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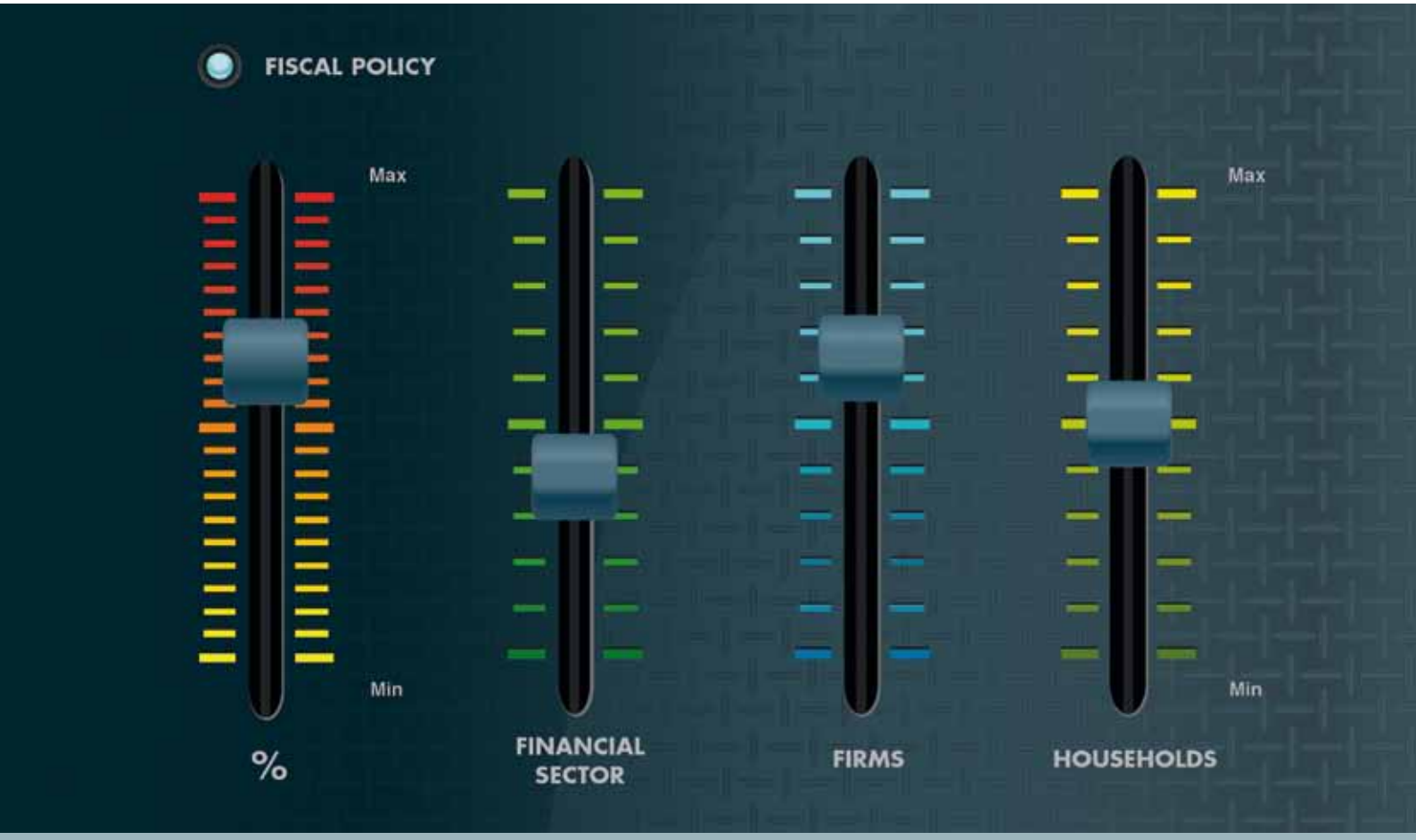
THE SPANISH ECONOMY

