL GDP, A CRUCIAL BUT UNCLEAR CONCEPT

With this May issue of 2013, the "la Caixa" *Monthly Report* is embarking on a new journey after more than 33 years of uninterrupted presence as a steadfast observatory of the economic situation in Spain and abroad.

In this new phase, the *Monthly Report* (MR) has changed its form and content in an attempt to offer society a better service, in line with the needs of the time in terms of content and the potential of new media in terms of form.

The new MR has enhanced its analysis of the economic environment, each month examining some of the most crucial issues in the Focus sections. Focus articles aim to illustrate and discuss, in some detail, rather more specialized but important subjects that complement the analysis of trends revealed by key economic and financial data and the presentation of the economic outlook.

Our analysis of the overall situation is now more concise. The typography used for the different headings makes it easier to scan these sections while the sidelines, which used to perform this function, are now used to increase the graphic information provided, following the well-known maxim that, on many occasions, a picture is worth a thousand words.

These changes in content are accompanied by a new format for the Report. Its new, more modular structure makes it easier to read isolated sections without sacrificing overall unity.

In the very near future, this new format should also help towards the Report's simultaneous publication on paper and online, making the whole process much faster and more flexible and thereby encouraging use of the online version. In this respect, its modular format is crucial.

The choice of the Dossier's theme is always a decisive factor when producing each *Monthly Report*. For this issue, which is very special, the theme chosen is particularly appropriate and opportune: the concept of potential GDP, the difficulties in measuring this accurately and its impact on the design and execution of economic policies.

On this occasion, this Editorial has run out of space to outline or sum up the main ideas covered by the Dossier. All I can do is recommend you read it. However perhaps, by way of conclusion, it would be worth pointing out two key ideas which the articles have suggested to me.

The first is that, given the huge difficulties created by the economic crisis, it is important not to lose sight of those factors that determine an economy's potential to grow. There is no better way to successfully direct the vital reforms that must be adopted in the short term than by bearing in mind the ultimate objectives of economic and social policy and the key factors that result in a good standard of living and progress in the long term.

The second is that we economists must, once again, be relatively humble. The concept of potential GDP has a huge impact on economic policies, both in determining the room for fiscal and monetary policies to adopt a more expansionary stance as well as in assessing the structural or cyclical nature of budget imbalances.

Unfortunately, as shown by the articles in this Dossier and in spite of the huge effort by several generations of economists, we still only have highly imprecise measures of such an important concept. Consequently, in practical terms the more caution the better and those responsible for the *res publica* would do well to complement their examination of large macroeconomic aggregates (GDP, potential GDP, output gap) with a healthy dose of common sense and first-hand knowledge of the real situation.

Jordi Gual
Chief Economist
30 April 2013

EXECUTIVE SUMMARY

TO COUNTER DOUBTS, MORE MONETARY AND FISCAL AMMUNITION

Doubts regarding global economic growth have reappeared on the scene. The latest indicators for activity have been surprisingly negative, giving grounds to question, once again, the solidity of the pillars supporting the recovery process. Following the pattern of the last few years, economic policy has not been slow to respond. The drip of announcements of new stimulus measures has again become constant over the last few months. Belief that this is only a temporary glitch is based on confidence in the effectiveness of these measures and that the economy will continue to receive support, if necessary.

The Bank of Japan has responded by starting its own monetary revolution: it aims to take the monetary base from 29% to 57% of GDP. The first consequence of this monetary expansion has been the yen's depreciation, accompanied by significant stock market gains. The effects, however, are also being felt beyond the Japanese economy. The drop in yields on European government securities is partly due to the anticipation of easier global monetary conditions.

The ECB and the Fed are still active. For months now, the ECB has been debating whether to lower the official interest rate, a decision that, should it be carried out, will have little impact on the real economy as risk-free short and medium-term interest rates have little room to fall. Much more relevant are the measures being studied, and which must soon be taken, to end the euro area's financial fragmentation, seen particularly in the different credit conditions suffered by SMEs depending on which country they are based in. For its part the Fed is still keeping an eye on the pace at which the US economy is recovering and is prepared, if necessary, to speed up its asset purchase programme.

European fiscal policy is plotting a new course. The USA and Japan had already been implementing a more lax approach since the crisis started but the slowness of the recovery on the old continent has convinced Brussels that it is better to ease fiscal consolidation measures. Spain is the clearest example: the new public deficit target for 2013 has finally been set at 6.3%, 3.3 percentage points higher than the target set by the Stability Programme last year. Moreover, the deadline for bringing the deficit below 3% has been extended to 2016. This is not a unique case. For example, Portugal has also been given 2 more years to lower its deficit to below 3% and France has been given one additional year's margin. To a great extent, the euro area's double dip recession is due to inopportune management of the sovereign debt crisis and slow advances towards European integration. Whether the economic recovery consolidates or not will therefore depend, ultimately, on the progress being made in areas such as banking or fiscal union over the coming months. However, less pressure on public accounts will help to make this process easier to bear.

The emerging economies are prepared to act, if necessary. The listless stock markets of the main emerging countries, the fall in oil prices and in the main commodity indices have raised doubts regarding the sustainability of current growth rates. However, we interpret the recent stock market losses as a one-off that is not only due to weak global growth figures but also to transitory factors such as the squaring up of speculative positions. It is also important to distinguish between the economic situations the different countries are going through. The robust growth presented by China has little to do with the slowdown being suffered by India, Russia and Brazil. In these countries, moreover, inflation is far from under control. However, the main emerging countries have enough room to implement policies to stimulate their economies. In fact, they have already started to apply expansionary measures, combining monetary with fiscal depending on the circumstances. This factor, together with continuing structural reforms and the low level of public and private indebtedness, leads us to believe that the economic revival in the emerging world will not be long in coming.

Implementing the agenda of structural reforms is the major guarantee for long-term growth. In developed countries, the fiscal and monetary measures being applied, are making it easier to digest the adjustments to imbalances generated over the last decade. However, a more or less easy monetary or fiscal policy does not guarantee a good growth rate in the long term. The stimuli announced so far, and the commitment to continue taking action if necessary, are providing a window that must be used to carry out an ambitious agenda of structural reforms. We trust it will be implemented.

Chronology

NOVEMBER 2012

26 The Eurogroup agrees to release 43.7 billion euros of **aid for Greece** and takes measures to guarantee the sustainability of its debt by improving conditions for loans and buying back bonds.

DECEMBER 2012

13 The **Asset Management Company for Assets Resulting from Bank Restructuring (Sareb)** widens its capital with a majority contribution from private shareholders.
The European Council approves the creation of the **Single Supervisory Mechanism** for the banking sector.

JANUARY 2013

25 The government approves the Market Unity Guarantee Bill, establishing a **single licence** to trade in goods and services throughout Spain.

FEBRUARY 2013

22 The government approves a Decree-Law with measures to **support entrepreneurs and boost growth and job creation**. The Decree-Law includes measures to increase competition in the hydrocarbon and railway sectors.

MARCH 2013

25 The Eurogroup and the Cypriot government establish the **bailout agreement for Cyprus**. The troika will provide a maximum of 10 billion euros. Moreover, shareholders, bank deposits over 100,000 euros and bond holders will meet part of the recapitalisation costs.

APRIL 2013

19 The government approves the **reform of the mortgage act**, amending the procedure for mortgage foreclosures.
26 The government presents the 2013-2016 Stability Programme, with a **more relaxed fiscal consolidation path**.

Agenda

MAY 2013

1 Fed Open Market Committee.
2 Governing Council of the European Central Bank.
6 Registration with Social Security and registered unemployment (April).
9 Industrial production index (March).
14 CPI (April).
16 EU HICP (April).
20 International trade (March).
24 Producer prices (April).
28 Government revenue and expenditure (April).
30 CPI flash estimate (May).
Quarterly National Accounts (first quarter).
31 Balance of payments (March).

JUNE 2013

4 Registration with Social Security and registered unemployment (May).
6 Governing Council of the European Central Bank.
7 Industrial production index (April).
10 Labour costs (first quarter).
12 CPI (May).
14 EU HICP (May).
19 International trade (April).
Fed Open Market Committee.
25 Producer prices (May).
27 CPI flash estimate (June).
28 Balance of payments (April).
Government revenue and expenditure (May).

FORECASTS

Year-on-year change (%), unless otherwise specified

International economy

	2012	2013	2014	3Q 2012	4Q 2012	1Q 2013	2Q 2013	3Q 2013	4Q 2013
GDP GROWTH									
Global	3.2	3.3	4.1	3.1	2.9	2.9	3.2	3.4	3.7
Developed countries									
United States	2.2	2.0	2.8	2.6	1.7	1.8	2.0	1.8	2.2
Euro area	–0.5	–0.4	1.0	–0.7	–0.9	–0.9	–0.7	–0.4	0.5
Germany	0.9	0.5	2.0	0.9	0.4	0.1	0.2	0.4	1.4
France	0.0	–0.1	0.8	0.0	–0.3	–0.3	–0.1	–0.1	0.4
Italy	–2.4	–1.3	0.5	–2.6	–2.8	–2.1	–1.4	–1.3	–0.2
Spain	–1.4	–1.4	0.8	–1.6	–1.9	–2.0	–1.8	–1.4	–0.5
Japan	2.0	1.4	1.9	0.4	0.4	–0.3	0.6	2.3	2.9
United Kingdom	0.0	0.8	1.4	0.0	0.0	0.6	1.2	0.5	1.1
Emerging countries									
Russia	3.6	2.6	3.6	3.3	2.4	1.4	2.4	3.2	3.5
China	7.8	7.9	8.4	7.4	7.9	7.7	7.8	7.9	8.0
India	5.1	5.0	6.2	5.1	4.5	4.5	4.2	5.1	6.4
Brazil	0.9	2.5	3.4	0.8	2.0	2.4	2.8	3.0	3.1
Mexico	3.9	3.5	3.7	3.3	3.3	2.9	3.2	3.8	4.2
Poland	2.0	1.7	2.8	1.7	0.7	0.6	1.1	2.0	2.9
Turkey	2.3	3.8	5.6	1.6	1.4	2.0	3.2	4.6	5.5
INFLATION									
Global	3.7	3.3	3.5	3.6	3.6	3.3	3.3	3.4	3.4
Developed countries									
United States	2.1	1.9	2.0	1.7	1.9	1.7	1.9	2.1	2.0
Euro area	2.5	1.5	1.6	2.5	2.3	1.8	1.4	1.4	1.5
Germany	2.1	1.6	1.7	2.1	2.0	1.8	1.4	1.5	1.7
France	2.2	1.2	1.5	2.3	1.7	1.2	1.1	1.2	1.3
Italy	3.3	1.7	1.8	3.4	2.7	2.1	1.4	1.6	1.8
Spain	2.4	1.9	1.6	2.8	3.1	2.6	2.1	1.5	1.3
Japan	0.0	–0.2	2.6	–0.3	–0.2	–0.6	–0.6	0.0	0.2
United Kingdom	2.8	2.8	2.4	2.4	2.7	2.8	2.9	2.8	2.6
Emerging countries									
Russia	5.0	6.2	4.8	6.0	6.5	7.1	6.5	5.8	5.4
China	2.7	3.0	3.2	1.9	2.1	2.4	2.8	3.3	3.4
India (*)	7.5	6.4	5.9	7.9	7.3	6.7	6.5	6.2	6.2
Brazil	5.4	6.0	5.6	5.2	5.6	6.4	6.1	5.9	5.8
Mexico	4.1	3.9	3.6	4.6	4.1	4.1	4.0	3.8	3.7
Poland	3.7	1.6	2.4	3.9	3.0	1.6	1.5	1.6	1.7
Turkey	8.9	6.9	6.5	9.0	6.8	7.2	7.0	6.7	6.5

Note: *(*) Wholesale figures.*

Forecasts.

Spanish economy

	2012	2013	2014	3Q 2012	4Q 2012	1Q 2013	2Q 2013	3Q 2013	4Q 2013
Macroeconomic aggregates									
Household consumption	–2.2	–2.7	0.1	–2.1	–3.0	–3.9	–3.1	–2.8	–1.0
General government consumption	–3.7	–5.1	–2.2	–4.0	–4.1	–4.9	–6.0	–4.4	–4.9
Gross fixed capital formation	–9.1	–6.9	–1.0	–9.7	–10.3	–9.3	–7.4	–7.1	–3.8
Capital goods	–6.7	–4.6	1.8	–7.0	–7.9	–7.1	–5.5	–5.6	–0.1
Construction	–11.5	–8.1	–2.4	–12.4	–12.3	–10.8	–8.6	–7.6	–5.6
Domestic demand (contr. Δ PIB)	–3.9	–3.9	–0.6	–4.0	–4.6	–5.2	–4.5	–3.9	–2.2
Exports of goods and services	3.0	3.9	4.2	4.2	3.2	6.2	5.2	1.1	3.1
Imports of goods and services	–5.0	–4.1	0.4	–3.4	–5.4	–4.2	–3.5	–6.6	–2.2
Gross domestic product	**–1.4**	**–1.4**	**0.8**	**–1.6**	**–1.9**	**–2.0**	**–1.8**	**–1.4**	**–0.5**
Other variables									
Employment	–4.4	–3.2	0.3	–4.6	–4.7	–4.0	–4.0	–2.8	–2.1
Unemployment rate (% labour force)	25.0	26.7	25.9	25.0	26.0	27.2	26.6	26.2	26.7
Consumer price index	2.4	1.9	1.6	2.8	3.1	2.6	2.1	1.5	1.3
Unit labour costs	–3.4	–2.9	–0.5	–2.9	–5.8	–4.8	–3.9	–2.2	–0.8
Current account balance (% GDP)	–0.8	1.0	1.9	–2.2	–0.8	–0.5	0.2	0.6	1.0
Net lending or borrowing rest of world (% GDP)	–0.2	1.5	2.4	–1.7	–0.2	0.0	0.7	1.1	1.5
Fiscal balance (% GDP)	–10.6	–6.3	–5.5	–10.0	–10.6				

Financial markets

INTEREST RATES									
Dollar									
Fed Funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-month Libor	0.43	0.33	0.47	0.42	0.32	0.29	0.30	0.34	0.38
12-month Libor	1.01	0.83	1.06	1.04	0.88	0.77	0.75	0.85	0.95
2-year government bonds	0.27	0.30	0.46	0.26	0.27	0.26	0.27	0.31	0.36
10-year government bonds	1.78	1.89	2.42	1.62	1.69	1.93	1.75	1.86	2.03
Euro									
ECB repo	0.88	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
3-month Euribor	0.57	0.21	0.39	0.36	0.20	0.21	0.21	0.21	0.21
12-month Euribor	1.11	0.55	0.74	0.89	0.60	0.57	0.53	0.54	0.55
German 2-year government bonds	0.08	0.13	0.58	–0.01	0.01	0.11	0.04	0.14	0.23
German 10-year government bonds	1.55	1.55	2.33	1.42	1.42	1.51	1.32	1.55	1.81
EXCHANGE RATES									
$/euro	1.29	1.31	1.33	1.25	1.30	1.32	1.31	1.31	1.32
¥/euro	102.71	127.07	136.13	98.44	105.44	121.84	126.60	128.64	131.21
£/euro	0.81	0.86	0.85	0.79	0.81	0.85	0.86	0.86	0.85
OIL									
Dollars per Brent barrel	111.38	105.41	108.46	109.19	109.52	112.23	100.92	103.13	105.34
Euros per Brent barrel	86.61	80.21	81.54	87.21	84.40	85.03	77.33	78.57	79.89

Forecasts.

FINANCIAL MARKETS

The run of bad surprises in international economic indicators over the last few weeks has left its mark on the markets. Commodity prices have been particularly hard hit. Stock markets have looked weak, although some have managed to stay in the zone of cyclical maximums (such as the US stock market), but others have weakened from already depressed levels (for example, the Spanish stock market). Monetary interest rates and yields on sovereign debt have fallen both in the USA and in the euro area (including the periphery countries).

In the USA, the reappearance of the spectre of relapse is reminiscent of the pattern over the last three years: aggressive monetary boosts, hopes of revival, incipient improvement, debate regarding the Federal Reserve's exit strategy, disappointing growth and further stimuli. Fortunately, on this occasion there are very good reasons to believe that recent figures are due to a transitory bad patch and that the US economy will maintain its cruising speed. Moreover, this episode might possibly serve for the Fed to reassert its belief that too many stimuli are better than too few. Given this scenario, stock market losses are merely a temporary correction and sovereign debt yields will remain at an all-time low for a long period of time.

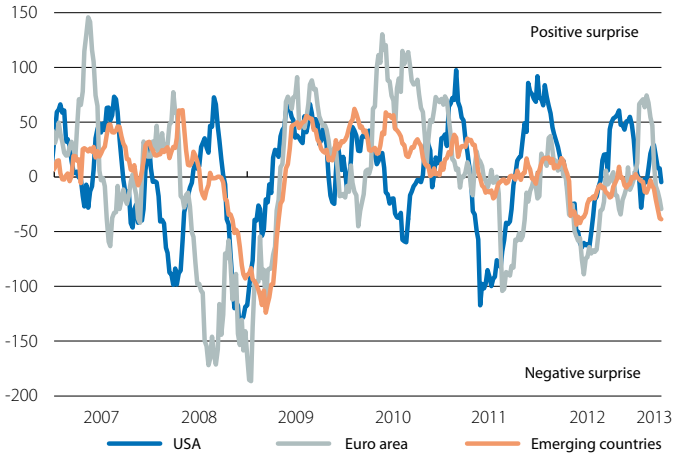
The Bank of Japan's actions constitute another key factor. The gestation process for its ambitious quantitative easing plan has already affected the foreign reserve and bond markets (helping to push down yields in a number of countries). After the «go-ahead» received at the G20 meeting, this programme is likely to be comprehensively implemented, thereby prolonging the reflationary effects not only for Japan itself (continuity in the downward trend of the yen and upward trend for the Nikkei) but also at a global level.

The panorama in the emerging countries has both positive and negative points and a wealth of fine distinctions. The difficulties encountered in controlling inflation, reviving growth and becoming the motor of the international economy are in addition to doubts regarding their true long-term potential, particularly in the BRIC countries. This is reflected in listless stock markets but lively debt markets. The authorities have already started to apply expansionary measures, combining monetary with fiscal measures depending on the circumstances. The fact that there is ample room in this area, together with the continuation of structural reforms and the low level of public and private debt, suggest the economy will not take long to revive. Stock markets and currencies will benefit (with a leading role for the Chinese yuan's appreciation).

The euro area continues to be the weakest link. In this case, the doubts regarding growth capacity seem more justified, both in the short and long term. This is the reason behind the

Index of economic surprises

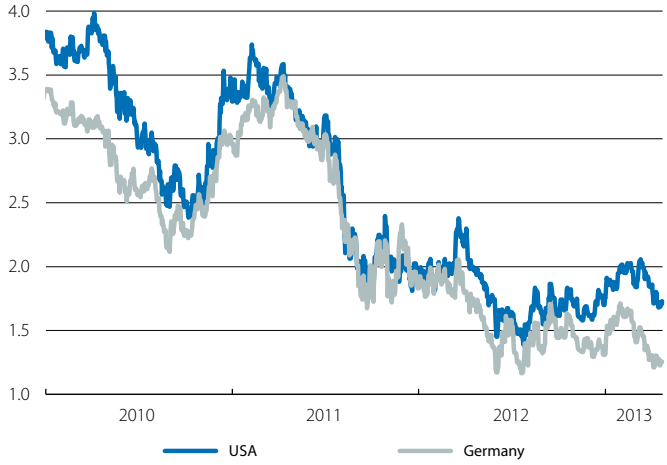
Number of standard deviations of the current financial conditions normalized with the average for the period January 1999-June 2008



Sources: *Bloomberg and Citigroup.*

The USA and Germany: yields on 10-year government bonds

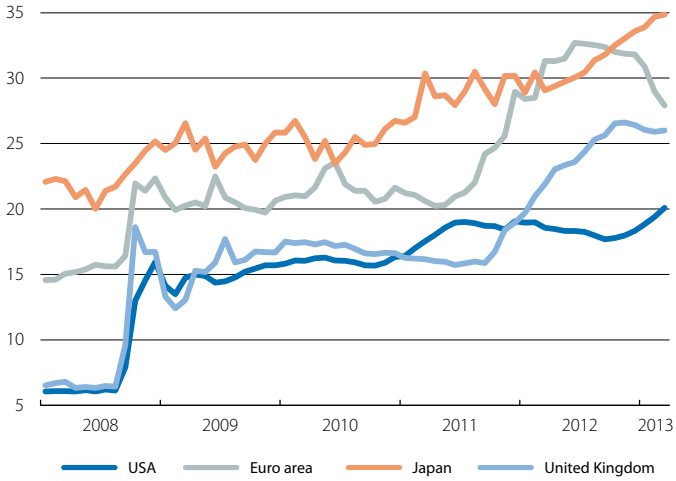
(%)



Source: *Bloomberg.*

Balance sheets of the main central banks

Total assets (% of GDP)



Source: *Bloomberg.*

relatively bad performance by Europe's stock markets which have continued to lose ground compared with the USA and Japan. However, there are grounds to expect better performances from now on. Tail-end risks have shrunk convincingly. On the one hand, the political commitment to reinforce EMU seems firm, as testified by the advances being made to complete the institutional framework and consolidate common economic governance. On the other hand, the presence of the ESM and of the ECB's OMT programme is avoiding the selling spirals in sovereign debt markets that inflicted such damage during 2010-2012. This has been indicated by the calm that reigned during the Cypriot crisis and the political impasse in Italy.