Monthly Report



FISCAL POLICY AND THE WORLDWIDE ECONOMIC AND FINANCIAL CRISIS

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2009	2010	2011	2010				2011	
				1Q	2Q	3Q	4Q	1Q	2Q
INTERNATIONAL ECONOMY			Forecast					Forecast	
Gross domestic product									
United States	–2.6	2.9	2.8	2.4	3.0	3.2	2.8	2.3	2.7
Japan	–6.3	4.0	0.6	5.4	3.3	4.7	2.6	1.4	–0.1
United Kingdom	–4.9	1.3	2.1	–0.4	1.5	2.5	1.5	1.8	1.9
Euro area	–4.0	1.7	1.5	0.8	2.0	2.0	2.0	2.1	1.4
Germany	*–4.7*	*3.5*	*2.4*	*2.1*	*3.9*	*3.9*	*4.0*	*4.1*	*2.2*
France	*–2.5*	*1.5*	*1.6*	*1.2*	*1.6*	*1.7*	*1.5*	*1.9*	*1.5*
Consumer prices									
United States	–0.3	1.6	2.9	2.4	1.8	1.2	1.2	2.2	3.2
Japan	–1.4	–0.7	0.8	–1.1	–0.9	–0.8	0.1	0.0	0.6
United Kingdom	2.2	3.3	4.0	3.3	3.4	3.1	3.4	4.1	4.2
Euro area	0.3	1.6	2.3	1.1	1.5	1.7	2.0	2.5	2.5
Germany	*0.4*	*1.1*	*2.1*	*0.7*	*1.0*	*1.2*	*1.5*	*2.1*	*2.2*
France	*0.1*	*1.5*	*1.9*	*1.3*	*1.6*	*1.5*	*1.7*	*1.8*	*2.0*
SPANISH ECONOMY			Forecast					Forecast	
Macroeconomic figures									
Household consumption	–4.3	1.3	0.9	–0.3	2.2	1.5	1.7	1.0	–0.1
Government consumption	3.2	–0.7	–1.7	–1.1	–0.1	–0.7	–0.9	–0.9	–2.4
Gross fixed capital formation	–16.0	–7.5	–3.6	–10.5	–6.7	–6.7	–6.1	–5.1	–5.2
Capital goods	*–24.8*	*1.9*	*3.0*	*–4.6*	*8.7*	*2.4*	*1.2*	*1.7*	*–1.3*
Construction	*–11.9*	*–11.1*	*–7.5*	*–11.3*	*–11.3*	*–11.2*	*–10.6*	*–9.4*	*–8.7*
Domestic demand (contribution to GDP growth)	–6.4	–1.2	–0.6	–3.0	–0.3	–0.7	–0.6	–0.7	–1.7
Exports of goods and services	–11.6	10.3	9.4	9.4	11.9	9.4	10.5	8.5	9.5
Imports of goods and services	–17.8	5.5	4.7	2.0	9.6	5.0	5.3	3.1	1.0
Gross domestic product	**–3.7**	**–0.1**	**0.5**	**–1.4**	**0.0**	**0.2**	**0.6**	**0.6**	**0.5**
Other variables									
Employment	–6.6	–2.3	–0.5	–3.8	–2.5	–1.7	–1.4	–0.6	–0.6
Unemployment (% labour force)	18.0	20.1	20.4	20.0	20.1	19.8	20.3	21.3	20.4
Consumer price index	–0.3	1.8	3.0	1.1	1.6	1.9	2.5	3.5	3.4
Unit labour costs	1.0	–1.5	–0.5	–0.9	–0.9	–1.9	–2.3		
Current account balance (% GDP)	–5.5	–4.5	–4.3	–6.0	–5.1	–3.7	–3.2	–5.1	–4.2
Net lending or net borrowing rest of the world (% GDP)	–5.1	–3.9	–3.7	–5.5	–4.4	–3.1	–2.6	–4.6	–3.7
General government financial balance (% GDP)	–11.1	–9.2	–6.4						
FINANCIAL MARKETS			Forecast						Forecast
International interest rates									
Federal Funds	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
ECB repo	1.2	1.0	1.3	1.0	1.0	1.0	1.0	1.0	1.3
10-year US bonds	3.2	3.2	3.6	3.7	3.5	2.8	2.8	3.4	3.6
10-year German bonds	3.3	2.8	3.5	3.2	2.8	2.4	2.6	3.2	3.5
Exchange rate									
$/Euro	1.39	1.33	1.42	1.38	1.27	1.29	1.36	1.37	1.47

Contents

Fiscal policy and the worldwide economic and financial crisis

Given the threat of depression triggered by the global financial crisis, authorities implemented exceptional measures on three fronts: direct support for the financial sector, aggressive easing of monetary policy and discretional fiscal stimuli to sustain aggregate demand. The medicine was appropriate but it had significant adverse effects, including high deficits and public debt that must be reduced as soon as possible. Moreover, in many cases economies have seen their potential growth vary substantially, resulting in the need to adapt public budget structures to the new situation. And not only to recoup deficits but also, and particularly, to boost growth. So what should be the focus for fiscal policy now that countries are exiting the crisis?

The answer could not be more controversial. There's general agreement that 2011 must be a year of fiscal consolidation, clearly setting a trend towards smaller deficits and more stable debt. However, the United States and Europe are following different paths while Japan, forced to face the costs of reconstruction after the earthquake, is a case apart. Even more a case apart are the emerging countries, whose high growth has relegated fiscal issues to second place.

In the United States, the debate between Democrats and Republicans on how to contain a public deficit that will reach almost 11% of gross domestic product (GDP) in 2011 and a debt of close to 100% of GDP is at its peak. Proposals focus on spending cuts but fiscal consolidation is unlikely to be achieved without increasing revenue. On 18 April, the seriousness of this situation was reflected in the rating agency, Standard & Poor's, giving a negative outlook to the country's rating, the maximum AAA, due to politicians being incapable of reaching a fiscal agreement in the medium term.

Meanwhile, in Europe the commitment to budgetary stability could not be more evident. The sovereign debt crisis that erupted at the end of 2009 left no alternative but fiscal austerity, even for those countries with a lower degree of imbalance and better economic prospects. Most member states of the European Union have undertaken to reduce their public deficits to 3% by 2013, if not earlier.

Another thing is how to approach this austerity without it destroying growth. Is it better to cut spending or raise taxes? In general, empirical evidence points towards spending cuts being less damaging to economic growth in the medium term than tax hikes. And if taxes are raised, it's believed that hikes in taxes on consumption, some special taxes and those on real estate are less harmful to economic growth. Alternatively, improving tax administration and gains in public spending efficiency should also be stressed in order to achieve the same goals but at a lower cost. We should also consider the alternative of reducing certain taxes if this helps to create jobs or boosts economic growth.

In any case, there's no universal recipe. Fiscal reforms must take various aspects into account such as the existing fiscal burden and the quality of public expenditure. What must be avoided at all cost is not doing anything at all, as the cost of inaction could be dramatically high, given that the crisis has left public accounts on a state of alert.

EXECUTIVE SUMMARY

Favourable outlook for the world economy, with provisos

The IMF predicts 4.4% growth for the world economy in 2011.

Keeping its springtime appointment, the International Monetary Fund (IMF) published its conclusions regarding the situation of the world economy. Few variations on January's forecasts and fewer risks of a double-dip recession. Growth in 2011 stands at a healthy 4.4%, slightly lower than the 5.0% of 2010. Emerging economies continue to be strong, with 6.2% growth forecast for 2011, while advanced economies are consolidating their recovery, which is still modest, with 2.4% growth forecast for 2011. Rising oil prices are the greatest risk to growth in the advanced economies, as well as representing an inflationary risk for the emerging economies.

Rising commodity prices, the problems of sovereign debt and slow job creation are just some areas of concern.