Economic policy is being shifted, albeit timidly, towards expansion. In the fiscal area, all the evidence suggests that the deadlines for reducing public deficit will be eased in numerous countries. Regarding the ECB, there is a rumour in the markets that it might implement measures both in the area of official interest rates and unconventional measures. A cut in interest rates is now more likely and we are also likely to see a mechanism started up to boost SME financing, especially in periphery countries.

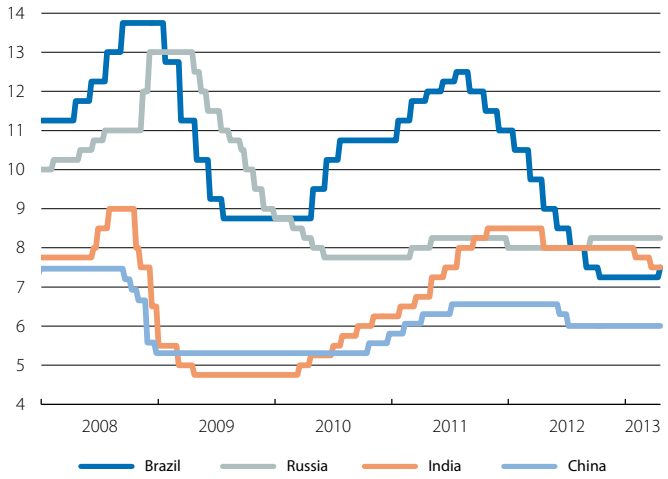
The normalization of the banking sector is still pending. Unfortunately, some actions by the political authorities have had a negative effect. Specifically, the Cyprus bailout exposed the debate, in an untimely and disorderly fashion, regarding how deposits, bonds and the rest of bank liabilities will be treated in future crises. This was not a good time for such a debate, given the hypersensitivity that still exists regarding this issue among the public and investors. Consequently, bank bonds and shares were notably punished, and the overshooting is now gradually tending to correct itself. Apart from the direct effect of the relatively large weight of this sector in the indices for both types of assets, there is also as significant effect through the central role played by the banking system in financing the euro area's economy, with the consequent macroeconomic repercussions.

We expect the authorities to be very sensible regarding the upcoming events in the banking sphere. The negotiations to design and start up the different elements of banking union form the core of these events. However, there are two additionally important elements: the stress tests prior to the single supervisor starting operations and Slovenia's likely bailout. Satisfactory results on these two fronts would help to combat financial fragmentation, facilitate private sector financing and, ultimately, contribute to exiting the recession.

This possible improvement in conditions in the euro area would be a great help for Spain's financial markets. International perception of the country's solvency has been improving, as shown by the notable reduction in the risk premium on sovereign debt and the larger number of bonds in foreign hands. However, there is still a lot of scepticism

Emerging countries: official interest rates

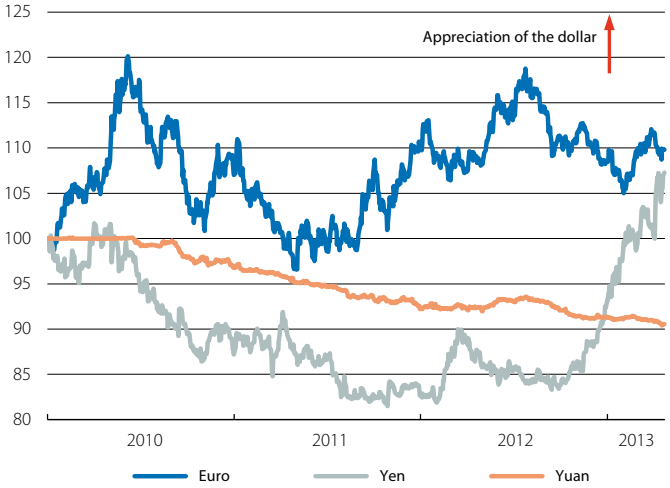
(%)



Source: *Bloomberg.*

Exchange rates of the euro, yen and yuan against the dollar

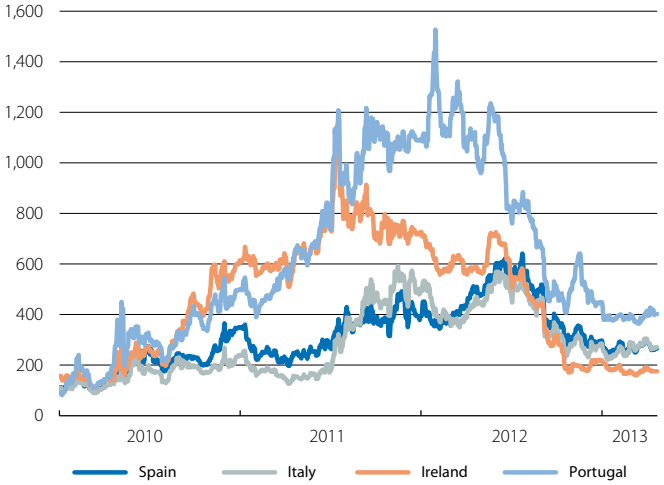
(Index January 2010 = 100)



Source: *Bloomberg.*

Sovereign CDS premia

(Basis points)



Source: *Bloomberg.*

concerning Spain's capacity to return to the path of sustainable growth. This is weighing heavy on the stock market, particularly on the banking sector. Another negative factor for share prices is regulatory uncertainty, once again with the banking sector as the main target but also affecting other important industries such as electricity. Restructuring public accounts, progressing with structural reforms and clarifying regulatory frameworks is the contribution we expect from the Spanish authorities for the Spanish stock market to regain its appeal and improve its performance.

Companies are still immersed in a twofold process of improving their solvency and efficiency. The former (financial deleveraging) has already been recognised by the corporate bond markets with low risk premia for large Spanish companies with access to capital markets. The latter (better bottom line potential) not yet, neutralized by the disappointing figures still coming from the macroeconomic environment.

In short, the market environment has contrasting influences at both a global and local level: unfavourable figures for economic activity, very easy liquidity conditions and steps being taken by political powers that are slow but in the right direction (albeit with some stumbles).

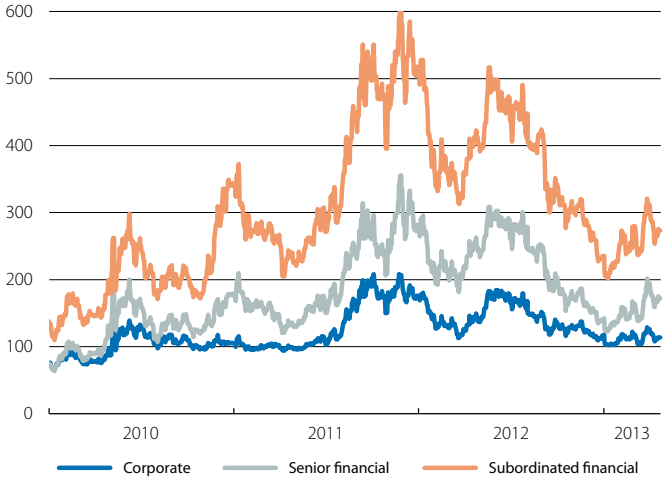
Investors will have to continue putting up with this mixed scenario in the short term. The money and bond markets are still likely to be well-supported, while risk assets will become notably volatile although without any huge downward pressures. On the stock markets, the announcement of corporate earnings should bolster share prices. In fact, this is already happening in the USA, the first country to publish its corporate results. With regard to commodities, we see the recent drop in prices as a short-lived occurrence that is not only due to the latest weak figures for global growth but also to temporary factors such as speculative sales by pseudo-financial investors (particularly evident in the plummeting gold prices mid-April). In the case of oil, we expect it to pick up slowly towards its level at the start of the year.

In the medium and long term, we expect a scenario of global economic revival, regional rebalancing, contained inflation and a slow withdrawal of monetary stimuli (so that liquidity will still be abundant). The outcome would be a gentle improvement in yield curves and gains for international stock markets.

Unfortunately, there are big risks. Two stand out in the short term. Firstly, macroeconomic indicators might still provide some negative surprises. Secondly, possible disagreements between euro countries regarding monetary and fiscal policy or details of banking union could make the euro markets nervous, particularly within the current situation of political and social discontent. In the medium and long term, the main risk is posed by ultra-expansionary monetary policies not only failing to revive growth but also resulting in destabilizing financial bubbles.

CDS premia in Europe by type of issuer

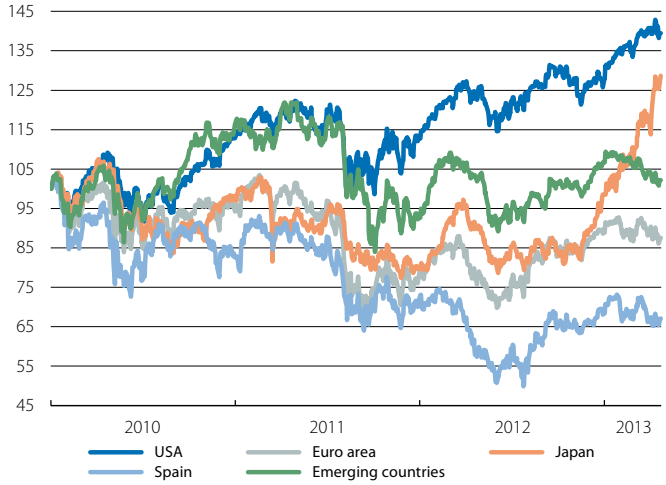
(Basis points)



Source: *Bloomberg.*

Performance of the main international stock markets

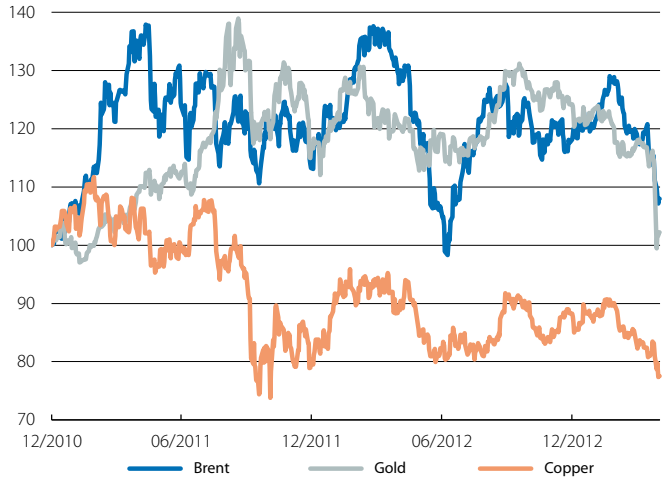
(Index January 2010 = 100)



Source: *Bloomberg.*

Trends in oil, gold and copper prices

(Index December 2010 = 100, dollars)



Sources: *Thomson Reuters Datastream and own calculations.*

FOCUS · The United States bond market: Bernanke's view

Ben Bernanke, Chairman of the Federal Reserve (Fed) of the USA, recently gave a speech dealing with two questions of concern to many investors: why are US bond yields at such a low level and how will they perform over the coming years?

To answer the first question, Bernanke proposed an analysis in which long-term yields are decomposed into three components: (i) the inflation expected by bond market participants, (ii) the path of the short-term real rate expected by these agents and (iii) the term premium, namely the premium demanded to compensate the time-related risk (i.e. investing long instead of short). This decomposition is represented in the first graph.

Bernanke associated the stability recorded by the first component with the high credibility of the Federal Reserve's commitment to price stability. The anchoring of inflation expectations has been a key factor influencing long-term interest rates over the last few decades but has remained stable since 2007-2008. However, he pointed out that, since this date, the short-term real interest rate has been influenced by the exceptional nature of monetary policy and expectations of how this policy will evolve (a factor that is, in turn, closely related to the economic outlook). Market participants expect real short-term rates to remain around zero for some time, expectations that are strengthened by the monetary authority's own messages. Lastly, the term premium component lies behind most of the fall observed in nominal yields since 2010. This is not surprising as it coincides with the extensions of large-scale long-term bond purchases (QE2 and QE3) and with operations to extend the maturities of the public debt portfolio (Operation Twist).

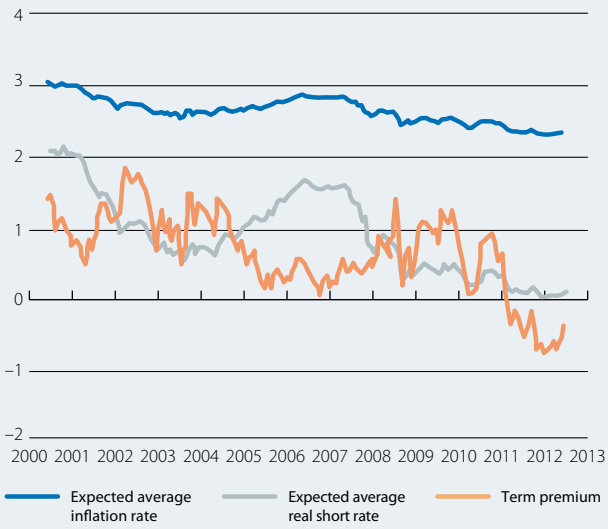
In response to the second question, Bernanke outlined a relatively reassuring main scenario. He pointed out that, if the economic recovery continues at a moderate pace, unemployment declines slowly and inflation expectations remain near 2%, then long-term yields will rise gradually toward more normal levels over the next few years. Based on different estimates, he therefore stated that long-term yields will increase by between 200 and 300 basis points between now and 2017.

However, he also admitted that there are significant risks of reality deviating from this main scenario, both upward and downward. Once again, he revealed what particularly concerned him on stressing that any sharp rise in yields is not desirable within a context of a slow recovery since it would harm economic activity and financial stability. He stated that, given such a situation, the institution might once again resort to its balance sheet tools.

There are at least two risks that Bernanke did not deal with explicitly: (i) a possible unanchoring of investors' inflation expectations and, (ii) within the medium term, the failure to achieve any convincing political agreement related to the country's fiscal challenges. The impact of either of these would be negative insofar as they would generate upward tensions on yields and a much more volatile and erratic environment.

Decomposition of 10-year US Treasury yield

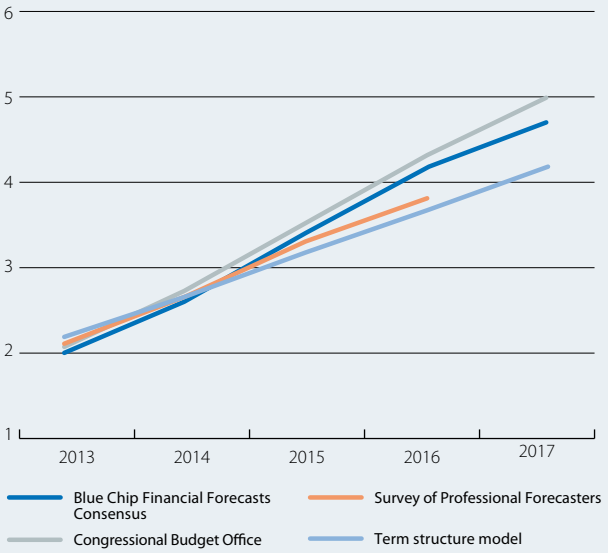
Monthly (%)



Source: *Federal Reserve.*

10-year Treasury yield forecasts

Annual average (%)



Source: *Federal Reserve.*

FOCUS · The repo market: slow but sure

One of the critical points in the financial crisis of the last few years took place at the end of 2011. In the midst of doubts whether the euro would survive, there was a crisis of confidence regarding the capacity of numerous banks to meet their commitments. For some, access to wholesale financing markets, both monetary and capital, had practically shut down. Given the emergency, at its meeting on 8 December 2011 the ECB took an unprecedented decision: to carry out two special three-year long term refinancing operations (LTROs). Mario Draghi explained that the aim of this measure was to shore up liquidity in the banking sector given the highly serious restrictions. Without doubt, the LTROs carried out on 21 December 2011 (used by 500 banks and assigning 489 billion euros) and 29 February 2012 (in which 800 banks requested almost 530 billion) were a lifesaver for European banks as they almost neutralized the risk of illiquidity. In this respect, they were a success.

However, there is another, less positive interpretation: these two LTROs exacerbated banks' addiction to ECB funding. This circumstance is highlighted when we observe the drop in the volume traded on the European repo market, an extremely important source of short-term funding for financial institutions. A repo (the abbreviation for repurchase agreement) is used to obtain liquidity in exchange for pledging a financial asset as collateral against default. According to the data published recently by the ICMA (International Capital Market Association), Europe's volume of repo contracts shrank to 5.6 trillion euros at the end of 2012, down 10% on the figure for December 2011. This occurred in spite of the fact that the repo market has benefited from a reduction in unsecuritized interbank loans.

According to its critics, the generous amount of surplus liquidity provided by the ECB discouraged operations between banks, delaying the return to normality. According to its defenders, the action taken by the ECB has prevented a disaster and is designed to ensure a gentle, gradual normalization. Several signs support this second interpretation. For example, the early repayment of LTRO loans. The most vulnerable parts of the market have also reacted positively. Specifically, as can be seen in the first graph, Spain's local market (MeffRepo) is showing encouraging signs, especially over the last few months.

Another distinctive feature in the repo market's performance is the substantial change occurring in the type of operations. The second graph shows that, in the years prior to the crisis, 90% of repos were bilateral, involving significant counterparty risk. The rest of the operations were carried out via an intermediary (generally a third bank) that looked after the collateral and transferred the funds, a situation that reduced but did not entirely eliminate counterparty risk. As a result of the financial crisis, a considerable proportion of bilateral repos started to be carried out via clearing houses, operations called cleared or CCP repos. The preliminary findings of the quarterly survey carried out by the ECB and the Money Market Contact Group revealed that cleared repos currently account for more than 60% of operations. This sharp growth recorded by CCP repos is due to the fact that, should the borrower default, the clearing house takes on its commitments.

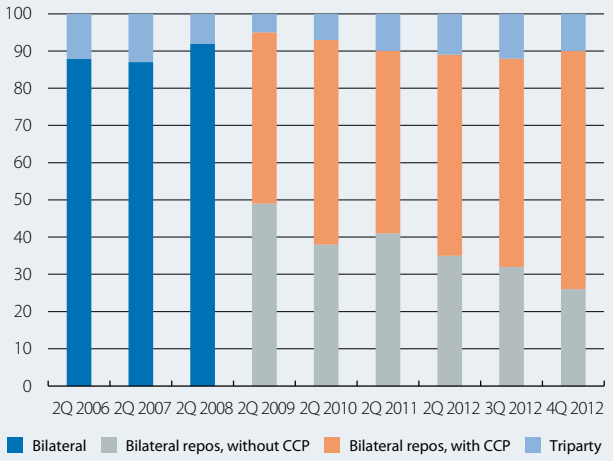
Total volume of the Spanish repo market

(Billion euros)

Source: *MeffRepo.*

Structure of the European repo market

(%)



Source: *European Central Bank.*

KEY FINANCIAL INDICATORS

Interest rates (%)

	30-Apr.	28-Mar.	Monthly change (b.p.)	Cum. change in 2013 (b.p.)	Year-on-year change (b.p.)
Euro					
ECB official	0.75	0.75	0	–25	–50
3 months (Euribor)	0.21	0.21	0	2	–50
1 year (Euribor)	0.51	0.55	–4	–5	–80
1-year Bubills (Germany)	0.01	0.02	–1	–13	–7
2-year government bonds (Germany)	0.01	–0.02	3	2	–10
10-year government bonds (Germany)	1.22	1.29	–7	–7	–36
10-year government bonds (Spain)	4.14	5.06	–92	–115	–165
Spread 10 years (b.p.)	292	377	–85	–108	–128
Dollar					
Fed funds	0.25	0.25	0	0	0
3 months (Libor)	0.27	0.28	–1	–3	–19
1 year (Libor)	0.70	0.73	–3	–14	–35
1-year T-Bills (USA)	0.10	0.12	–2	–4	–7
2-year government bonds (USA)	0.21	0.24	–3	–3	–4
10-year government bonds (USA)	1.67	1.85	–18	0	–12

Spreads corporate bonds (b.p.)

	30-Apr.	28-Mar.	Monthly change (b.p.)	Cum. change in 2013 (b.p.)	Year-on-year change (b.p.)
Itraxx Corporate	96	126	–30	–25	–52
Itraxx Financials Senior	146	194	–49	–10	–113
Itraxx Subordinated Financials	235	312	–77	–21	–183

Exchange rates

	30-Apr.	28-Mar.	Monthly change (%)	Cum. change in 2013 (%)	Year-on-year change (%)
$/euro	1.317	1.282	2.7	–0.8	0.3
¥/euro	128.320	120.670	6.3	–11.7	–19.5
£/euro	0.848	0.844	0.5	–3.6	–4.3
¥/$	97.450	94.150	3.5	–12.4	–19.3

Commodities

	30-Apr.	28-Mar.	Monthly change (%)	Cum. change in 2013 (%)	Year-on-year change (%)
CRB Index	478.3	479.8	–0.3	–1.9	–1.8
Brent (US dollars/barrel)	101.8	109.3	–6.8	–6.2	–7.2
Gold (US dollars/ounce)	1,476.8	1,596.8	–7.5	–12.8	–10.9

Equity

	30-Apr.	28-Mar.	Monthly change (%)	Cum. change in 2013 (%)	Year-on-year change (%)
S&P 500	1,597.6	1,569.2	1.8	13.4	18.1
Eurostoxx 50	2,712.0	2,624.0	3.4	4.5	20.7
Ibex 35	8,419.0	7,920.0	6.3	4.7	21.0
Nikkei 225	13,860.9	12,336.0	12.4	36.4	51.2
MSCI Emerging	1,039.5	1,032.6	0.7	–0.9	4.4
Nasdaq	3,328.8	3,267.5	1.9	12.4	14.7

INTERNATIONAL ECONOMY

The IMF sees a gradual recovery at three different speeds. According to its latest outlook report in April, only marginally worse than what was forecast in January, the world's economy will grow by 3.3% in 2013 and by 4.0% in 2014, led by the emerging economies (with growth above 5% in both years). The large advanced non-European economies will see more moderate growth (the USA, 1.9% in 2013 and 3% in 2014). Bringing up the rear is the euro area, with a predicted drop of 0.3% in 2013 and growth of 1.1% in 2014, hit by the widespread entrenchment of the crisis.