According to the IMF, the slight improvement in financial conditions is helping world demand to pick up which, in 2011, is supported more by private consumption and less by inventory rebuilding, as happened in the first half of 2010. The labour market and real estate crisis are the greatest obstacles to growth in advanced economies. Delay in US fiscal consolidation and the sovereign debt problems of Europe's peripheral countries represent another additional risk.
In the case of the emerging economies, rising food prices are a source of political instability, particularly in the Middle East and North Africa.

The recovery becomes firmer in the United States.

The Fund states that the recovery is gradually consolidating in advanced economies. The United States' growth prospects remain a little below 3% in 2011 and 2012. Whereas private consumption and business sentiment are the positive face of economic activity, the housing and labour market are the negative. Employment is recovering slowly and the housing sector is still extremely weak. The growth prospects for 2011 are relatively solid but we must not forget that they are still being supported by expansionary measures, both fiscal and monetary, adopted at the onset of the crisis. The fiscal deficit is once again around 10% of gross domestic product (GDP) in 2011 and politicians can't agree as to how to tackle fiscal adjustment. The agency Standard & Poor's revised the outlook on the long-term debt rating to negative, given the lack of definition in fiscal policy in the medium term.

With regard to US monetary policy, the debate concerns when and how to start its normalization: i.e. to undo the quantitative easing adopted to tackle the risk of depression. The Federal Reserve believes that long-term risks have increased but is still of the opinion that core inflation will remain under control.

Japan grew by 3.9% in 2010 thanks to the recovery of its exports, but it's expected to perform more moderately in 2011 with growth of 1.4%, which might increase to 2.1% in 2012. However, the growth forecast for 2011 could be downgraded if the energy cuts continue as a result of the Fukushima nuclear crisis. The huge human tragedy caused by March's earthquake will entail losses of capital

stock equivalent to between 3% and 5% of GDP, according to the IMF.

The outlook for emerging economies is still healthy, particularly East Asia, where China's growth is especially good and which, according to the IMF, will remain strong with 9.6% growth in 2011 and 9.5% in 2012. The most recent data indicate that China grew by a healthy 9.7% year-on-year in the first quarter of 2011, slightly below the 9.8% of the previous quarter, although higher than consensus forecasts. This strength has been accompanied by another upswing in inflation, reaching 5.4% in March, the highest level in almost three years. Within this context, the monetary authority has once again raised the official interest rate by 0.25 basis points to 6.31%, the fourth increase since October.

The economies of Latin America and Eastern Europe will continue to grow less than the Asian economies but are improving their prospects. In the case of Brazil, the IMF has warned of the risk of the economy overheating. The real was on the attack again in April, breaking through the resistance level of 1.60 reais per dollar. The markets have taken advantage of the Brazilian authorities' shift in priorities, which have temporarily ceased battling to stop the currency from appreciating in order to focus all their efforts on stamping out inflation. Inflation that had already reached the central bank's target range in April, when it stood at 6.5% year-on-year. Given this situation, no-one was surprised when the Monetary Policy Committee decided to raise the Selic rate a further 25 basis points to 12% in the same month.

Meanwhile, 1.6% growth is expected for the euro area in 2011 and 1.8% in 2012, with the prospect of low growth in its periphery. The IMF points out that the recovery in the euro area is consolidating although growth is still below its potential. It has also warned of the region's financial fragility. Available indicators confirm the good performance by production and domestic demand. However, three factors have appeared that are causing concern regarding the economic outlook. One is inflation, which rose to an annual rate of 2.7% in March; core inflation, which excludes volatile elements such as foods and energy, is lower but is also tending to rise, standing at 1.3%.

China's growth is still healthy, although clear signs of overheating are appearing.

Another cause for concern is the corollary of inflation; i.e. the tightening up of monetary policy. In the euro area, in April the European Central Bank raised its official interest rate to 1.25%, a hike which had been clearly predicted by Jean-Claude Trichet at the beginning of March. The reason given for this hike is the institution's concern for the upswing recorded in the rate of inflation. Lastly, and as a result of the increasing distance between the monetary policies on both sides of the Atlantic, another concern is the appreciation of the euro, making the euro area's goods and services more expensive compared with the rest of the world and harming European exports.

The euro area consolidates its recovery.

Nonetheless, the month's most relevant event has been Portugal's decision, on 6 April, to ask for the financial support mechanism to be activated given the overwhelming market pressure on Portuguese sovereign debt. The difficulty of the negotiations is two-fold, as the adjustment plan will require Portugal to carry out strenuous fiscal consolidation but, on the other hand, the elections on 5 June mean that both the government and the opposition must be present in the negotiations to ensure the plan can be viably implemented.

Pressure on Portuguese public debt has been combined with rumours of the restructuring of the Greek debt.

Portugal asks to be bailed out.

Investors welcome Spain's adjustment efforts.

This uncertainty affected the spread between Spanish and German debt, which widened again, albeit without reaching the previous levels and moving away, at least partially, from the serious and reasonable doubts hovering over Greece and Portugal. Investors welcome Spain's fiscal efforts and also the advances made in economic governance and financial solidarity in the euro area.

The IMF forecasts believe that Spain's fiscal deficit will increase its correction in 2011, reaching 6.2% of GDP (9.2% in 2010). This represents an improvement in the imbalance of three percentage points compared with last year, the biggest fall recorded among the main developed economies. This forecast is in line with the Bank of Spain's and is only two tenths of a percentage point more pessimistic than the target the government is committed to. It therefore seems as if there's general consensus regarding the good outcome of the fiscal adjustment measures approved by the economic authorities, mainly via reduced government spending.

Growth in the first quarter, still fragile.

One of the biggest risks to achieving the public deficit targets is the economy's growth, as the imbalance will be difficult to redress if activity does not get up to cruising speed. The data available for the first quarter of 2011 show that economic activity is progressing very gradually. Various indicators confirm that, in terms of consumption, the element with the greatest relative weight in the economy, its capacity to recover will still be quite limited in 2011 due to the reduction in households' real income. The weak progress made by household spending, together with the poor trends in fiscal expenditure and investment, suggest that domestic demand's contribution to growth will again be negative in 2011.

Prices, higher interest rates and the slow recovery in the labour market, the main risks to growth.

However, the data on the foreign sector are being somewhat better than expected, confirming the significant support it will provide to GDP growth this year. In February 2011, the non-energy trade balance posted a surplus of 125.9 million euros, unheard of since 1986. This improvement is due to the higher year-on-year rise in exports, namely 19.7%, compared with the 12.6% recorded by imports. As a result, the non-energy deficit accumulated since March 2010 fell to 15,033 million euros, 77% below the maximum reached three years ago.

Although the recovery seems to be on the right track, uncertainty still remains high. Notable threats to this recovery are the following: inflation due to rising oil prices, this being sharper in Spain than in other countries in the region; higher interest rates, which reduce the purchasing power of the household segment most in debt; and the sluggish recovery in the labour market, which has yet to create net employment. We should also note, however, the existence of opportunities, such as the risk premium improving more quickly than expected once Portugal's bail-out has been specified and progress is made in restructuring the Spanish financial system. Without doubt, improved confidence would be the best boost for business investment.