UNITED STATES

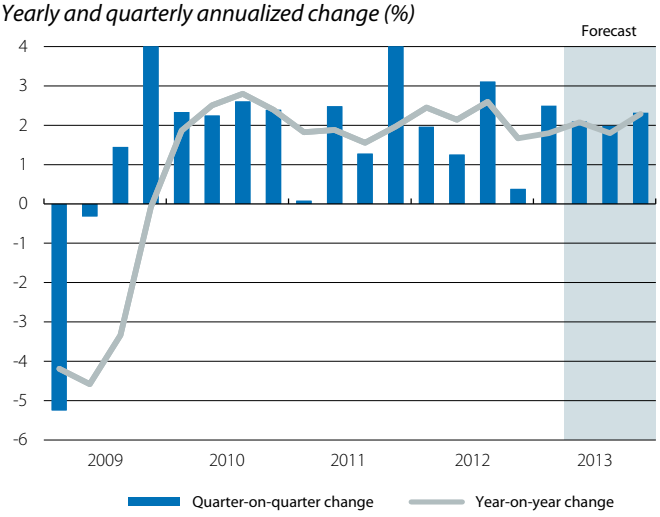
The outlook we predict does not differ greatly from the Fund's forecast. For the USA, we place growth in 2013 around 2.0%. After robust growth in the first quarter, 0.6% quarter-on-quarter at the time this Report went to press, more moderate growth is forecast for the rest of the year. Better financial conditions and the recovery in the housing market and production investment will support this expansion. However, the persistence of high indebtedness, the slow recovery in employment and the fiscal adjustment (the automatic reduction in public spending whose contractive effects will be concentrated in the second and third quarters) will hinder growth in 2013.

In general, March's activity figures are somewhat worse than expected. Retail sales, without cars or petrol, slowed down, losing part of their upswing in January-February albeit growing by 2.1% year-on-year. Similarly, the Conference Board Consumer Confidence index lost what it had gained in February and its net figure fell below its historical average. The outlook for business is slightly better but this cannot escape the lukewarm environment either. The business indices of the Institute for Supply Management for manufacturing and services lost ground, reaching levels that correspond to economic growth of around 2.0%. In the area of investment, however, we can still see an improvement in 2013, helped by peak corporate earnings and financial improvements with room for investment's contribution to GDP to continue rising.

The labour market is still the greatest burden and also the greatest risk to the US recovery. March's figures were also disappointing with 88,000 new jobs created, less than half the forecast. The drop in unemployment to 7.6% is fundamentally due to a decrease in the labour force. In this respect, the indicator that best reflects the situation of the labour market is the employment-population ratio (the proportion of people that are working compared with the total population aged over 16), which includes unemployment and the contingent of discouraged workers who have left the labour force (employees or registered unemployed who are actively looking for work) who are not recorded as unemployed. Between December 2006 and November 2010, the employment-

USA: GDP

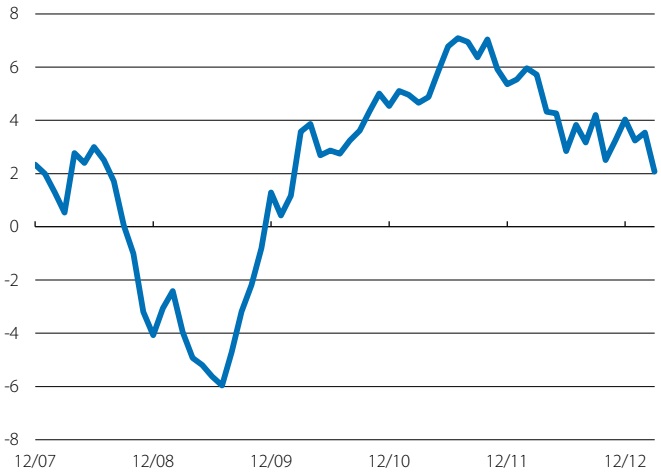
Yearly and quarterly annualized change (%)



Sources: *Bureau of Economic Analysis and own calculations.*

USA: retail sales

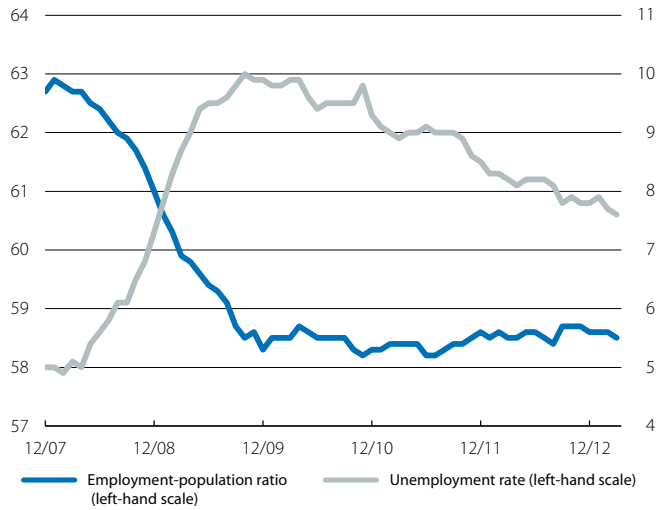
Year-on-year change (%)



Sources: *Department of Commerce and own calculations.*

USA: employment

(%)



Sources: *Department of Labor and own calculations.*

population ratio went from 63.4% to 58.2% and has remained almost unchanged since then (58.5% in March 2013). All this means that the unemployment rate is expected to fall very slowly as these discouraged and under-employed people will absorb a significant part of the jobs generated by the economy, hindering a drop in the unemployment rate. The high proportion of long-term unemployed, who find it particularly difficult to get another job, will be an additional burden.

This weakness in employment, together with the moderation of prices in March, gives the Fed arguments to maintain the expansionary tone of its monetary policy. The CPI advanced by 1.5% year-on-year in March (2.0% in February) and core inflation by 1.9% (2.0% in February). These figures, and the marked drop in oil prices, have removed the prospect of inflationary tensions in 2013. This guarantees that the Fed's QE3 will continue, within an environment of moderate growth in spite of the gradual recovery in construction and employment.

Housing has remained apart from the lukewarm figures for March and is consolidating its recovery, spurred on by the reduction in the surplus supply, the upward trend in the formation of households and better financial conditions. The good figures for housing starts indicate that construction will liven up considerably while prices continue to pick up gradually.

JAPAN

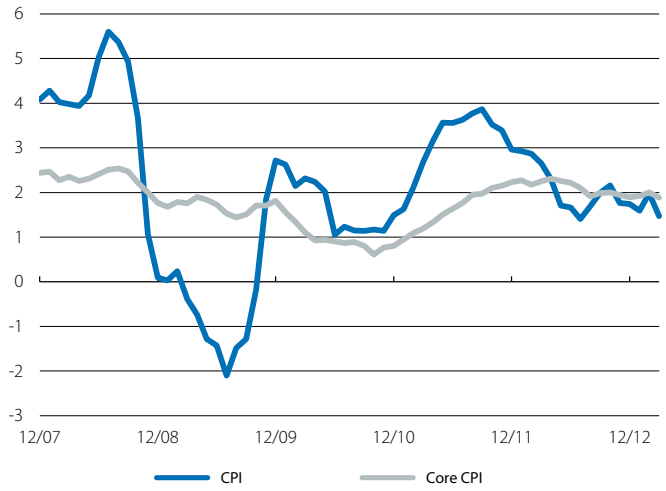
Japan has embarked on its monetary revolution. Haruhiko Kuroda, the new governor of the Bank of Japan, aims to take the monetary base from its current level of 139 trillion yen to 270 trillion (2.1 trillion euros) by December 2014, which means going from 29.4% to 57.3% of Japan's GDP. This increase will be achieved via public debt purchases, including long term. In absolute terms, this measure is comparable with the Federal Reserve's quantitative easing whose assets represent 18.9% of the US's GDP (2.3 trillion euros). Such a drastic measure is aiming to offset the structural surplus of private savings, mostly in the hands of companies, via increases in the current balance and greater growth and investment.

The first consequence of this monetary expansion has been the depreciation of the yen, accompanied by significant stock market gains. Given that Japan's leading firms are exporters, they benefit from a cheaper yen as it makes them more competitive. This should boost the current surplus, channelling private savings abroad. The ultimate aim of monetary expansion is to put a stop to deflation, which has now lasted 15 years. An environment of moderate inflation and low interest rates would stimulate growth and investment and would provide an internal exit for surplus savings.

Deflation, which continued in March, has prevented nominal growth and has led to huge public debt. Real GDP, discounting price variations, rose by 9.0% between the end of

USA: CPI

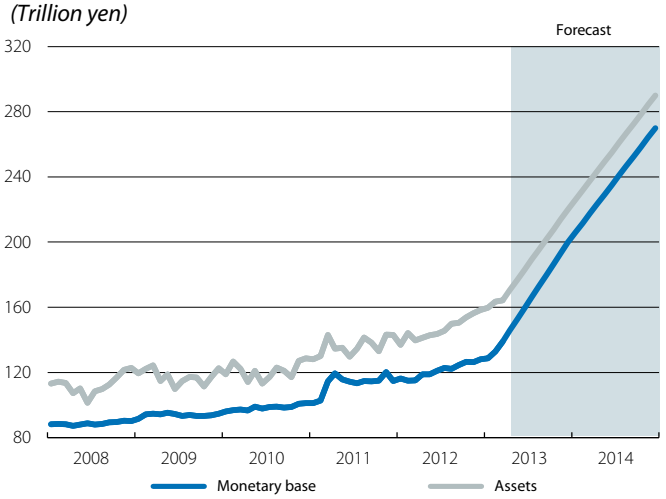
Year-on-year change (%)



Sources: *Department of Commerce and own calculations.*

Japan: monetary base and assets of the central bank

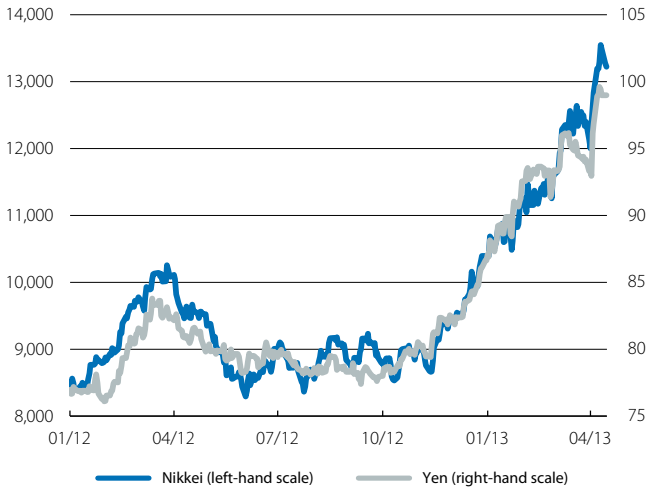
(Trillion yen)



Sources: *Bank of Japan and own calculations.*

Japan: Nikkei and yen

(Index) *(Yen/dollar)*



Sources: *Thomson Reuters Datastream and own calculations.*

1997 and December 2012 but GDP in current yen fell by 10.1%. This fall, together with successive fiscal stimuli, has taken public debt to 236% of GDP. Here lies the biggest risk for Kuroda's monetary expansion: if inflation grew more than expected, it might generate a lack of confidence among Japanese savers, who finance most of this debt, and they might take flight from the yen. If this flight were substantial, Japan might be forced to raise the interest rate on its debt.

Structural reforms will be crucial in the medium and long term. The success of Japan's monetary expansion and fiscal stimuli in boosting growth depends on the implementation of the third pillar of Abenomics: structural reforms. Otherwise, in the long term, the current surplus will not be enough to channel this surplus of corporate savings, being limited by the export competitiveness of its Asian neighbours such as South Korea and China. Production investment, at 13.0% of GDP compared with 10.9% in the USA in 2012, will not be able to make any further progress without structural reforms to boost growth and reinvest corporate earnings.

EMERGING ECONOMIES

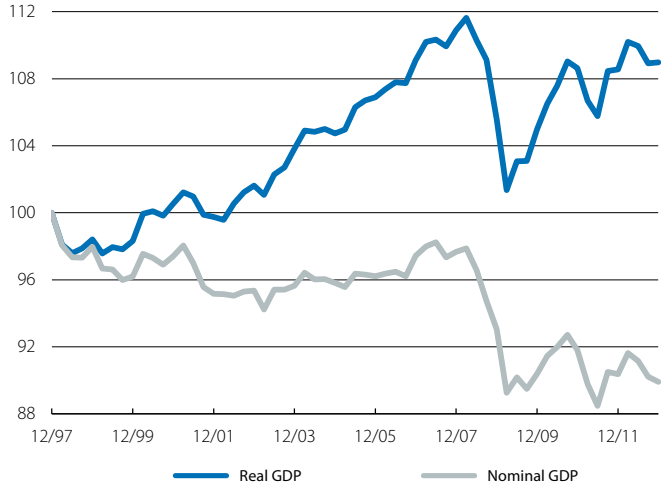
The emerging economies will continue to lead global growth in 2013 in spite of the relatively disappointing indicators for activity recently, which are showing a more disparate trend. China is the emerging country with the most robust growth. Although its 7.7% advance year-on-year in the first quarter indicates a more gradual reacceleration than expected (see the Focus on China), its growth contrasts with the slowdown in India, Russia and particularly the anaemic growth of Brazil. Mexico and Turkey, well placed to grow by around 3.5% in 2013, are in-between these two poles, with room for more stimuli if necessary.

Inflationary tensions are appearing in those economies growing the least as they have less and less room for monetary stimuli. China has once again set itself apart from the rest with a CPI of 2.1% in March, but high inflation persists in Russia and India, although in this case it is falling. In Brazil, the CPI speeded up to 6.6% in March, higher than the government's target of 6.5% and forcing the central bank to raise the official interest rate by 25 basis points in spite of low growth. Mexico is once again in the middle ground although March's surprise of 4.3% CPI leaves it above the central bank's target of 4%.

In addition to fiscal and monetary stimuli in the short term, the emerging economies also need far-reaching structural reforms to embark upon a robust, sustainable path of growth. For the time being, only Mexico has started. Following its labour and educational reforms at the end of 2012 will come the reform of the telecommunications sector in 2013, leaving fiscal and energy reform for later. Nonetheless, recent discrepancies between the main parties have interrupted this reform process, a stoppage that we believe is temporary.

Japan: Real and nominal GDP

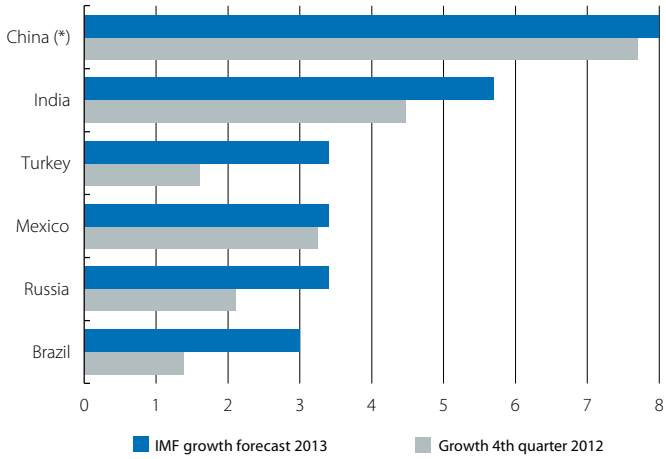
Real and nominal GDP (index, December 1997 = 100)



Sources: *Japanese Ministry of Communications and own calculations.*

Emerging economies: GDP

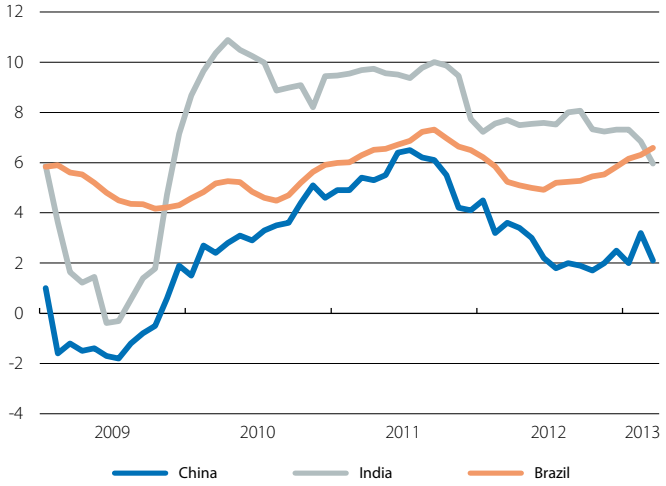
Year-on-year change (%)



Note: *(*) First quarter of 2013.*
Sources: *National statistics institutes, IMF and own calculations.*

Emerging economies: CPI

Year-on-year change (%)



Sources: *National statistics institutes and own calculations.*

FOCUS · A three-speed recovery

In its spring forecasts, the International Monetary Fund (IMF) outlines relatively contained economic outlook. The Fund expects global growth to be 3.3% in 2013, afterwards speeding up to 4.0% in 2014. These forecasts are slightly lower than the ones from last January. Specifically, the global growth expected for 2013 is 0.2 percentage points lower than the previous forecast. The revision for most national economies is of a similar size.

The IMF outlines three different trajectories, which have led the institution to describe the situation as a three-speed recovery. In the most dynamic trajectory are the emerging economies, which will grow by more 5% in both years. The emerging Asian countries still stand out favourably in this group, with flash gross domestic product (GDP) forecasts above 7% for 2013-2014. The second speed group is made up of advanced non-European countries. Of particular note here is the recovery expected for the United States (1.9% growth in 2013 and 3% in 2014).

Lastly, the countries of the euro area would be in a slightly worse situation. The euro area as a whole would see a 0.3% drop this year, afterwards barely growing in 2014 (an increase of 1.1%). Out of the main economies of the single currency, only Germany escapes this recessionary situation and, even so, its 0.6% growth in 2013 compares badly with that of other non-European economies. For its part, Spain would see a 1.6% drop in GDP in 2013, afterwards picking up to 0.7% in 2014.

So what lies behind this disparate economic recovery? With regard to the economies of the euro area, the aspect highlighted by the IMF is the fact that the prolonged debt crisis in the euro area has spilled over and affected not only the activity of the periphery but also several core economies.

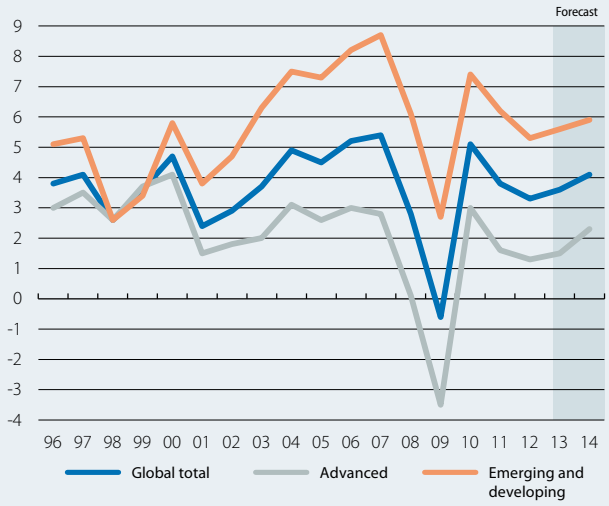
In the case of the United States, the Fund mentions that the efforts being made towards fiscal consolidation (which will equal 1.8% of GDP in 2013 according to the IMF) will hinder its recovery. Japan, for its part, will benefit in 2013 from the announced shift in economic policy with notable monetary and fiscal expansion, but the IMF doubts this impetus will last long.

With regard to the emerging economies, one key factor shared by many has been consumption's resistance, even during the slowdown in 2012. Based on this situation, the Fund believes that the current trend towards easier economic policies and the expected recovery in exports will support its scenario of acceleration.

In the area of risks, the IMF believes the measures adopted since the summer (the banking union project, new European Central Bank (ECB) instruments, etc.) have helped to reduce the risk of the euro area breaking up and that fiscal decisions in the United States have lessened the downside risks to activity due to the «fiscal cliff». However, there are still a large number of medium-term risks: the absence of credible fiscal consolidation plans in the United States and Japan; excessive debt, little room for economic policies and insufficient institutional advances in the euro area; the possible unwanted effects of unconventional monetary policies and, in the case of some emerging countries, the excessive investment and overpricing of some assets.