27 April 2011

CHRONOLOGY

2010

May	2	Countries in the euro area **approve financial aid for Greece**, totalling 110 billion euros.
	10	The European Union adopts a **European Stabilization Mechanism**, provided with 750 billion euros, with the involvement of the International Monetary Fund.
	20	The government approves a Decree-Law to adopt **extraordinary measures to speed up the planned reduction in its public deficit**.
June	17	The European Council decides to publish the **stress tests** for the main European banks, to levy a **new tax on banks** and improve the **budget discipline and macroeconomic standards**.
	22	The Spanish parliament **approves a Decree-Law with urgent measures to reform the labour market**, proposed by the government.
	26	One year after the Fund for Orderly Bank Restructuring (FROB) was set up, the Bank of Spain considers the **process of restructuring savings banks** in Spain to be almost complete.
	27	The **G-20** summit decides to halve the deficits of advanced economies by 2013.
July	1	**Rise in the general VAT** rate from 16% to 18%, and the reduced rate from 7% to 8%.
	9	The government approves the **reforms of the Savings Bank Governing Body Act**.
	22	The Ministry of Public Works specifies its **cuts in public works spending**.
	23	The Committee of European Banking Supervisors publishes the results of the **stress tests** on European banks.
September	9	The Spanish lower house passes the **labour reforms**.
	24	The government passes the bill for the **2011 General State Budget**, involving strong adjustments aimed at reducing the public deficit.
	29	**General strike**, called against the labour reforms.
October	20	Extensive reshuffle in the **Spanish government**.
November	19	The government establishes a **legislative calendar** that includes **pension and collective bargaining reforms**.
	24	**Ireland** presents an **adjustment plan** with tough measures to cut its public deficit in order to receive **financial aid** from the EU and the IMF.
December	3	The government approves a package of **economic policy measures** that includes, among others, the partial privatization of the state lotteries management body and the public corporation AENA, as well as raising taxes on tobacco.
	16	The European Council agrees to create a **European Stability Mechanism** in 2013, which will replace the current bailout fund, as well as to enlarge the capital of the European Central Bank.

2011

January	1	Estonia joins the **euro area**, which grows to seventeen member states.
	14	Ben Ali's regime in Tunisia falls, the first in a chain of **political changes** in North Africa and the Middle East, with repercussions for oil prices.
February	2	Signing of the **Social and Economic Agreement** by the government, trade unions and employers, including pension reform.
	18	The government passes a Decree-Law to reinforce the solvency of **financial institutions**.
March	25	The **Euro Plus Pact** is approved and the foundations are laid to set up the **European Stability Mechanism** in the European Council.
April	6	**Portugal**'s government asks the European Union for financial assistance.
	7	The **European Central Bank** raises the official interest rate to 1.25%.

AGENDA

May

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

June

- **2** Registration with Social Security and registered unemployment (May).
- **6** Industrial production index (April).
- **9** Governing Council of the European Central Bank.
- **14** CPI (May).
- **16** Labour costs (first quarter).
  EU HCPI (May).
- **22** Foreign trade (April).
  Fed Open Market Committee.
- **24** Producer prices (May).
- **28** Government revenue and expenditure (May).
- **29** Retail sales (May).
- **30** HCPI flash estimate (June).
  Balance of payments (April).

INTERNATIONAL REVIEW

IMF forecasts: two-speed growth

The IMF predicts 4.4% growth worldwide for 2011 with less risk of relapse.

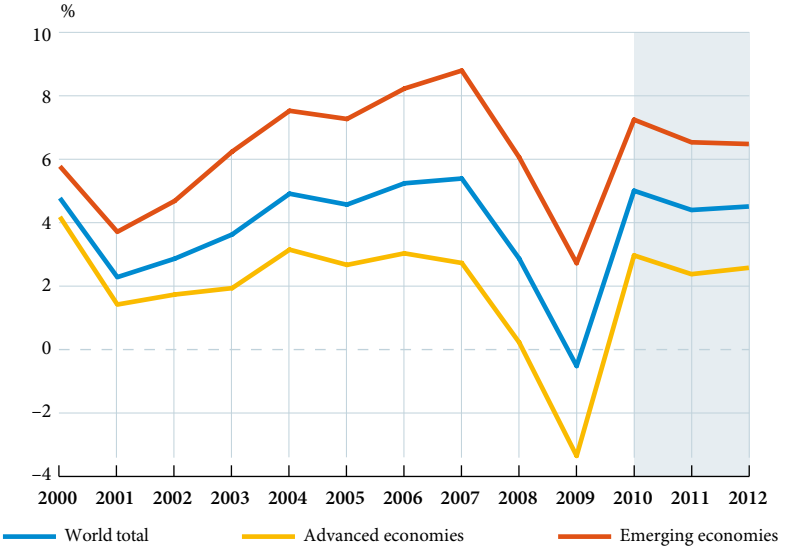
In its World Economic Outlook for April, the International Monetary Fund (IMF) maintained most of its forecasts from January and stated that the risk of relapse has diminished. Growth in 2011 remains at a healthy 4.4%, slightly lower than the 5.0% for 2010. Emerging economies continue strong, with a growth forecast of 6.2% for 2011, while advanced economies are consolidating their recovery, which is still modest, with 2.4% growth forecast for 2011. Rising oil prices are the greatest danger to growth in advanced economies, as well as representing an inflationary risk for emerging countries.

Growth is strong in the emerging economies and consolidating in advanced economies.

According to the IMF, the slight improvement in financial conditions is helping world demand to pick up which, in 2011, is supported more by private consumption and less by readjustments in stocks, as was the case in the first half of 2010. The labour market and real estate crisis are the greatest obstacles to growth in advanced economies, while the delay in US fiscal consolidation and the sovereign debt of Europe's peripheral countries represent other, additional risks. In the case of emerging economies, rising food prices are a source of political instability, particularly in the Middle East and North Africa.

THE RECOVERY CONSOLIDATES

Year-on-year change in CPI (*)



NOTE: (*) 2010, 2011 and 2012 are forecasts (shaded).
SOURCE: International Monetary Fund.

The Fund states that the recovery is gradually becoming firmer in advanced economies. The United States maintains its growth prospects with 2.8% forecast for 2011 and 2.9% for 2012, although the labour market is recovering too slowly and the housing industry is still extremely weak. For its part, the euro area expects to grow by 1.6% in 2011 and 1.8% in 2012, with low growth prospects for its periphery.

Germany continues to be the engine of the euro area. After the boost from exports in 2010, pushing German growth up to 3.5%, the IMF expects more moderate advances for 2011 and 2012 of 2.5% and 2.1% respectively. Spain continues to see its prospects improve, although its growth will still be one of the most moderate in the euro area, namely 0.8% in 2011 and 1.6% in 2012.

Japan shares some similarities with Germany as an exporter among the advanced economies. In 2010 its economy grew by 3.9% thanks to the recovery of its exports, but the economy is expected to take a more moderate path in 2011 with 1.4% growth, which might rise to 2.1% in 2012. However, the growth forecast for 2011 could be downgraded if the power cuts continue as a result of the Fukushima nuclear crisis. The huge human tragedy caused by March's earthquake will entail losses of capital stock equivalent to between 3% and 5% of GDP, according to the Fund.

2.8% growth is forecast for the United States in 2011 and 1.6% for the euro area.

Japan will slow down in 2011 while China and the emerging countries of Asia will continue to lead world growth.

IMF FORECASTS

Annual change as percentage (*)

	GDP		Consumer prices		Unemployment rate (**)	
	2010	2011	2010	2011	2010	2011
United States	2.8	2.9	2.2	1.6	8.5	7.8
Japan	1.4	2.1	0.2	0.2	4.9	4.7
China	9.6	9.5	5.0	2.5	4.0	4.0
Germany	2.5	2.1	2.2	1.5	6.6	6.5
France	1.6	1.8	2.1	1.7	9.5	9.1
Italy	1.1	1.3	2.0	2.1	8.6	8.3
United Kingdom	1.7	2.3	4.2	2.0	7.8	7.7
Spain	0.8	1.6	2.6	1.5	19.4	18.2
Euro Area	**1.6**	**1.8**	**2.3**	**1.7**	**9.9**	**9.6**
Advanced economies	**2.4**	**2.6**	**2.2**	**1.7**	**7.8**	**7.4**
Developing countries	**6.5**	**6.5**	**6.9**	**5.3**	...	...
Latin America	*4.7*	*4.2*	*6.7*	*6.0*	...	...
Eastern and Central Europe	*3.7*	*4.0*	*5.1*	*4.2*	...	...
Emerging Asia	*8.4*	*8.4*	*6.0*	*4.2*	...	...
World Total	**4.4**	**4.5**	**4.5**	**3.4**	...	...
World trade by volume (***)	**7.4**	**6.9**				

NOTES: (*) Forecasts at Abril 2011.
(**) As percentage of labour force.
(***) Goods and services.
SOURCE: International Monetary Fund.