Economic growth by zone

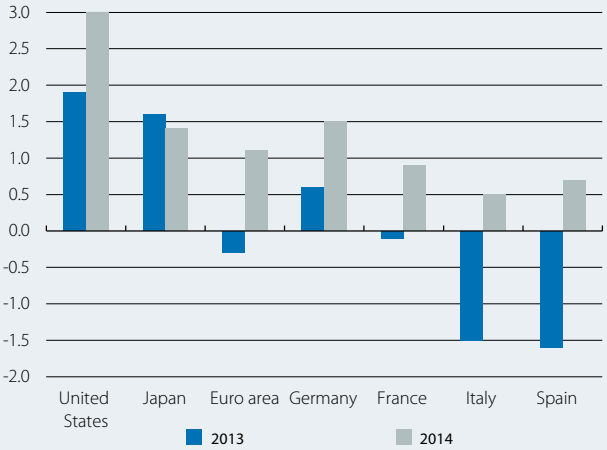
Year-on-year change in gross domestic product (%)



Source: *International Monetary Fund.*

Growth forecasts in advanced countries

Year-on-year change in gross domestic product (%)



Source: *International Monetary Fund.*

FOCUS · China: changing the model

The Chinese economy grew less than expected in the first quarter of 2013, advancing 7.7% year-on-year. The quarter-on-quarter figure reveals a certain slowdown compared with the last part of 2012, going from 2.0% to 1.6% growth. These figures, together with some macroeconomic indicators that are pointing to a certain slowdown in the pace of activity in March (especially industrial production and exports), have revived doubts concerning the energy of China's reacceleration. Nonetheless, a closer look at China's figures and situation allows us to rule out any alarmist interpretations, at least for the moment. Although China's reacceleration may be more gradual than expected, the composition of its growth seems to be embarking on a transition towards a healthier structure, more sustainable in the medium term and more in line with global rebalancing.

Looking at the details of the GDP figures for the first quarter, we can therefore see, first of all, that 2012 was a leap year and that, given the relevance this has for calculating China's GDP, it may have lowered the growth figures for the first quarter of 2013. Second, the breakdown of GDP by component in the first quarter suggests that the improved quality for growth pursued by the new government, prioritizing quality and efficiency over the size of growth and tolerating more moderate rates, is starting to come about.

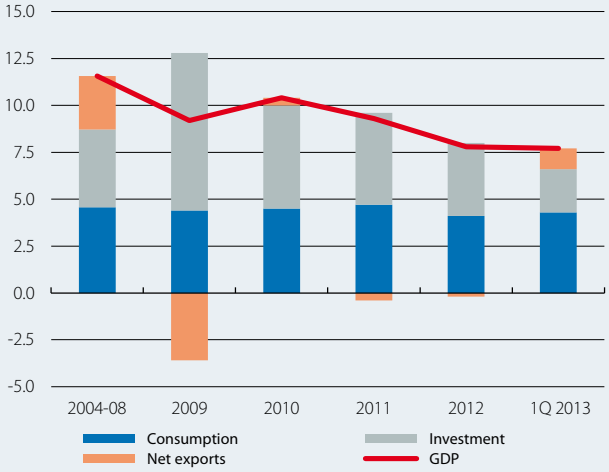
In particular, the relative weight of investment fell substantially, adding 2.3 percentage points to year-on-year growth compared with the 3.9 points for 2012 as a whole. On the other hand, net exports increased their contribution, adding 1.1 points and, more importantly for the desired change in model, so did domestic consumption, both private and public, adding 4.3 points. Although it is still early days, this rebalancing of growth's composition is essential to ensure sustainable economic growth in China in the medium term. This rebalancing is not only being seen in terms of demand but also in supply. Although the relative economic weight of the services sector is still small, its contribution to growth once again outperformed that of industry, for the third consecutive quarter.

Regarding the outlook for the coming months, the most probable scenario is still one of gradual reacceleration, even though the latest indicators suggest a slightly more contained performance than expected at the start of the year. The robustness of credit and the expansionary tone of fiscal policy will support growth although we do not expect such an intense implementation of stimuli as happened in 2008 and 2009, equivalent to 7% of GDP and which jeopardized the health of the banking system, real estate market and local government finances. On the other hand, the recent moderation in inflationary pressures (2.1% in March compared with the cumulative figure of 2.6% for January-February) gives the Chinese authorities more room to employ easier monetary policy should activity slow up too much.

Consequently, although the first quarter's figure has led us to revise our growth forecast for the whole of 2013 slightly downwards (from 8.0% to 7.9%) due to base effects, we have maintained our main scenario of a gradual reacceleration and predict growth of 8.4% for 2014.

GDP growth: contribution by demand component

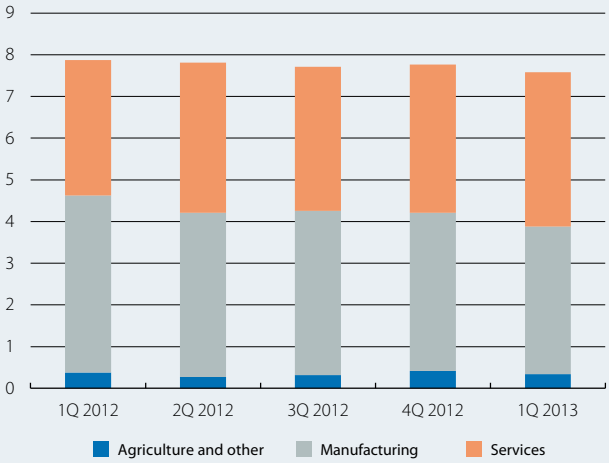
Year-on-year change (%)



Sources: *National Bureau of Statistics of China, IIF and own calculations.*

GDP growth: contribution by supply component

Year-on-year change (%)



Sources: *National Bureau of Statistics of China and own calculations.*

KEY ECONOMIC INDICATORS

Percentage change compared with the same period a year ago, unless otherwise specified

UNITED STATES

	2011	2012	1Q 2012	2Q 2012	3Q 2012	4Q 2012	01/13	02/13	03/13
Activity									
Real GDP	1.8	2.2	2.4	2.1	2.6	1.7	–	1.8	–
Retail sales (without cars or petrol)	5.9	4.1	5.7	3.8	3.7	3.3	3.2	3.5	2.1
Consumer confidence *(value)*	58.1	67.1	67.5	65.3	65.0	70.4	58.4	68.0	59.7
Industrial production	3.4	3.6	4.0	4.5	3.3	2.7	1.9	2.5	3.5
Manufacturing activity index (ISM) *(value)*	55.2	51.7	53.0	52.3	50.9	50.6	53.1	54.2	51.3
Housing starts *(thousands)*	612	782	715	736	774	889	902	968	1.036
Case-Shiller repeat sale price *(value)*	140	141	141	143	144	145	...	...	...
Unemployment rate *(% lab. force)*	8.9	8.1	8.3	8.2	8.0	7.8	7.9	7.7	7.6
Employment-population ratio *(% pop. > 16 years)*	58.4	58.6	58.5	58.5	58.5	58.6	58.6	58.6	58.5
Trade balance (1) *(% GDP)*	–3.8	–3.2	–3.8	–3.5	–3.2	–3.2	–3.3	...	...
Prices and financial variables									
Consumer prices	3.2	2.1	2.8	1.9	1.7	1.9	1.6	2.0	1.5
Underlying consumer prices	1.7	2.1	2.2	2.3	2.0	1.9	1.9	1.9	1.9

Note: *(1) Cumulative figure over last 12 months.*
Sources: *Department of Commerce, Department of Labor, Federal Reserve, Standard & Poor's, ISM, Thomson Reuters Datastream and own calculations.*

JAPAN

Activity									
Real GDP	–0.5	2.0	3.3	4.0	0.4	0.4	–	...	–
Consumer confidence *(value)*	37.7	40.0	40.0	40.4	40.1	39.4	43.3	44.3	...
Industrial production *(value)*	–2.3	–1.0	2.7	5.1	–4.6	–6.7	–7.1	–5.1	...
Business activity index *(Tankan)*	–1.3	–5.0	–4.0	–1.0	–3.0	–12.0	–	–8.0	...
Unemployment rate *(% lab. force)*	4.6	4.4	4.5	4.4	4.3	4.2	4.2	4.3	...
Trade balance (1) *(% GDP)*	–0.6	–1.4	–1.0	–1.0	–1.3	–1.4	–1.5	–1.7	...
Prices and financial variables									
Consumer prices	–0.3	0.0	0.3	0.2	–0.4	–0.2	–0.3	–0.6	...
Underlying consumer prices	–1.0	–0.6	–0.6	–0.5	–0.6	–0.5	–0.7	–0.9	...

Note: *(1) Cumulative figure over last 12 months.*
Sources: *Communications Department, Bank of Japan, Thomson Reuters Datastream and own calculations.*

CHINA

Activity									
Real GDP	9.3	7.8	8.1	7.6	7.4	7.9	–	7.7	–
Retail sales	17.1	14.3	14.9	13.9	13.5	14.9	12.2	12.2	12.6
Industrial production	13.7	10.0	11.6	9.5	9.1	10.0	9.9	9.9	8.9
PMI manufacturing *(value)*	51.4	50.8	51.5	51.3	49.7	50.5	50.4	50.1	50.9
Foreign sector									
Trade balance (1) *(value)*	154	231	157	179	196	231	233	280	274
Exports	20.2	8.0	7.7	10.5	4.5	9.5	25.0	21.8	10.0
Imports	25.0	4.3	6.8	6.4	1.4	2.8	28.8	–15.2	14.1
Prices									
Consumer prices	5.4	2.6	3.8	2.9	1.9	2.1	2.0	3.2	2.1
Official interest rate *(value)*	6.56	6.00	6.56	6.31	6.00	6.00	6.00	6.00	6.00
Renminbi per dollar *(value)*	6.5	6.3	6.3	6.3	6.4	6.2	6.2	6.2	6.2

Note: *(1) Cumulative balance over 12 months. Billion dollars.*
Sources: *National Bureau of Statistics, Thomson Reuters Datastream and own calculations.*

EUROPEAN UNION

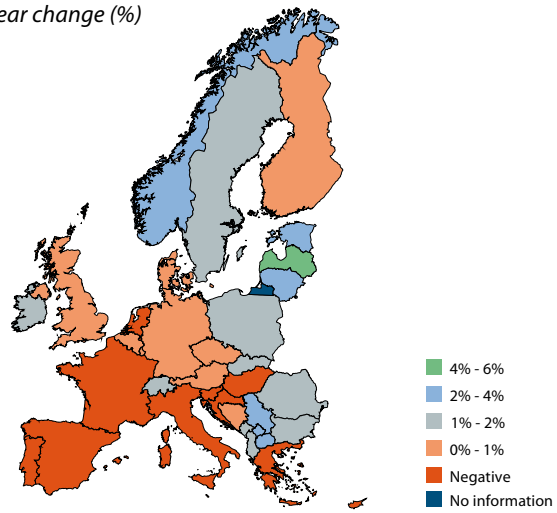
The winds of recovery are still blowing but the euro area is at the tail end. The latest IMF forecasts confirm this scenario by suggesting, if anything, that the upturn might take a little longer to get going. The decline predicted for 2013 is 0.3% and for 2014 it has proposed a slight advance of 1.1%. Although the euro area is likely to start seeing positive quarter-on-quarter growth rates between the second and third quarter this year, these will be very modest and, after the significant drop in the fourth quarter of 2012, will not be enough to stop 2013 as a whole from having a lower GDP than 2012. Moreover, the differences between countries will still be considerable. While we expect Germany to grow by 0.6%, the French economy will remain at a standstill with a decline of –0.1%. Although the periphery countries are still bringing up the rear, with decreases forecast for this year ranging from –4.2% for Greece to –1.6% for Spain, in 2014 the IMF expects all these countries to see positive growth rates of between 0.5% and 1%.

Business indicators, erratic throughout the first quarter of 2011, seem neither to be in favour nor against the recovery. The rate of deterioration in activity seems to be slowing down as, on average, the values recorded by the different indicators were at levels higher than those of the previous quarter. Industrial production in the euro area, for example, shows a slight upward trend. In spite of the 3.1% drop year-on-year in February, the average reduction in the first two months of the year was lower than that of the last quarter of 2012. This pattern is quite widespread between countries. However, when we analyze the developments in other indicators for which we already have March and April's figures, this trend blurs and it's more difficult to make out any clear improvement. For example, for the euro area as a whole, the PMI (purchasing managers' index) for services in March wiped out part of the progress made at the start of the year, although it was still higher than in the last quarter of 2012. The index for the manufacturing sector is following a similar pattern. The initial estimates for these indicators in April do not suggest any great variations in the euro area either. Of note, however, is the sharp drop observed in the German index, which has returned to contraction after 4 consecutive months of expansion.

The confidence indices, which do show more solid progress, took a break in March, partly due to the doubts caused by Cyprus's bailout and the outcome of Italy's elections. For example, the EC economic sentiment index fell by 1.1 points after four months of uninterrupted rises. This slight drop was widespread throughout all activity sectors and in most countries, particularly Germany and France. Nonetheless, the trend seen over the last few months in the aggregate indicator for the euro area seems quite robust and, although not very pronounced, should this

European Union: GDP growth forecast for 2013

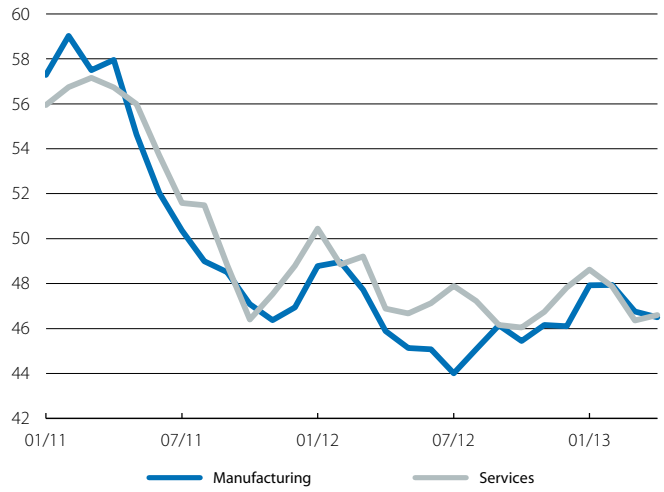
Year-on-year change (%)



Source: *International Monetary Fund.*

The Euro area: PMI manufacturing and services

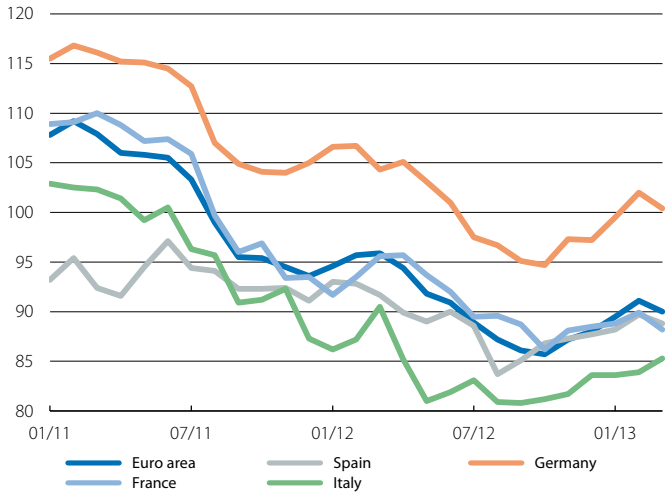
(Value)



Source: *Markit*

Economic sentiment index

(Value)



Source: *European Commission.*

continue throughout the rest of the year it would be enough for the economic sentiment index to rise, between the second and third quarter, to levels where growth rates have historically been positive. In order for this improved confidence to firm up, however, it is essential to push ahead with European integration, both on the fiscal front and in terms of banking union. In this respect, the advances made by the European Council in June will once again be vitally important.

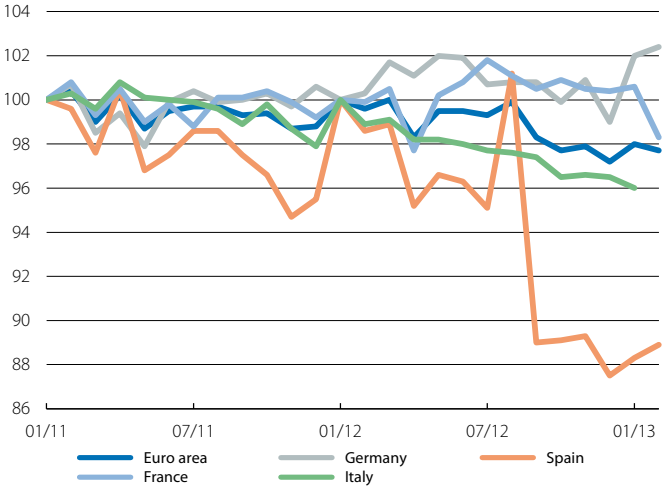
The euro area's recovery is still lacking the support of domestic demand, making it weaker and more vulnerable. The unemployment rate shows no signs of stabilizing; in March it posted a new record high of 12.1% and this makes it extremely difficult for household consumption to recover, still immersed in a clearly downward trend. After a rather promising January, retail sales started to fall again in February and took the year-on-year rate of change to –1.4%. However, differences between countries are considerable. Wherever the unemployment rate has more stoically withstood the buffeting of the crisis, such as in Germany where it is at an all-time low, signs of recovery have been seen in the last few months. The Spanish case is the opposite. Between the fourth quarter of 2012 and the first of 2013, 686,000 jobs were lost and the unemployment rate rose from 25.0% to 27.2%. The drop in retail sales has been historic. This, however, is also a result of purchases being brought forward due to the hike in VAT in September last year, as well as the elimination of the Christmas bonus for civil servants, effects that should partly reverse in the short term.

The labour market is finding it hard to get going. For the euro area as a whole, the index of employment expectations for the next three months has consolidated the rises of December and January but remains at a very low level. However, the path outlined by the index for each country is very different and perhaps reveals the underlying trends in each case. In Germany, the index is stable at levels above the euro area average while a notable improvement can be seen in Spain.

Employment expectations remain at a very low level in France which, added to the country's loss of competitiveness over the last few years, is not painting a very encouraging picture. In general there are no great imbalances at a macroeconomic level: a moderate public deficit (4.8% of GDP), a level of private and public debt that does not appear to be alarming (165% of GDP and 90%, respectively) and a relatively healthy financial sector. However, the trend in productivity has been very poor over the last decade. The most palpable consequence is the country's continual loss of competitiveness at an international level, translated into a significant drop in market share for its exports. However, the most worrying sign is actually France's apparent inability to carry out the structural reforms that could turn this situation around. Within this context, it is surprising that

Retail sales

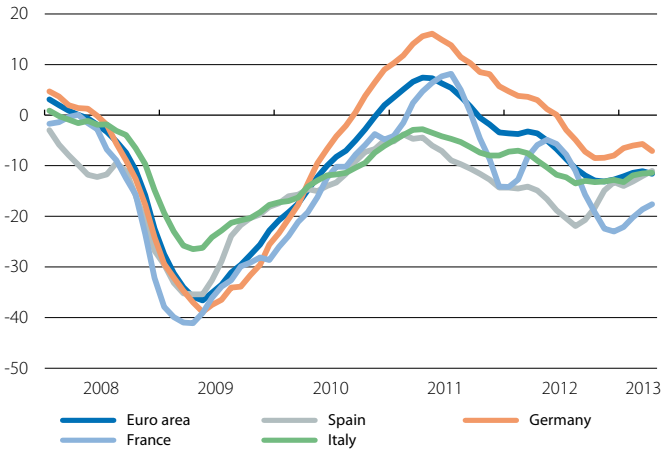
(Index, January 2011 = 100)



Source: *Eurostat.*

Employment expectations

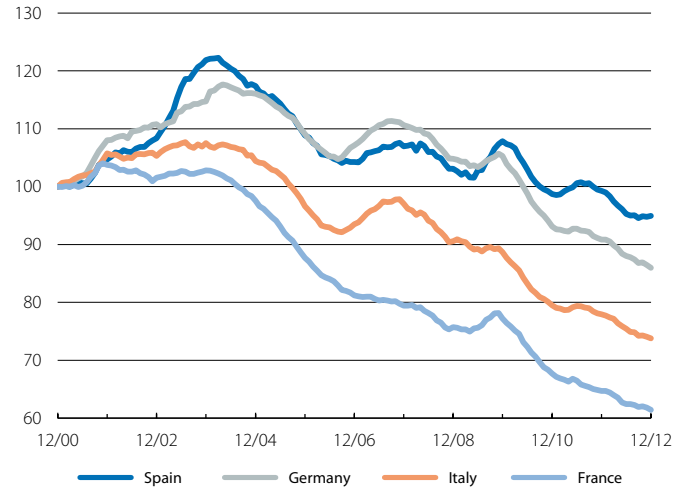
Net balance, moving average of 3 months (*)



Note: *(*) Differences between positive and negative responses in the survey on employment expectations in the manufacturing sector.*
Source: *European Commission.*

Global share of goods exports

(Index, December 2000 = 100)



Sources: *International Monetary Fund and own calculations.*

the IMF places France's long-term growth capacity at 1.9% and that of Germany at 1.2%. In any case, the situation of the French economy is delicate and must therefore be closely monitored.

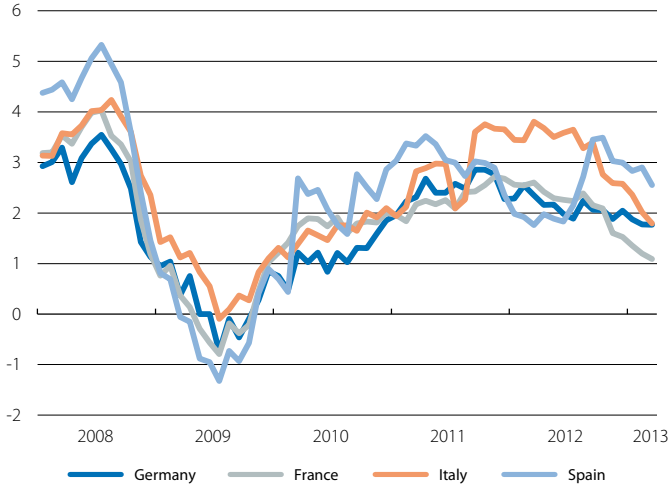
Inflation is responding to the weak domestic demand and the fall in oil prices standing at 1.2% in April according to Eurostat's flash estimate. In one year it has fallen by 1.4 points and all the evidence suggests that this trend should continue over the coming months. No great changes are expected in taxation and domestic demand is unlikely to push it up.

The ECB has room and justification to implement expansionary policies. Private credit has yet to recover, although some stabilization has been observed in its rate of decline, especially in terms of credit to enterprises. Credit to households is on a downward slide although still posting slightly positive rates of change. Nevertheless, what the ECB still has to sort out is how to reduce the current fragmentation of Europe's financial system. The clearest example of this problem is the range of different conditions for SMEs to access credit depending on which country they reside in. In this respect, at the April meeting of the ECB's Governing Council, Mario Draghi explained that they are looking at possible measures to help firms access financing, although he stressed they already have the possibility to discount loans as collateral in the auctions. The ECB repeated that it cannot replace capital that is lacking nor can it compensate for lack of action by governments.

Hungary's GDP slumped to 2.8% in the last quarter of 2012, setting off some alarm bells. In March, the new governor of the central bank stated his intention to reduce the relative weight of foreign banks in the financial system to some extent, as well as regulating the free fixing of energy prices and modify the conditions for foreign currency loans. This pushed up the country's risk premium and led to a depreciation of the forint and a downgrade in the credit rating of four large Hungarian banks by Moody's. However, in the last few weeks the country's production and financial environment seems to have been less hazardous. Although the deputy governor of the central bank has resigned, possibly due to discrepancies regarding the new guidelines for monetary policy (more oriented towards supporting growth), the initial decisions taken by the government and the central bank to reduce the burden of foreign currency loans for individuals and small firms are prudent. The central bank will offer two credit facilities at a preferential rate that will allow banks to offer SMEs cheap financing, one of these specifically aimed at replacing foreign exchange loans with funding in forints. This moderate bias has been well received by international investors to the point that the country's risk premium has returned to its situation before these measures were announced.

HICP

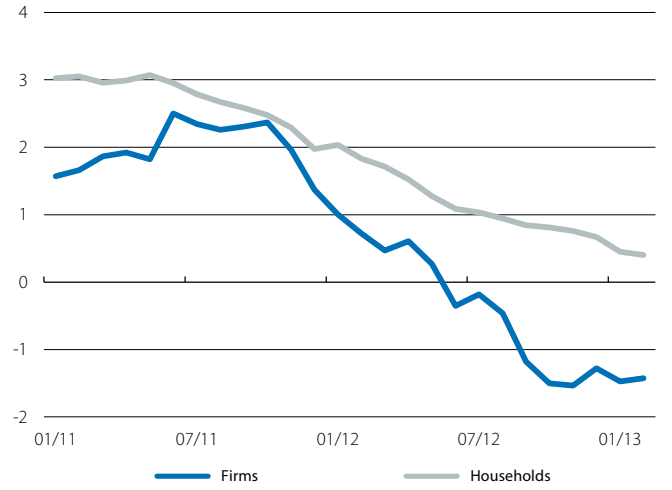
Year-on-year change (%)



Source: *Eurostat.*

The Euro area: private sector credit

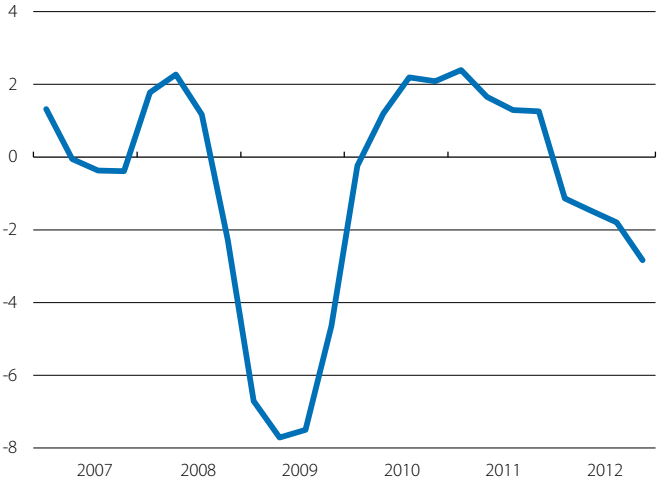
Year-on-year change (%)



Source: *European Central Bank.*

Hungary: gross domestic product

Year-on-year change (%)



Source: *Eurostat.*

FOCUS · The European Union in search of lost equilibrium

Most of the EU countries have significant economic imbalances. This is the conclusion reached by the latest macroeconomic imbalance procedure (MIP) prepared by the EC. Of the 27 countries that make up the EU, 11 have mismatches that jeopardize the functioning of their economies and 2, Spain and Slovenia, have excessive imbalances that require urgent adjustment. In fact, with the new regulations the EC can impose penalties if the necessary measures are not taken. Lastly, a further 5 countries have received financial assistance with the conditionality to comply with detailed reform programmes (Greece, Ireland, Portugal, Cyprus and, outside the euro area, Romania).

The MIP is one of the new measures aimed at strengthening EU governance. The objective: to improve the coordination and surveillance of the different macroeconomic policies of Member states. The process is simple. At the start of each year, the EC identifies the imbalances within each country as indicated by an analysis of 11 economic indicators such as the level of debt, the trend in house prices and external competitiveness. Based on these, it recommends the measures to be taken in those areas identified as potentially problematic. Suggestions the governments must bear in mind when drawing up their Reform Programmes.

According to EC Vice-President, Olli Rehn, excessive debt, poor competitiveness and challenging external liabilities are the main imbalances suffered by EU countries. Regarding private debt, for example, in 2011 15 of the 27 European Union countries exceeded the threshold at which their debt is considered to pose a risk for economic growth (160% of GDP). However, there are significant differences between countries. In Germany this figure stood at 128% while in Ireland it was over 300%.

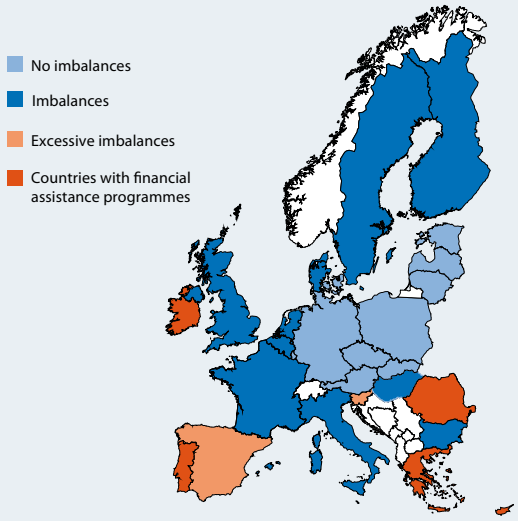
In fact, according to the MIP, the German economy has no worrying macroeconomic imbalances. However, this situation might change if it does not stimulate domestic demand. Over the last 3 years, on average its current account surplus has remained below 6%, the limit established by the EC, but in 2012 this reached 7.0%. At the other end of the scale are the periphery countries which, after many years of large deficits, seem to be finally managing to adjust.

Of these countries with imbalances, the EC singles out Slovenia and Spain. In the first case, the main priority is to strengthen its public banking system. The high NPL ratio, which reached 15% in 2012, is keeping pressure on the sector's capital requirements, which different estimates set at between 3% and 5% of GDP. The EC's recommendations focus on promoting the creation of a body to amass the banks' impaired assets, and on improving bank supervision.

With regard to the Spanish economy, the EC believes it has significant imbalances in spite of the progress made over the last few years. The main concerns are high debt levels as well as the impact of the recession on the labour market and public finances. Consequently, in Spain's case reforms must focus on improving competitiveness and boosting growth, as well as ensuring public finances are sustainable in the medium term; suggestions which the Spanish government has taken into account in drawing up its National Reform Programme.

Imbalances in the European Union

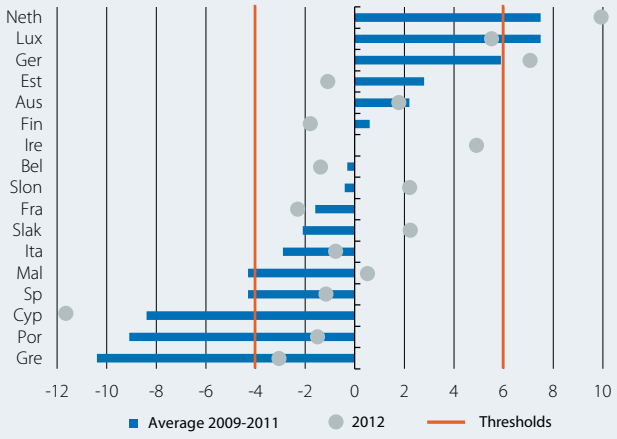
Situation of the EU countries according to the MIP



Sources: *European Commission and own calculations.*

The Euro area: external imbalance by country

Current account balance (% GDP)



Sources: *European Commission, Eurostat and own calculations.*

FOCUS · Household wealth by country: great differences and some reasons

The wealth of households reveals differences between euro area countries that seem surprising. This is what can be deduced from the first household finance survey at a European level coordinated by the European Central Bank (ECB). According to this, the median net wealth[1] of Spanish households in 2008, the year when the survey was carried out, was 182,700 euros. In Germany, however, it was just 51,400 euros in 2010. What lies behind these differences which, in principle, seem to contradict our perception of how income and wealth are distributed among Europe's countries?

Two factors explain these figures. Firstly, the share of households that own their main residence is very different between countries, ranging from 83% in Spain to just 44% in Germany. These differences are even more acute in the lowest income quintile: 78% of Spanish households own their residence while, in Germany, this figure is just 16%.

Owning a residence is the most usual way for households to accumulate wealth. Consequently, in those countries where a higher proportion of households own their own home, net wealth is higher. In fact, if we compare the real estate wealth of those households that own a residence, these differences are reduced considerably. Specifically, for this group the net real estate wealth totals 180,000 euros in Germany and 209,000 euros in Spain.

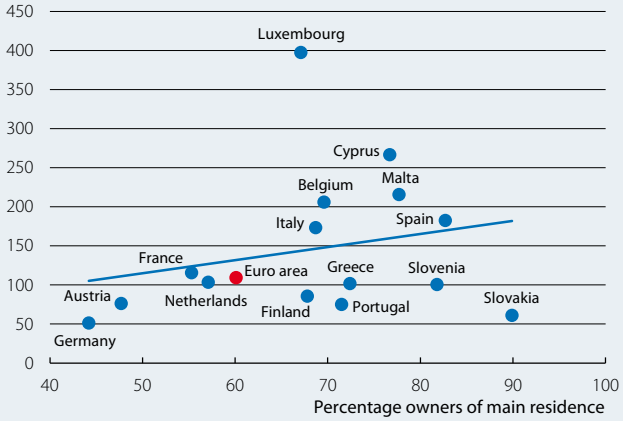
Given that, at a European level, most household assets are related to real estate, namely 69% of the total, fluctuations in house prices have a significant effect on their wealth. Since the survey was carried out, house prices have fallen by 26% in Spain while they have risen by 11% in Germany. Taking these movements into account, we can get an initial idea of the median real estate property of households that own a residence in 2012. In this case, German households have a median value of 199,800 euros, higher than the figure of 155,100 for Spanish households.

In short, there are certainly differences in wealth between Spanish and German households but these are due to specific factors. As long as the wealth of households continues to be concentrated in the real estate sector in Spain, it is likely to be more affected by fluctuations in house prices than other European countries.

(1) Net wealth is caculated by deducting the debt of households from their total assets.

Percentage of households owning their main residence and net wealth

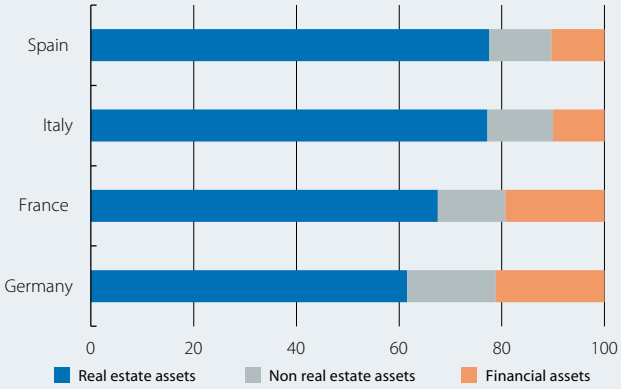
Net wealth (median, thousands of euros)



Source: *Household Finance and Consumption Survey (between 2008-2011, depending on the country).*

Value of household assets

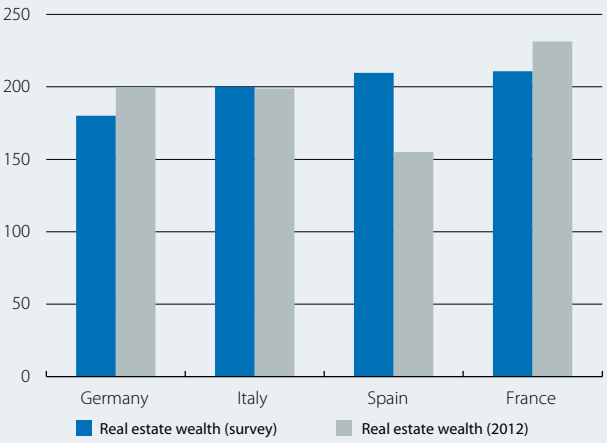
As percentage of total assets



Source: *Household Finance and Consumption Survey (between 2008-2011, depending on the country).*

Real estate wealth

(Thousands of euros)



Sources: *Household Finance and Consumption Survey (between 2008-2011, depending on the country), Bank for International Settlements and own calculations.*

KEY ECONOMIC INDICATORS FOR THE EURO AREA

Activity and employment indicators

Values, unless otherwise specified

	2011	2012	2Q 2012	3Q 2012	4Q 2012	01/13	02/13	03/13	04/13
Retail sales *(year-on-year change)*	–0.4	–1.9	–1.8	–1.6	–2.9	–1.9	–1.4	...	...
Industrial production *(year-on-year change)*	4.6	–2.1	–2.3	–2.2	–3.1	–2.4	–3.1	...	...
Consumer confidence	–14.5	–22.3	–19.5	–23.8	–26.2	–23.9	–23.6	–23.5	–22.3
Economic sentiment	101.7	90.4	92.3	87.4	86.8	89.7	90.4	90.1	88.6
PMI Manufacturing	52.2	46.2	45.4	45.1	45.9	47.9	47.9	46.8	46.5
PMI Services	52.6	47.6	46.9	47.1	46.9	48.6	47.9	46.4	46.6
Labour market									
Employment (people) *(year-on-year change)*	0.3	–0.7	–0.8	–0.6	–0.7	–	...	–	–
Unemployment rate: euro area *(% labour force)*	10.2	11.4	11.3	11.5	11.8	12.0	12.0	12.1	...
Germany *(% labour force)*	5.9	5.5	5.5	5.4	5.4	5.4	5.4	5.4	...
France *(% labour force)*	9.6	10.2	10.2	10.3	10.5	10.8	10.9	11.0	...
Italy *(% labour force)*	8.4	10.6	10.6	10.7	11.2	11.7	11.5	11.5	...
Spain *(% labour force)*	21.7	25.0	24.8	25.5	26.1	26.4	26.5	26.7	...

Sources: *Eurostat, European Central Bank, European Commission, Markit and own calculations.*

Foreign sector

Cumulative balance over the last 12 months as % of GDP of the last 4 quarters, unless otherwise specified

	2011	2012	1Q 2012	2Q 2012	3Q 2012	4Q 2012	01/13	02/13	03/13
Current balance: euro area	0.2	1.4	0.3	0.7	1.0	1.4	1.4	1.6	...
Germany	6.2	7.0	6.2	6.5	6.8	7.0	7.0	7.1	...
France	–1.9	–2.3	–1.9	–2.1	–2.2	–2.3	–2.4	–2.4	...
Italy	–3.1	–0.7	–2.5	–1.8	–1.3	–0.7	–0.6	–0.4	...
Spain	–3.7	–1.1	–3.5	–3.1	–2.3	–1.1	–0.9	–0.4	...
Nominal effective exchange rate [1] *(value)*	103.4	97.9	99.4	98.2	95.9	97.9	100.4	101.6	100.2

Note: *(1) Changes weighted by flow of foreign trade. Higher figures indicate the currency has appreciated.*
Sources: *Eurostat, European Commission, national statistics institutes and own calculations.*

Financing and deposits of non-financial sectors

Year-on-year change (%), unless otherwise specified

	2011	2012	1Q 2012	2Q 2012	3Q 2012	4Q 2012	01/13	02/13	03/13
Private sector financing									
Credit to non-financial firms [1]	2.0	–0.3	0.7	0.2	–0.6	–1.4	–1.5	–1.4	–1.3
Credit to households [1] [2]	2.7	1.2	1.9	1.3	0.9	0.7	0.4	0.4	0.4
Interest rate on loans to non-financial firms [3] *(%)*	2.8	2.4	2.7	2.6	2.3	2.2	2.2	2.1	...
Interest rate on loans to households for house purchases [4] *(%)*	3.3	3.1	3.4	3.1	3.0	2.9	2.9	2.9	...
Deposits									
On demand deposits	1.4	4.2	1.9	2.5	4.9	7.3	7.7	8.2	8.2
Other short-term deposits	2.6	2.0	2.7	2.4	1.0	1.8	1.7	0.8	0.5
Marketable instruments	–5.5	0.1	0.5	2.8	0.7	–3.6	–6.1	–8.8	–13.8
Interest rate on deposits up to 1 year from households *(%)*	2.6	2.8	2.9	2.7	2.8	2.7	2.6	2.4	...

Notes: *(1) Data adjusted for sales and securitization. (2) Including NPISH. (3) Loans of more than one million euros with a floating rate and an initial rate fixation period of up to one year. (4) Loans with a floating rate and an initial rate fixation period of up to one year.*
Source: *European Central Bank.*

SPANISH ECONOMY

The intensity of the recession is easing. The series of indicators, both for activity and confidence, are slightly better than they were at the end of 2012. However, in March and April they lost the vigour with which they had started the year. This is no cause for concern, for the moment, so we have kept our growth forecast for 2013 at –1.4%, continuing with negative growth for the first six months followed by a second half of the year in which advances will gradually gain ground. This scenario is similar to the new set of forecasts provided by the IMF, with a 1.6% fall in GDP for this year and 0.7% growth for the next. Nonetheless, the IMF warns that there are notable medium-term risks and particularly stresses the importance of keeping up with the agenda of structural reforms.

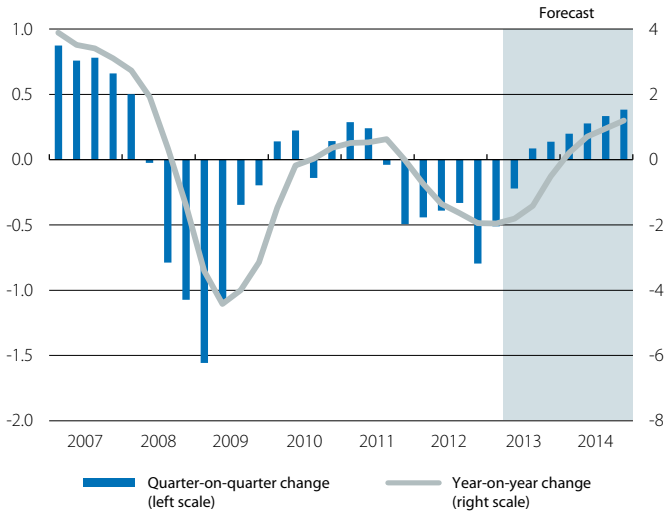
In the first quarter, GDP shrank by 0.5% quarter-on-quarter, 0.3 percentage points less than the previous quarter (in line with our forecast). This more favourable trend can essentially be attributed to the smaller decline in domestic demand: after a very negative fourth quarter due to purchases and investment being brought forward, caused by the VAT hike in September and the suppression of the bonus for civil servants, domestic demand has recovered some of the ground lost. This has been accompanied by improved consumer confidence, up by more than 8 points from the minimum of –40 reached in December to –31.9 in March.

Business indicators went from good to bad in the first quarter. After the promising rises seen at the start of the year, part of this improvement was lost again in March. For example, the Purchasing Managers' Index (PMI) for manufacturing reached 46.8 points in February but fell to 44.2 points in March, a value slightly lower than the average for the fourth quarter. This deterioration is largely due to the new sources of uncertainty coming from Italy and Slovenia, two elements that should be favourably resolved in the near future. In Italy, 87-year-old Giorgio Napolitano has been re-elected as the country's President and Enrico Letta has been given the difficult task of leading a coalition government. No great advances are expected in the agenda of reforms which Italy nevertheless urgently needs, but this political improvement should be enough for the country to step out of the limelight. Slovenia, with its public banking sector facing serious insolvency problems, is more than likely to be forced to request financial aid from the ESM in the short term. It would be surprising if the errors committed in the Cyprus case were repeated so, *a priori*, there is no reason to think this might increase tension in the financial markets.

The labour market is performing well given the overall serious situation. On the whole, the number of employed fell by 322,300 people in the first quarter, a somewhat smaller decline than the figure for the same period the previous year. It is useful to look at the breakdown of this trend in the private

Spain: GDP

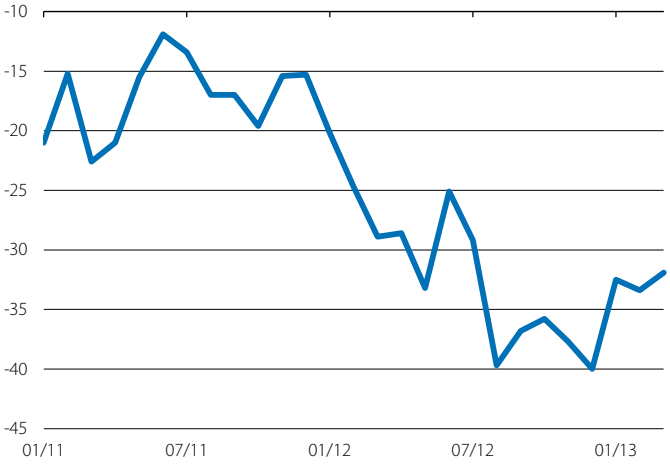
(%)



Sources: *National Institute of Statistics and own calculations.*

Spain: consumer confidence

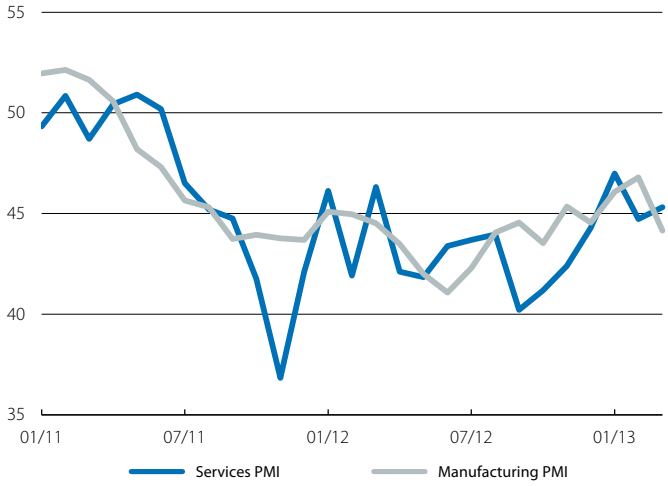
(Value)



Source: *European Commission.*

Spain: PMI

(Value)



Source: *Markit.*

and public sector. The adjustment in the latter started later and, for the moment, does not look like having touched bottom. In the private sector, the decline, albeit large, was the smallest for the last four years. An assessment of the rise in the number of unemployed, namely by 237,400 people, is similar: although this figure cannot be seen as positive, it is one of the best first quarters in the last 6 years. Only in the first quarter of 2011 was the increase in the number of unemployed lower, although the difference is small. Both the employment and unemployment figures are therefore accompanied by a crucial message: the recession is still present and is being felt in the labour market but it does seem to be running out of steam. Other relevant figures from the LFS have been the decrease in the labour force of 85,000 people; this has placed unemployment at 27.2%, 1.1 percentage points above the figure for the previous quarter.

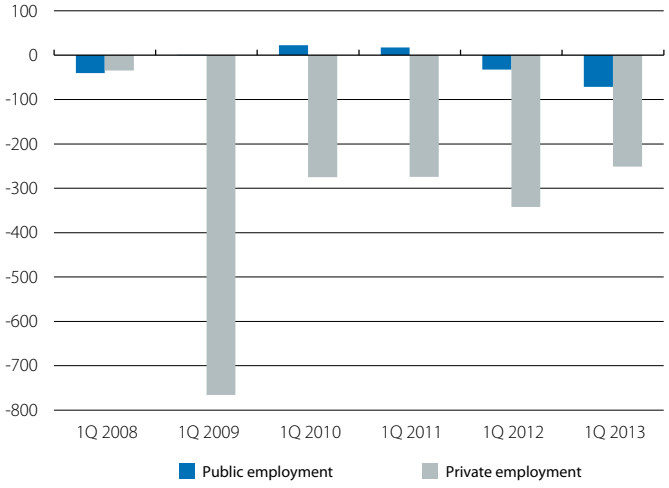
Employment expectations are starting to regain the ground lost. Although these have remained very weak since the recession started, over the last few months an interesting upward trend has nonetheless started in line with the improvement in business indicators. In industry, where these expectations fell the most, they have been recovering for the last 7 months, while this is a more recent phenomenon in the services sector. Although the pace of this improvement seems somewhat slow, should it continue the indicators would reach positive figures by the end of this year. In the short term, the labour market is therefore unlikely to present any structural improvements. The movements we will observe over the coming quarters will be particularly affected by seasonal factors. But if this change in trend becomes confirmed, next year might see the labour market stabilizing.

Support for exports to countries outside the euro area is key. The relative weight of Spanish exports to the euro area has gone from above 60% to below 50% in just 8 years. The strong growth rates demonstrated by exports have been decisive in cushioning, in part, the impact of the recession (see the Focus «Spain: diversify and you will export», in the chapter on the Spanish Economy of this *Monthly Report*). Consequently, one particular concern is whether the more or less general signs of weakness observed in recent activity indicators at a global level will lead to a reduction in exports to outside the EU. For the moment there are no signs of this happening. In fact, industrial orders from outside the euro area rose by 14.2% year-on-year in February, one point more than in January. What is known, however, is the weakness of national orders and those from the rest of the euro area countries (–9.2% and –2.6% year-on-year, respectively) which, for the moment, have yet to show any sign of perking up, although they should do so soon if the recovery continues to gain ground.

The slower pace of fiscal consolidation will also help. The government, supported by the EC and the IMF, has relaxed its fiscal consolidation programme and has postponed reducing the deficit to below 3% of GDP until 2016. For

Spain: employment trend

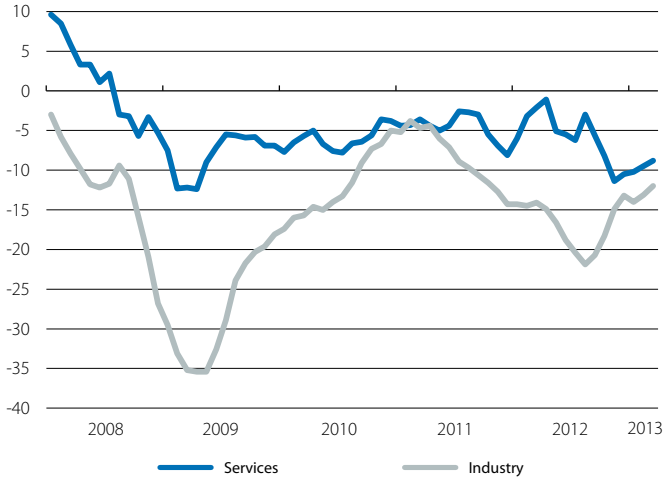
Quarter-on-quarter change (thousands of employees)



Source: *INE.*

Spain: employment expectations

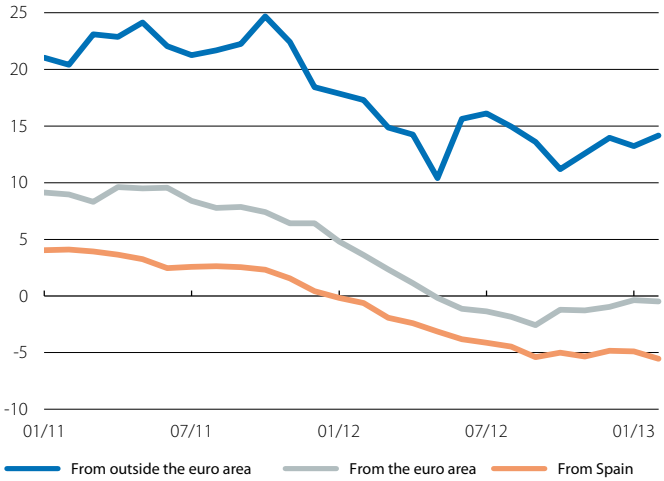
Moving average 3 months (value)



Source: *European Commission.*

Spain: industrial orders

Cumulative figures over 12 months, year-on-year change (%)



Source: *INE.*

this year, the Stability Programme presented contains an adjustment in the deficit of 0.7 percentage points, to 6.3% (compared with 4.5% previously). This has been accompanied by the announcement of further structural reforms that aim to increase the economy's capacity for growth in the long term and improve the sustainability of national accounts. Of note is the separation of civil service wages from the inflation rate, the creation of a working group to reform the pension system and the rationalization of local administration. (For a more detailed analysis, see the Focus «The pace of fiscal consolidation eases but not the effort», in the chapter on the Spanish Economy of this *Monthly Report*).

The changes in fiscal policy are supported by the markets. At the end of April, the Treasury issued 3-month bills at a lower interest rate than the historical series and the risk premium fell to below 300 basis points. Moreover, the expectations of a possible cut in the official interest rate by the ECB and the entrance of liquidity from Japan suggest that this improvement in financing conditions will continue over the coming months.

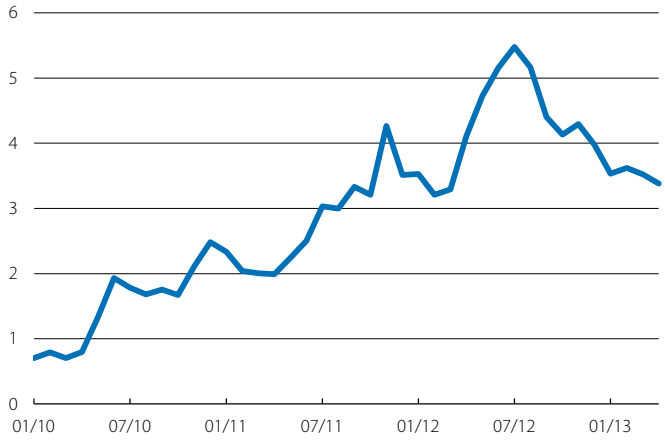
Confidence in the banking sector is gradually improving. In March, Spanish banks reduced their dependence on ECB financing to 260 billion euros. The reopening of the wholesale financing markets and the advances made in sorting out the banking sector suggest this trend will continue over the coming months. Deposits held by households and firms in Spanish banks are continuing to increase, with a preference for term deposits, which have risen by 9 billion euros in the first two months of the year. Depositors are therefore looking for a better return on their savings, which have been reduced in an environment of low interest rates and limits on the returns fixed by the Bank of Spain.

The adjustment in credit is advancing in line with the weak pulse of the economy. Private sector financing continued to shrink in February with a year-on-year change of –5.8%, reflecting the deleveraging being carried out by households and firms. Only public sector financing increased, up by 13.7% year-on-year in February. The NPL ratio fell in February to 10.4% due to the transfer of assets to the Sareb by banks that have received state aid.

Credit will once again flow to the real economy as the economic recovery consolidates. For the moment, the banking sector's credit capacity is still limited by high uncertainty but, once the sector has been sorted out, this should help to restore the supply of credit over the coming quarters. More worrying is the trend in the demand for credit, which continues to contract.

Spain: risk premium

Spread in 10-year bonds, Spain-Germany
Monthly average (%)



Source: *Bloomberg.*

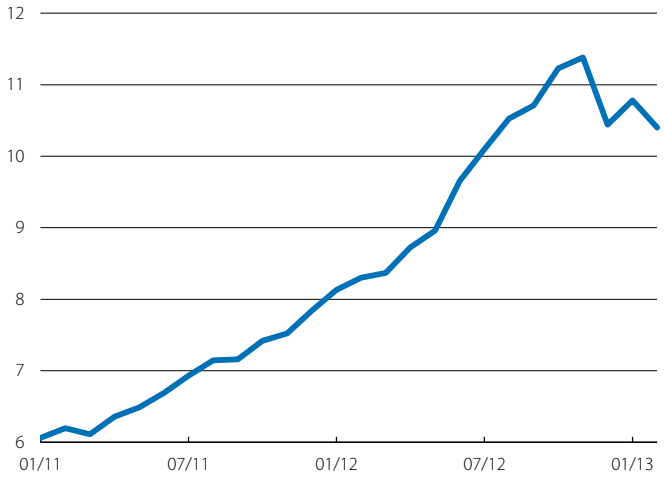
Spain: household deposits

Year-on-year change (%)

Source: *Bank of Spain.*

Spain: bank NPL rate

NPL rate as % of total credit



Source: *Bank of Spain.*

FOCUS · Corporate financing: less indebtedness and more diversification

Over the last five years, Spanish firms have notably improved their financial position. This trend speeded up in 2012 with a 92.4% annual increase in net lending up to 36.27 billion euros (3.5% of GDP). In contrast, households and the general government saw a significant deterioration in their net lending over the same period. To a certain extent, it is surprising that, within a context of economic recession, companies have seen such an overall improvement.

A detailed analysis of the National Accounts figures shows that this is due to two fundamental factors. Firstly, gross operating profit (GOP) rose by 4.6% in 2012 as a result of lower payroll costs which, in turn, can be explained by the drop in employment. It is important to note that, in the National Accounts system, GOP is what remains of the gross value added after payments to the labour factor and net of taxes on production. This is therefore not equivalent to corporate earnings as it also includes amortization and other income (rent, etc.). The second factor helping to boost corporate savings is the fall in investment, which was –3.6% in 2012.

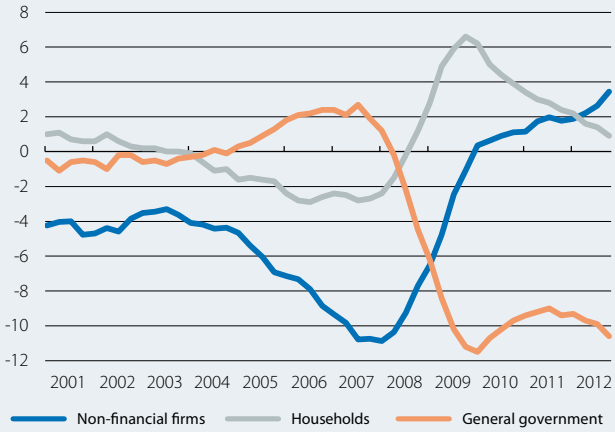
Firms are using this financing capacity to deleverage. According to the financial accounts published by the Bank of Spain, corporate debt has fallen from the peak of 1,495 billion euros recorded in 2010 (144.4% of GDP) to 1,372 billion in the fourth quarter of 2012 (131.7% of GDP). This trend speeded up in the fourth quarter last year due to the transfer of bank loans to the Sareb, as they were valued at their transaction price, lower than the value at which they were previously recorded on the banks' balance sheets.

A change is also occurring in the composition of corporate debt. In the last quarter of the year, as international financing markets gradually reopened, large Spanish firms took advantage of the occasion to issue corporate bonds. These placements were very well received and helped to diversify the sources of corporate financing. This trend speeded up in the first quarter of the year with bond issuances totalling 6.9 billion euros. However, the capacity of this financing channel to soften the fall in bank credit is limited as the main buyers of these bonds were financial institutions and, moreover, only a few companies can access this market.

In short, non-financial firms are the sector of the Spanish economy that has made most progress in their deleveraging and that, little by little, are managing to diversify their sources of financing. This greater capacity of the sector is helping to secure a strategic position for firms to increase investment whenever new business opportunities appear.

Net lending (+) / borrowing (-) by sector

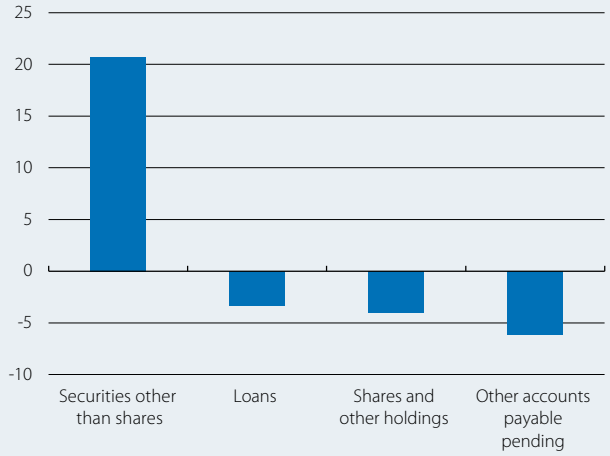
(% GDP, cumulative over 4 quarters)



Source: *Bank of Spain.*

Liabilities of non-financial firms

(%, change 2011-2012)



Source: *Bank of Spain.*

FOCUS · Spain: diversify and you will export

The foreign sector is becoming increasingly prominent. Its performance over the last few years has been helping to cushion the impact of the crisis and correct external imbalances more quickly. The balance of goods and services, for example, has gone from recording a deficit of 71 billion euros in 2008 to a surplus of 11.3 billion in 2012. In the first few months of the year, this trend does not look like running out of steam and the surplus has already reached 15.4 billion euros. What is the Spanish foreign sector's secret of success? And, especially, is it sustainable?

After world trade plummeted in 2009, in one year Spanish exports recovered the ground lost and continued to grow at a more than considerable rate in 2011 and 2012. This sharp growth is being helped largely by the notable improvements in competitiveness over the last few years. It is precisely in those countries against which Spain is gaining the most competitiveness where its exports have increased the most. Advantage is being taken of this situation to diversify exports, both in terms of geography and product.

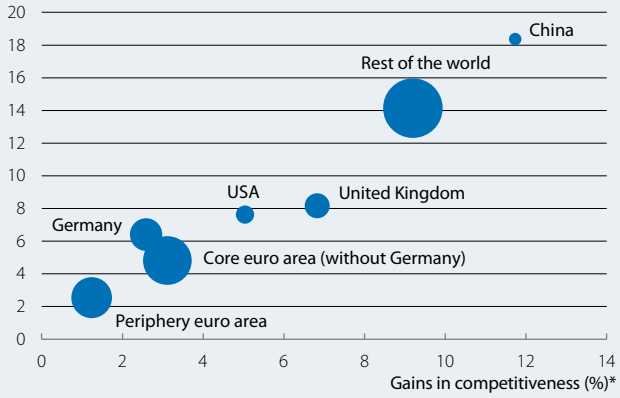
Regarding greater geographical diversification, of note is the loss in relative weight of exports to the euro area in favour of new destinations. In 2012, exports of goods towards the euro area accounted for 49.6% of the total, compared with 60.1% in 2004. This is the result of the poor performance by exports of goods towards euro area countries, down by 2.7% last year, combined with the impressive advance in sales towards Africa, America and Asia, up by 30.6%, 14.1% and 11.9%, respectively. This trend shows no sign of running out of steam in 2013 and industrial orders from outside the euro area have actually speeded up over the last few months.

The greater diversification of the products exported is also highly significant. Perhaps the clearest example has occurred in exports of non-tourism services. The relative weight of tourism and non-tourism services was similar in 2005 but the growth in exports of services provided to foreign firms, financial, computing, transport and construction services, has meant that, today, the figure for non-tourism is now 50% higher. The stereotypical image of Spain only exporting tourism will gradually disappear over time.

This leading role being acquired by the foreign sector seems to be well-deserved, at least at present. Whether it continues to play a key part, opening new markets and diversifying its range of products, will largely depend on whether further improvements are made in the economy's competitiveness.

Exports of goods and competitiveness

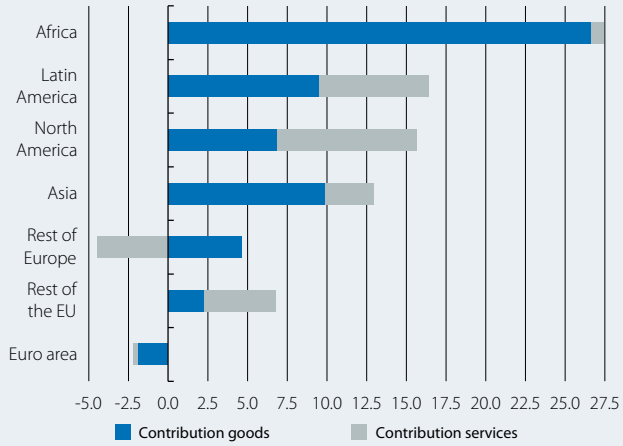
Annualized change in Spanish exports of goods, 2009-2012 (%)



Notes: *The size of the circles represent the volume of Spanish exports towards these markets.*
(*) From Spain compared with these countries based on the reduction in the real exchange rate.
Sources: *International Monetary Fund, OECD and own calculations.*

Growth in exports

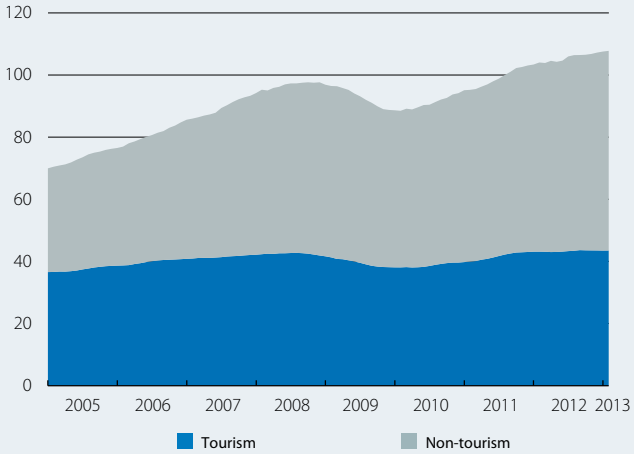
Year-on-year change in 2012 (%)



Source: *Ministry of Finance and Competitiveness.*

Exports of services

(Billion euros)



Source: *Bank of Spain.*

FOCUS · The rate of fiscal consolidation slackens but not the effort

The government has announced a significant relaxation in the path of fiscal consolidation. Specifically, the new public deficit target for this year is 6.3% of GDP, 1.8 percentage points higher than the target agreed last July with the EC and 3.3 points higher than the figure presented in the Stability Programme last year. The support of the EC and the IMF for this revision highlights the new international consensus that is coming about in favour of a slower rate of adjustment in fiscal imbalances. This is expected to help speed up the rate of economic recovery. The reduction in the public deficit predicted for this year will therefore be just 0.7 percentage points, three times less than last year. So does this mean that the fiscal effort will be less?

Fiscal effort is the set of measures, both in terms of revenue and spending, that have to be taken to reduce the public deficit. Consequently these, in addition to the desired deficit reduction, also have to compensate the impact of the economic deterioration on revenue and spending and the end of temporary fiscal measures taken previously. This year, neither of these two effects will be irrelevant. According to the government's estimates, the end of the temporary fiscal measures taken last year, such as the suppression of the Christmas bonus for civil servants and the income gained through the fiscal amnesty, will reduce revenue and increase spending by 1.0% of GDP.

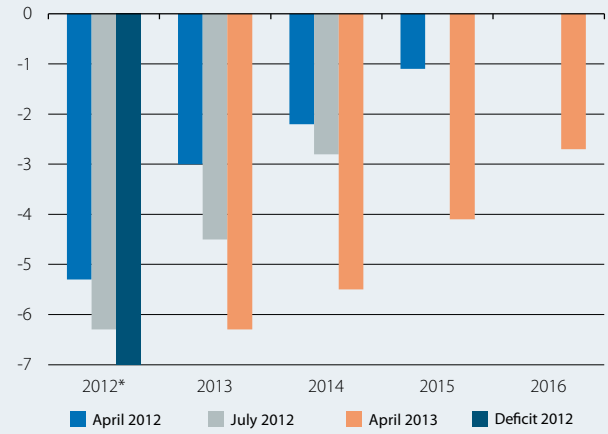
The economic situation will not help either. In this case, the effect of the rise in unemployment is one of the most important elements, both due to the impact this has on fiscal income — due to lower tax revenue — and also on spending, due to an increase in unemployment benefit. The growth seen in the public debt over the last few years is applying additional pressure. Although the average cost of this debt has remained relatively stable, its higher level has pushed financing costs from 16.9 billion euros in 2007 to 31.3 billion euros in 2012. This year the cost is likely to increase by a further 5.4 billion euros.

Given this scenario, considerable fiscal effort needs to be made. According to the government's estimates, the measures announced, both for revenue and spending, will result in savings for the public coffers of 4.4% of GDP. Among these measures, of note is the increased revenue from corporation tax and VAT, the latter due to the hike in this tax in September 2012. Lower expenditure on unemployment subsidies resulting from a change in how benefit is calculated will also help to reduce spending.

A fiscal effort of 4.4 p.p. should be enough to reduce the deficit by 0.7 percentage points, down to 6.3% of GDP. Given that the effect of the temporary measures is 1.0 p.p., the measures announced might even offset the effect of economic deterioration on the national accounts of up to 2.7 p.p., a figure that seems quite conservative given that, last year, with a similar fall in GDP to that predicted for this year, the effect of the economic decline was 2.2 p.p. All the evidence suggests, therefore, that the fiscal deficit target might be achieved. In any case, the government has shown itself willing to take additional measures in September should the effect of those taken to date is less than expected, or if the economic deterioration ends up being greater than expected.

Fiscal deficit targets

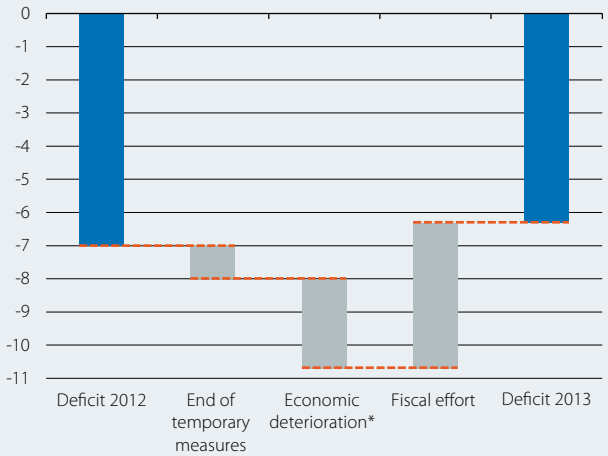
(% GDP)



Note: *(*) Does not include costs related to bank restructuring.*
Source: *Ministry of Taxation and Public Administrations.*

Adjustment of the 2013 public deficit

(% GDP)



Note: *(*) Includes interest payments.*
Sources: *Stability Programme and own calculations.*

KEY ECONOMIC INDICATORS FOR SPAIN

Year-on-year change (%), unless otherwise specified

Activity indicators

	2011	2012	2Q 2012	3Q 2012	4Q 2012	01/13	02/13	03/13	04/13
Industry									
Electricity consumption	–1.3	–1.9	–1.3	–1.9	–2.5	–4.3	–5.0	–2.1	...
Industrial production index	–1.4	–6.0	–7.1	–5.5	–5.6	–5.0	–6.5	...	...
Indicator of confidence in industry *(value)*	–12.5	–17.5	–17.4	–20.0	–17.9	–18.6	–13.5	–15.7	–17.4
PMI Manufacturing *(value)*	47.3	43.8	42.2	43.6	44.5	46.1	46.8	44.2	...
Construction									
Housing (building permits)	–14.6	–43.5	–46.4	–49.4	–44.1	–31.4	–6.6	...	...
House sales (INE)	–18.1	–8.6	–10.9	0.5	3.0	18.9	17.3	...	...
Services									
Foreign tourists	6.6	2.7	3.1	4.8	–1.8	–1.4	–0.4	7.7	...
PMI Services *(value)*	46.5	43.1	42.4	42.6	42.6	47.0	44.7	45.3	...
Consumption									
Retail sales	–5.4	–6.7	–6.3	–6.2	–9.3	–3.9	2.8	–1.2	...
Car registrations	–17.7	–13.4	–13.7	–17.8	–21.7	–9.6	–9.8	–13.9	...
Consumer confidence index *(value)*	–17.1	–31.7	–29.0	–35.2	–37.8	–32.5	–33.4	–31.9	–28.8

Sources: *Ministry of Finance and Competitiveness, Ministry of Public Works, INE, Markit, European Commission and own calculations.*

Employment indicators

	2011	2012	1Q 2012	2Q 2012	3Q 2012	4Q 2012	01/13	02/13	03/13
Registered as employed with Social Security [(1)]									
Employment by industry sector									
Manufacturing	–2.7	–5.3	–4.2	–5.2	–5.9	–5.9	–6.0	–5.7	–5.6
Construction	–12.2	–17.0	–16.4	–17.3	–17.7	–16.8	–16.0	–15.5	–15.7
Services	0.2	–1.7	–0.9	–1.6	–1.8	–2.6	–3.1	–3.0	–2.8
Employment by professional status									
Employees	–1.4	–3.8	–2.9	–3.7	–3.9	–4.7	–5.3	–5.0	–4.9
Self-employed and others	–1.2	–1.4	–1.3	–1.3	–1.4	–1.6	–1.2	–1.6	–1.5
TOTAL	**–1.3**	**–3.4**	**–2.6**	**–3.2**	**–3.5**	**–4.1**	**–4.6**	**–4.4**	**–4.3**
Employment [(2)]	**–1.9**	**–4.5**	**–4.0**	**–4.8**	**–4.6**	**–4.8**	–	–4.6	–
Hiring contracts registered [(3)]									
Permanent	–9.6	–2.2	–19.3	–5.7	–3.8	24.8	32.6	22.9	–0.4
Temporary	1.0	–4.8	–6.7	–4.8	–5.1	–3.0	4.0	–3.0	–6.1
TOTAL	**0.1**	**–4.6**	**–7.8**	**–4.8**	**–5.0**	**–1.1**	**6.1**	**–1.0**	**–5.6**
Claimant count [(3)]									
Under 25	0.6	4.5	6.2	7.3	4.0	0.5	–2.8	–4.4	–5.7
All aged 25 and over	5.4	11.7	9.7	12.4	12.8	11.7	9.6	8.3	7.4
TOTAL	**4.8**	**10.9**	**9.3**	**11.9**	**11.9**	**10.5**	**8.3**	**7.0**	**6.0**

Notes: *(1) Mean monthly figures. (2) LFS estimate. (3) Public Employment Offices.*
Sources: *Ministry of Employment and Social Security, INE, Public Employment Offices and own calculations.*

Prices

	2011	2012	1Q 2012	2Q 2012	3Q 2012	4Q 2012	01/13	02/13	03/13
General	**3.2**	**2.4**	**2.0**	**2.0**	**2.8**	**3.1**	**2.7**	**2.7**	**2.4**
Core	1.7	1.6	1.2	1.2	1.6	2.3	2.2	2.3	2.3
Unprocessed foods	1.8	2.3	1.4	1.9	2.5	3.3	4.3	3.1	2.5
Energy products	15.8	8.8	7.8	7.8	11.0	8.8	5.3	5.9	3.2

Source: *INE.*

Foreign sector

Cumulative balance over the last 12 months in billions of euros, unless otherwise specified

	2011	2012	1Q 2012	2Q 2012	3Q 2012	4Q 2012	01/13	02/13
Trade of goods								
Exports *(year-on-year change)*	15.4	3.8	3.2	3.5	4.2	4.2	7.9	2.4
Imports *(year-on-year change)*	9.6	–2.8	–0.6	–2.2	–2.1	–6.4	5.7	–9.8
Current balance	**–39.8**	**–11.3**	**–36.9**	**–32.4**	**–24.3**	**–11.3**	**–9.2**	**–4.6**
Goods	–42.3	–25.8	–39.9	–37.1	–32.7	–25.8	–25.5	–22.9
Services	34.6	37.1	35.7	35.7	37.1	37.1	37.5	38.3
Income	–25.7	–18.6	–26.1	–24.7	–21.4	–18.6	–17.4	–16.5
Transfers	–6.4	–4.0	–6.6	–6.3	–7.3	–4.0	–3.9	–3.5
Net lending (+) / borrowing (–) capacity	**–34.3**	**–4.7**	**–32.3**	**–27.4**	**–19.1**	**–4.7**	**–2.4**	**2.8**

Sources: *Department of Customs and Special Taxes, Bank of Spain and own calculations.*

Public sector

% GDP, cumulative in the year, unless otherwise specified

	2011	2012	1Q 2012	2Q 2012	3Q 2012	4Q 2012	01/13	02/13	03/13
Net lending (+) / borrowing (–) capacity	**–9.4**	**–10.6**	**–1.4**	**–4.4**	**–6.3**	**–10.6**	**–**	**...**	**–**
Central government [1]	–5.6	–7.8	–1.9	–4.6	–5.3	–7.8	–1.2	–2.2	–1.6
Autonomous regions	–3.3	–1.8	0.0	–0.7	–0.9	–1.8	–0.1	–0.1	...
Local government	–0.4	–0.2	0.1	0.0	0.1	–0.2	–	...	–
Social Security	–0.1	–1.0	0.4	0.9	–0.1	–1.0	0.2	0.3	...
Public debt *(% GDP)*	**69.3**	**84.2**	**73.0**	**76.0**	**77.4**	**84.2**	**–**	**...**	**–**

Note: *(1) Includes measures related to bank restructuring.*
Sources: *IGAE, Ministry of Taxation and Public Administrations, Bank of Spain and own calculations.*

Financing and deposits of non-financial sectors

Year-on-year change (%), unless otherwise specified

	2011	2012	1Q 2012	2Q 2012	3Q 2012	4Q 2012	01/13	02/13	Balance 02/13 [1]
Financing of non-financial sectors [2]									
Private sector	–2.0	–3.9	–3.1	–3.2	–4.0	–5.3	–7.0	–5.8	1,944.4
Non-financial firms	–2.0	–4.0	–3.0	–2.9	–4.0	–6.1	–9.0	–7.1	1,120.9
Households [3]	–2.0	–3.8	–3.3	–3.6	–4.1	–4.1	–4.2	–3.9	823.5
General government [4]	15.9	14.9	13.6	13.8	15.0	17.1	19.3	13.7	913.6
TOTAL	**1.8**	**0.7**	**0.8**	**0.9**	**0.7**	**0.3**	**–0.1**	**0.9**	**2,858.0**
Liabilities of financial institutions due to firms and households									
Total deposits	0.3	–4.5	–4.2	–5.1	–6.2	–2.7	–0.4	–0.2	1,172.2
On demand deposits	1.9	0.2	1.9	1.8	–0.9	–1.9	–0.2	0.8	263.8
Savings deposits	–1.4	–2.8	–5.6	–5.0	–0.8	0.2	–0.6	–0.2	195.9
Term deposits	0.6	–6.7	–5.7	–7.3	–9.6	–4.4	–0.8	–0.9	692.6
Deposits in foreign currency	–12.3	–4.0	–11.2	–17.8	–7.1	20.1	12.1	15.3	19.9
Rest of liabilities [5]	–4.4	–13.2	–4.3	–11.0	–19.2	–18.3	–20.5	–21.1	144.3
TOTAL	**–0.4**	**–5.7**	**–4.2**	**–5.9**	**–8.0**	**–4.8**	**–3.1**	**–3.0**	**1,316.5**

Notes: *(1) Billion euros. (2) Resident in Spain. (3) Including NPISH. (4) Total liabilities (consolidated). Liabilities between different levels of government are deduced.*
(5) Aggregate balance according to supervision statements. Includes asset transfers, securitized financial liabilities, repos and subordinated deposits.
Sources: *Bank of Spain and own calculations.*

POTENTIAL GDP, A CRUCIAL BUT UNCLEAR CONCEPT

Potential GDP and the output gap: what do they measure and what do they depend on?

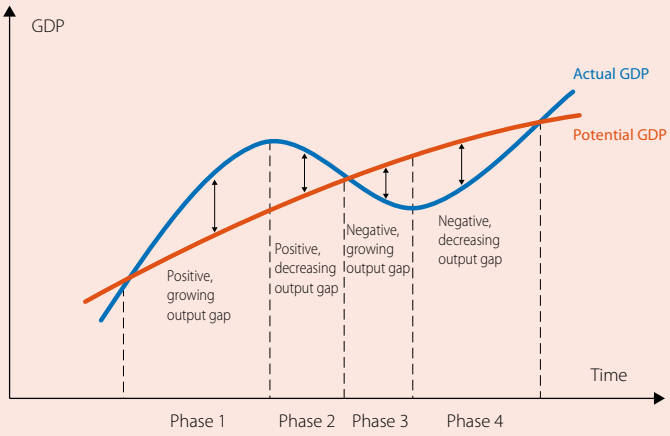
Like water from a shower, an economy is not always at the right temperature. Sometimes too hot, this causes inflationary pressures and other imbalances such as a high external deficit or asset bubbles. On other occasions too cold, this pushes the unemployment rate above what is usual and inflation falls below target. The level of economic activity does not often coincide with what an economy can produce in a sustained way, without generating pressures that push inflation away from its target or other imbalances, what is called potential GDP.

There are many different ways of defining and estimating potential GDP (see the article «How is potential GDP calculated?» in this Dossier). Its simplest and also most widely used version defines it as the level of production that is compatible with stable core inflation around its target level.[(1) (2)] This, in turn, requires that the degree of production capacity utilization and, in particular, the unemployment rate be at a level that does not put pressure on prices and wages, either upwards or downwards. This unemployment rate is called the NAIRU (Non-Accelerating Inflation Rate of Unemployment) or the structural unemployment rate.

In this respect, potential GDP is determined by anything that affects an economy's sustainable production capacity: the extent of production factors (size of the labour force, human capital, physical capital including infrastructures, etc.), how intensively these can be used without causing price tensions (the NAIRU) and the productivity they can be combined with (called the total factor productivity). In general, an economy's potential GDP keeps growing thanks to the gradual accumulation of production factors and technological innovation. In some circumstances, however, the level of potential GDP can fall temporarily such as in the case of a war or a natural disaster. Potential GDP can also fall during a deep, prolonged recession insofar as part of the capital stock becomes unusable (for example, surplus construction cranes after a real estate bubble has burst) or when some long-term unemployed leave the workforce permanently.

Economic policy plays a fundamental role in determining the path of potential GDP in the medium and long term and, therefore, an economy's capacity to grow via so-called supply policies. For example, labour legislation, active and passive employment policies, taxation, the retirement regime and education policy condition, together with demographics, the trend in the labour force and the NAIRU. For their part, public investment and policies to encourage or discourage private savings affect the trend in physical capital. Other factors, such as opening up the economy to international trade, the flexibility of the labour market, the degree of free competition, the regulatory environment and bureaucracy, the judicial system, etc. greatly influence the total productivity of these factors. In general, institutional quality is crucial both in terms of accumulating production factors and also in terms of their productivity.

The four phases of an economic cycle



Source: *Own chart.*

When designing and evaluating macroeconomic policies, economic authorities and analysts resort to a concept related to potential GDP: the output gap, defined as the difference between actual and potential GDP. A positive gap indicates the economy is operating above its sustainable level as a result of excessive demand. A negative gap means there is excessive supply or unused production capacity due to a lack of demand. Just as, if the water in the shower is too cold, we open the hot tap a little more, when this gap is negative the authorities try to stimulate economic activity by using fiscal or monetary policies. Gap estimates,

(1) Core inflation is general inflation corrected for the effects of disturbances on the supply side, such as a shock in oil or food prices or tax changes.
(2) A recent article argues that identifying sustainability with stable inflation is too restrictive and that it is also important to take financial imbalances into account (Borio, Claudio, Piti Disyatat and Mikael Juselius. 2013. «Rethinking potential output: Embedding information about the financial cycle», BIS Working Papers no. 404).

which can be interpreted as the cyclical component of GDP, are also used to identify the cyclical component of other variables of interest, such as the public deficit (see the article «The output gap, GPS and other fallible guides» in this Dossier).

So countercyclical policies attempt to influence aggregate demand to return GDP to its potential path or, in other words, to close the output gap. In this respect, an economic cycle can be broken down into four phases that require different macroeconomic policies (see the above graph): a first phase with a positive gap, in which growth remains above its trend and inflationary pressures and other imbalances increase; a second phase in which GDP growth is below its trend or when GDP even falls, closing the gap and reducing pressure on inflation; a third phase with a negative output gap and growth below its trend, or with GDP that continues to fall, which can lead to inflation falling below target; and, lastly, a phase that still has a negative gap but with growth above the long-term trend, which tends to close this gap. The Spanish economy is currently in the third phase, the one requiring greater support for demand. Another issue is the room that economic authorities have to implement these policies (currently inexistent for Spain in the fiscal area).

However, supply policies (structural reforms) can have a beneficial effect, even in the short term. By generating confidence, they can help to improve a demand that is overwhelmed by pessimism and uncertainty. In the current circumstances, indeed, there's nothing better for the short term than what is also good for the medium and long term.

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How is potential GDP calculated?

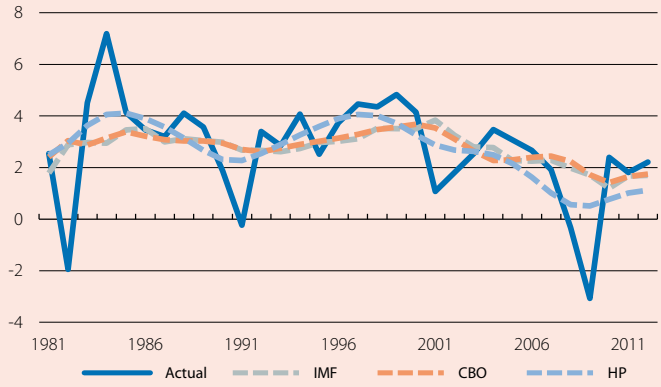
Both the GDP and employment of the countries in the epicentre of the crisis have been significantly hit. Yet the damage could be greater if the crisis hindered their production capacity or growth in the long term which, in economics jargon, is known as potential GDP and potential growth, respectively. How can we verify if this is the case? Potential GDP is an unobserved variable that has important policy implications so we have no choice but to estimate it.[1] However, as with all estimates, there is room for error and also for discrepancy since the outcome will largely depend on the methodology used.

Economists and analysts have drawn up different strategies to calculate potential output. These can be classified into three broad categories: methods that determine the trend in the cyclical part of GDP using statistical techniques; structural methods based on relations resulting from economic theory; and mixed methods that combine statistical procedures to filter the trend with elements based on economic theory. Whether one or the other is used depends primarily on data availability. In particular, most statistical methods are not very data-intensive since they only require output data to calculate the potential figure. On the other hand, structural methods, as they are based on a theoretical model that relates output to other variables, require a large amount of information that is not always available. For this reason, the International Monetary Fund (IMF), for example, does not define a standard methodology to calculate potential output but prefers to use the one that best suits the situation and availability of data for the country in question.

One of the main statistical methods is the Hodrick-Prescott (HP) filter which extracts a trend that is reasonably in line with the evolution observed in output and is «smooth»; i.e. it doesn't change too much from year to year. This data smoothing is based on the premise that variability in potential output, in the short term, cannot be excessive given that, on the one hand, the availability of basic production factors (labour and capital) is relatively inertial and, on the other, new technologies are slow to spread. The method's simplicity and its few requirements in terms of data (it only needs a sufficiently long series of GDP figures) are the advantages of the HP filter, as it can be applied to most countries. However, because of how it is constructed, the estimated potential output can be reasonably well adjusted to the middle years of the sample but not to the two extremes. This makes it difficult to use for contemporary estimates of potential output. Another drawback is the discretion allowed to the analyst in terms of the degree of «smoothing» carried out on the estimated trend.

Estimates that do not always coincide but are highly correlated

Actual and potential GDP growth of the USA according to different organisations (%)



Note: *IMF: International Monetary Fund; CBO: Congressional Budget Office; HP: Hodrick-Prescott (statistical approach). Most recent estimates.*
Sources: *IMF, CBO, Thomson Reuters Datastream and own calculations.*

Given these drawbacks, and although the HP filter is the most commonly used, the main international bodies resort to structural methods whenever possible.[2] These methods are based on more or less complex versions of the production function to produce a theory-based relation between a country's output and its production factors and technology. In practice, first the potential of the production factors and technology is calculated; these are then incorporated within the chosen production function and the result is the estimated potential GDP.

The wide range of options, both in terms of production function and possible strategies used to estimate the potential of production factors and technology, means that the resulting estimates can vary greatly. By way of example, the previous graph illustrates how the estimates for the potential output of the USA, calculated by the IMF and CBO, do not coincide even though both institutions use a methodology based on the production function. This discrepancy is even greater when these series are compared with the potential output obtained using an HP filter. The estimates also vary over time, as new data are included in the estimate.

(1) See the article «Potential GDP and the output gap: what do they measure and what do they depend on?» in this Dossier.
(2) The IMF and the OECD use these methods to estimate the potential GDP of the main advanced economies; also the European Commission, for EU countries.

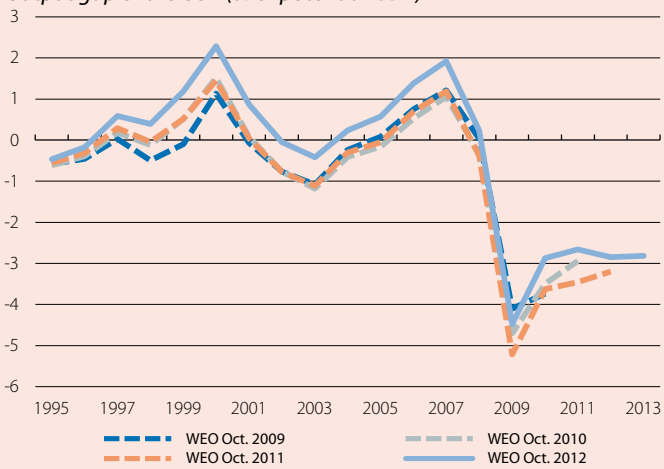
In addition to greater variability in the resulting estimate, the need to first calculate the potential of labour, capital and technology also makes this method more complicated in technical terms. For example, the calculation of the potential labour force or human capital depends crucially on initial assumptions and on how the estimates are calculated regarding future demographic trends, the activity rate in the labour market (labour force), labour legislation and educational policy, among other elements.

Similarly, calculating the potential value of capital services is particularly complex, due fundamentally to the difficulty posed by the heterogeneous composition of the capital factor (from factories to computers and patents). By way of example: one of the customary ways of calculating capital services is the perpetual inventory method, which estimates the existing capital stock based on past investment flows and the rate of depreciation. However, how to choose the depreciation rate? It seems logical to suppose that a computer depreciates more quickly than a building but, by how much?

Regarding technology, most organisations calculate its contribution as a residual (known in academic literature as the Solow residual); i.e. the part of economic growth that cannot be explained either by physical capital accumulation or a change in the labour factor. Using the historical technology series estimated as this residual, their potential is normally calculated via statistical methods such as the HP filter applied to the productivity series.

The estimates change as more data become available

Output gap of the USA (% of potential GDP)



Sources: *IMF (different WEOs) and own calculations.*

The structural approach is widely used in spite of its greater requirements in terms of data, its technical difficulty and disparity of results. Its main appeal lies in the fact that, by using the production function, the sources of any improvement or deterioration in economic growth can be well and easily identified, thereby resulting in well-substantiated recommendations.

Halfway between the oversimplification of statistical methods and the high technical and data requirements of structural methods are the mixed methods which, as their name suggests, combine the features of the other two approaches.(3) More specifically, they complement the statistical filters with relations based on economic theory. As a result of how they are constructed, these methods bring together some of the advantages and disadvantages of the two previous categories. For example, although the need for data is less when they include theory-based relations, the relative weight given to this economic information is, once again, arbitrary and depends on each analyst.

In short, there is no such thing as the perfect method so that, whatever approach is chosen, it is essential to maintain a critical view and be aware both of its qualities and its drawbacks. It is therefore no surprise that a calculation error, no matter how small, could have significant repercussions.(4)

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(3) Also known as semi-structural or multivariate filters.
(4) See the article «The output gap, GPS and other fallible guides» in this Dossier.

The output gap, GPS and other fallible guides

A storm is approaching. A car is stuck in the mud, right next to a cliff. After regretting having gone up the mountain, the owner asks for assistance. The mechanic arrives. He sits at the wheel and presses the accelerator to the floor. He stops. He hesitates and reduces the acceleration to gentle taps. The owner becomes exasperated: «First you almost send my car right over the precipice. Now you're moving it so little, we'll get struck by lightning before we ever manage to get out of this mud». The mechanic is also hesitating: «How far should I press the accelerator? If only I knew how deep the hole is!».

Back to reality: we can equate the car with the economy; being stuck in the mud with the recession; the cliff, with inflation; the storm, with economic depression; and the mechanic with macroeconomic policymakers. Unlike our mechanic, these policymakers do have indicators to measure the depth of the economic cycle and to judge, based on this measurement, which direction and how much «gas» they should give their policies. Most approaches are built on three basic concepts: potential growth, potential GDP and the output gap. This gap measures the distance between the actual level of GDP, indicative of the current tone of aggregate demand, and the potential level of GDP, indicative of output within a scenario of maximum employment (see the article «Potential GDP and the output gap: what do they measure and what do they depend on?» in this Dossier). The more negative this gap, the greater the room to manoeuvre and give more «gas» via countercyclical stimuli without incurring inflationary risks.

There is, however, a drawback: potential GDP is a theoretical construct and, as such, cannot be observed. So the measures used in practice are more or less complex estimates of this theoretical value (see the article «How is potential GDP calculated?» in this Dossier). As these are approximations of the ideal tally, at most they act as a guide. So what is the problem? If the estimate used is an imprecise approximation of the theoretical variable, for example because the model or the estimation method is flawed, this guide might be dangerously misleading. Followed to the letter, it could lead to completely wrong decisions and even counterproductive results. Resorting to another car-based analogy, it would be like following the instructions of a GPS that hasn't been updated, which tries to take us to our destination via a pedestrian precinct.

By way of example, let us think back to the experience of the Federal Reserve in the 1960s and 70s. Throughout this period, the Monetary Policy Committee maintained an excessively optimistic scenario of the US economy's production potential, which would have led it to underestimate the natural unemployment rate (the rate we would see if the output gap were zero and the economy grew in line with its potential). This misjudgement of the reality, which implied a larger output gap than was actually the case, led to the wrong monetary policy decisions: the official interest rate was lowered too far, resulting in high levels of inflation and damaging the monetary authority's credibility. Some studies conclude that, if the estimate of the natural unemployment rate had been regularly revised, i.e. if the Fed had updated its GPS, it could have avoided the harmful stagflation of the 1970s, a rather substantial corollary.[1]

Given what has been observed, some fear that the Federal Reserve might have come up against the same stumbling block today. In December, it linked maintaining its current highly accommodative stance to guidepost inflation and unemployment targets — inflation at 2.0% and unemployment at 6.5% — that presuppose a macroeconomic scenario in which the unemployment rate in the long term is around 6% (in the latest Fed minutes, the guidepost being used ranges between 5.2% and 6.0%). But what would happen if potential GDP was less than estimated and the natural unemployment rate higher than 6.5%? Well, the Fed's monetary expansion might once again go on for too long, possibly leading to inflationary pressures that could jeopardize the monetary authority's prized credibility.

In fact, there are reasons to believe that the US's potential GDP has not only diminished due to the crisis but that it also started to correct before the Great Recession, affected by demographic and economic trends that are developing in detriment to long-term growth.[2] Although, since the crisis started, the Fed has revised upwards its estimate for the natural unemployment rate, some are concerned that this revision may not be enough. Even the President of the Federal Reserve Bank of Richmond, Jeffrey Lacker, has disagreed with the latest monetary policy decisions, alluding precisely to the possibility of potential production being overestimated and the resulting underestimation of the inflationary risks posed by the Fed's policy.

(1) See Orphanides, Athanasios and John C. Williams. 2013. «Monetary Policy Mistakes and the Evolution of Inflation Expectations.» The Great Inflation, eds. Bordo and Orphanides. University of Chicago Press.
(2) See Gordon, Robert J. 2012. «Is U.S. Economic Growth Over? Faltering Innovation Confronts the Six Headwinds», NBER Working Papers no. 18315.

Spain: correction of the public deficit and structural deficit

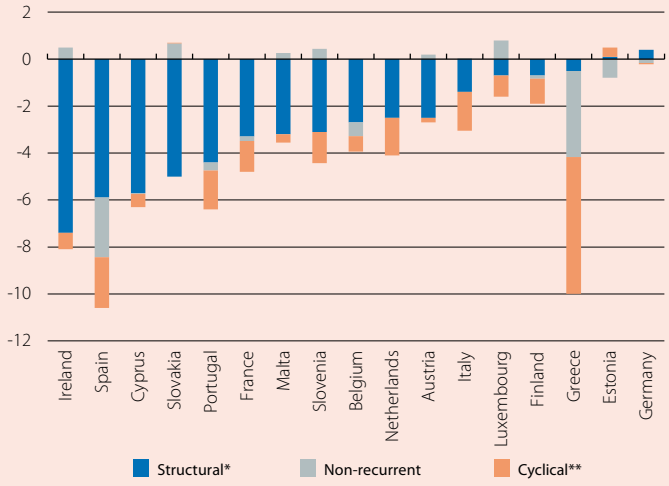
% of GDP

	2011	2012	Trend 2011-2012
Total government balance [1]	–9.5	–10.6	↓
Bank recapitalization costs [2]	–0.5	–3.6	
Government balance excl. bank recapitalization costs [1]-[2]	–9.0	–7.0	↑
Effect of other non-recurrent measures [3]	0.2	1.1	
Government balance adjusted for non-recurrent measures [1]-[2]-[3]	–9.2	–8.1	↑
Cyclical component	–1.9	–2.2	↓
Structural component	–7.3	–5.9	↑
Memorandum items:			
GDP growth	0.4	–1.4	↓
Output gap	–4.0	–4.5	↓

Sources: *European Commission and own calculations.*

Various structural balances in the euro area

(% of GDP, 2012)



Notes: *(*) Structural deficit estimated by the EC in its Winter Forecast 2013.*
(**) Cyclical deficit calculated based on definitive deficit figures published by Eurostat in April 2013 and on the elasticity rates used by the EC.[5]
Sources: *European Commission and own calculations.*

The uncertainty surrounding potential GDP not only makes it difficult to achieve consensus in the area of monetary policy but also to manage fiscal policy. It therefore comes as no surprise that the output gap is used to estimate the impact of the economic cycle on the fiscal balance and thereby purge the structural component; i.e. the part of the public surplus or deficit that persists when the output gap is closed. This structural component is very important when assessing the medium-term consolidation needs and determining the fiscal effort required by such consolidation, given that the cyclical balance will tend to disappear as the gap is closed.

Its identification, however, is also subject to errors of measurement resulting, once again, from the uncertainty regarding potential GDP and possible biases in the estimated sensitivity of the fiscal balance to the economic cycle. For example, the European Commission (EC), based on a deficit-cycle elasticity of 0.48 and an output gap of 4.5% of potential GDP, places the cyclical component of Spain's general government deficit in 2012 at 2.2% of GDP.[3] Discounting this 2.2% of GDP from the total deficit, previously corrected for the impact of non-recurrent adjustments (around 8.1% of GDP),[4] we obtain a structural deficit of 5.9%. If the estimated gap or elasticity were biased, this might lead to an over- or underestimation of the structural deficit, depending on the direction of this deviation, which could lead to mistakes in the adjustments imposed.

In this respect, the recent reform of the Stability and Growth Pact has made it even more important to measure structural balances accurately: fiscal targets now include requirements to correct the deficit's structural component in addition to those related to the overall balance. This structural correction requires permanent budgetary measures and reforms that boost potential economic growth; more or less far-reaching depending on the size of the imbalance.

In short, economic authorities employ measurements to set the course and intensity of their countercyclical policies that are not entirely reliable. Given that an error in such measurements is not always innocuous for the real economy, these indicators should be handled with extreme care. In addition to being regularly revised, they should also be combined with another, much more basic but infallible guide, the same one that helps us to avoid a pedestrian precinct no matter what the GPS tells us: common sense.

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(3) Estimates corresponding to its Winter Forecast 2013, published in February 2013.
(4) Difference between the total fiscal balance, –10.6% of GDP, and the part attributed to non-recurrent effects, –2.5% of GDP. These non-recurrent effects would include –3.6 points of GDP from bank recapitalization costs but also the positive effect of other measures deemed to be non-recurrent, such as savings in spending by cancelling the extraordinary Christmas pay to civil servants or revenue from the fiscal amnesty.
(5) See Mourre, Gilles *et al.* 2013. «The cyclically-adjusted budget balance used in the EU fiscal framework: an update». European Commission: European Economy-Economic Papers no. 478.

Spain after the recession: how fast can it grow?

The Spanish economy's growth capacity seems to have run out of steam. Since the recession started, GDP has fallen by 6.5%, the number of unemployed has grown by 4 million and the bulk of the evidence available suggests that, in the short term, these figures will merely increase. However, as the adjustments that are being implemented make headway and the European environment normalizes, the Spanish economy is more than likely to get back to growth. A scenario with many conditioning factors and full of unknowns, and this article deals with a very specific one: how fast will the economy actually grow?

Until a few years ago, the first pointer used to measure the growth capacity of the Spanish economy was by looking at history. From 1985 to 2008, the growth rate had been over 2% almost uninterruptedly, only posting lower figures in 1992 and 1993. In fact, the average growth rate was around 3% until just before the current recession. The narrowing of the gaps in the per capita income of Spanish citizens and their European neighbours is the most obvious effect of such a long period of prosperity. Between 1995 and 2008, this gap with the euro area narrowed by 7 percentage points, reaching 90% of the average income.

Given this situation, there were few doubts regarding the potential growth rate of the Spanish economy. The conclusions reached by using sophisticated econometric models were very similar to the simple average growth of the previous few years. Now, however, this simple calculation does not add up. To a large extent, the Spanish economy's growth over the last few years was boosted by four sectors that are unlikely to recover such a leading role. Between 2001 and 2007, the average rate of growth for construction was 5.0%. Real estate services also enjoyed a substantial growth rate, namely 2.7%. Between them, these two sectors contributed, on average, 0.8 percentage points to the economy's annual growth rate.

The financial sector is also unlikely to grow at a similar pace to its past achievements. Between 2001 and 2007 its average growth rate was 9.7%, contributing 0.6 percentage points to GDP growth on average. Lastly the public sector, with a level of debt that ended 2012 at 84% of GDP, will not be able to drive the economy either. Although its figures are somewhat more modest (the gross value added of public administration, health and education grew by 3.6% on average), these rates are unlikely to be repeated in the future.

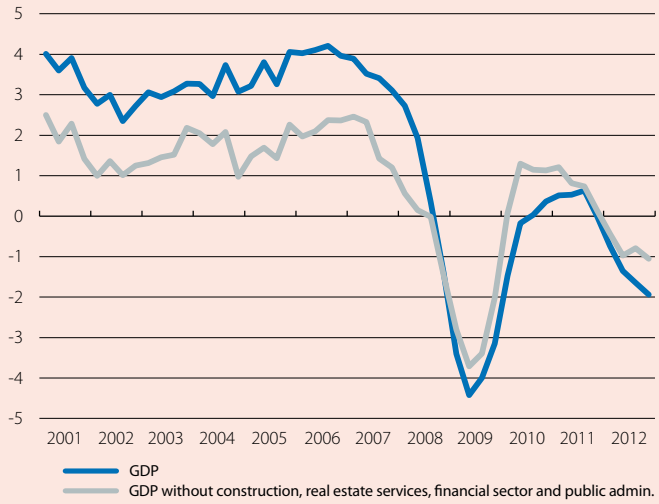
Discounting the contribution from these four sectors, the average growth rate for the Spanish economy was 1.8% between 2001 and 2007. This simple calculation gives us an idea of the growth capacity of the remaining sectors which, in principle, should be less affected. Although it is true they were enhanced by the booming economy and this will now affect them negatively, it is also true that they could not make use of the production factors that were being hogged by the more dynamic sectors. Moreover, the aforementioned four sectors are going to gradually gain ground as time goes on and, consequently, their contribution to growth will not be zero either.

In fact, 1.8% is a similar figure to the one various international organisations believe is the long-term growth capacity of the Spanish economy. For example, since 2008 the International Monetary Fund (IMF) has regularly published a 6-year growth forecast, a sufficiently long time span to consider this as an estimate of long-term growth capacity. As can be seen in the graph on the next page, in 2008 the IMF predicted long-term growth of 3.8%. Over the years, this forecast has gradually been cut back to the current figure of 1.6%, less than half the initial projection.

Another clue to the Spanish economy's long-term growth capacity is provided by the outlook for production factors, capital and employment, as well as productivity.[1] According to Hernández de Cos *et al.* (2011),[2] potential growth is around 2.0%; a slightly higher rate than the government's estimate

Growth was supported by four key sectors

Year-on-year change (%)

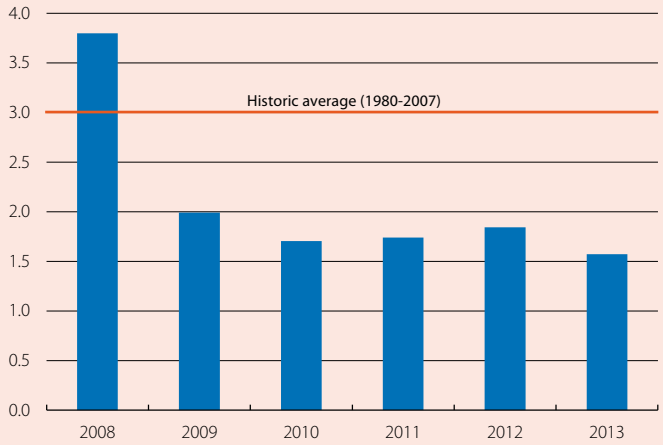


Source: *Spanish Statistics Institute (INE).*

(1) For a detailed explanation of this method of estimating potential growth, read the article «How is potential GDP calculated?» in this Dossier.
(2) Hernández de Cos, Pablo, Mario Izquierdo and Alberto Urtasun. 2011. «Una estimación del crecimiento potencial de la economía española». Bank of Spain, Documentos Ocasionales no. 1104.

The IMF revises downwards the long-term growth capacity of the Spanish economy

Forecasts over a 6-year span of GDP growth in Spain (%)



Source: *International Monetary Fund.*

which is between 1.2% and 1.5%. The large difference between both estimates lies in the assumed long-term investment rate. While the government expects this to remain close to its current level, Hernández de Cos *et al*. (2011) predict a certain recovery.

With regard to employment, its contribution will fall significantly and will remain at around 0.5 percentage points. This is due to the fact that the rise in the activity rate, which was considerable during the years prior to the recession, is now reaching its limit. Moreover, the migratory flows occurring, which led the population to increase by 5.1 million people between 2001 and 2010, are unlikely to be seen again. In both cases, however, it is assumed that structural unemployment, which Hernández de Cos *et al*. (2011) place at around 15% in 2012, will fall very slowly (by 0.5% per year, approximately). If measures were taken to speed up this process, the impact could be substantial. A reduction in the structural unemployment rate of one percentage point would increase the level of potential GDP by around 0.5 percentage points.

Productivity is another pending issue. Although it is true that, on the whole, the reduction in the relative weight of construction will allow resources to be allocated to more productive ends, under current conditions this does not look like being enough to reboot the economy. However, notable advances have been made over the last few years and provide a ray of hope. This is already resulting in significant improvements in Spanish exports which, over the last 3 years, have maintained an average annual growth rate of 7.3% and already account for 33% of GDP. Whether this rate of growth in the foreign sector can be maintained will largely depend on whether productivity continues to improve.

The growth capacity of the Spanish economy has not run out of steam but the bulk of the evidence available suggests it is substantially less than what was thought a few years ago. According to different estimates, it is between 1.2% and 2.0%. Naturally this figure is lower than the growth recorded between 2000 and 2007, namely 3.6%, which is when the huge imbalances were created that the Spanish economy is suffering from today. However, it is important not to give in to pessimism and commit, but in the opposite direction, the past errors of overestimating growth capacity. Moreover, it is necessary to remember that, if structural reforms are implemented that improve productivity and reduce structural unemployment, the impact could be considerable. Within such a scenario we might even see potential growth coming close to the figure of 2.5% which it exhibited, on average, between 1978 and 1999. The pending reforms have been extensively analyzed over the last few years and all that remains now is for them to be carried out; the sooner, the better.

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"la Caixa" GROUP: KEY FIGURES
As of December 31, 2012

Financial activity	MILLION €
Total customer funds	294,739
Receivable from customers	221,501
Profit atributable to Group	135

Staff, branches and means of payment	
Staff	34,128
Branches	6,342
Self-service terminals	9,696
Cards (million)	12.5

Community projects: budget for activities in 2013	MILLION €
Social	334
Science and environmental	67
Cultural	64
Educational and research	35
TOTAL BUDGET	**500**

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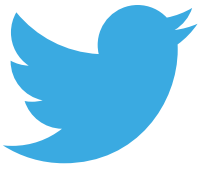

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