The United States grows by 2.3% but the sustainability of public debt becomes the key issue.

The outlook for the emerging economies is still very good, particularly in the more eastern part of Asia. Of note is China's growth, which will remain strong according to the IMF, advancing by 9.6% in 2011 and 9.5% in 2012. The economies of Eastern Europe and Latin America will continue to grow less than the Asian economies but their prospects have improved.

The United States: public debt for the sake of growth

US economic policy is increasingly biased towards supporting domestic demand at the same time as postponing fiscal consolidation. The slight improvement in financial conditions is helping a recovery to consolidate that, unlike in the first half of 2010, is now being supported more by private consumption and less by the constantly fluctuating stock adjustments. However, high unemployment and the weakness of the housing market, unparalleled since 1945, continue to particularly hit the middle classes hard. 2011's growth prospects do not go beyond 3.0%, ensuring these two burdens continue. Hence the maintenance of expansionary policies, whose consequence will be that the public deficit will once again be above 10% of GDP in 2011. In absence of a credible fiscal consolidation plan in the medium term, the bond markets continue treat US bonds benevolently. But the potential governmental stoppage in May illustrates, however, that the issue of the sustainability of this public debt will be increasingly present throughout 2011. When this Report was going to press, the Bureau of Economic Analysis announced that GDP had grown by 2.3% year-on-year in the first quarter.

Consumers continue to buy, in spite of everything.

Consumers continue to look strong in March. Retail sales, without the volatile cars or petrol, were up 5.1% year-on-year

UNITED STATES: MAIN ECONOMIC INDICATORS

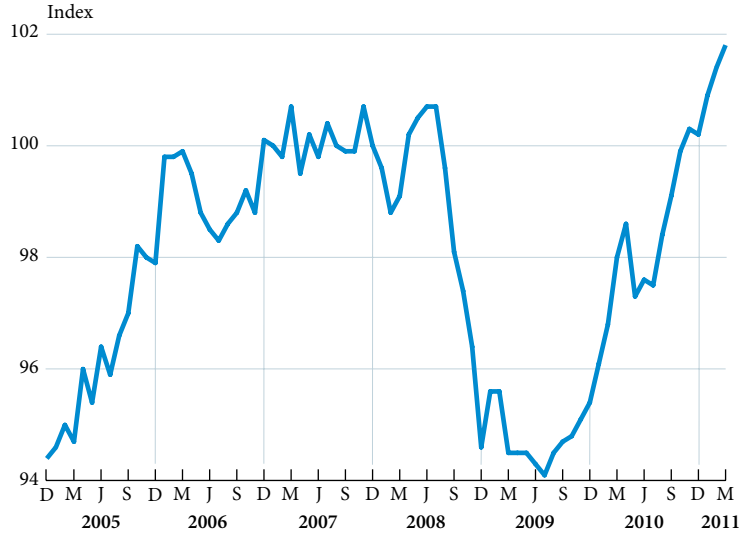
Percentage change over same period year before unless otherwise indicated

	2009	2010	2010				2011		
			1Q	2Q	3Q	4Q	January	February	March
Real GDP	–2.6	2.9	2.4	3.0	3.2	2.8	–	2.3	–
Retail sales	–6.4	6.5	5.3	6.9	5.8	7.7	8.2	9.1	7.1
Consumer confidence (1)	45.2	54.5	51.7	58.2	50.9	57.0	64.8	72.0	63.4
Industrial production	–11.2	5.3	1.6	6.5	6.9	6.4	6.0	5.8	...
Manufacturing (ISM) (1)	46.3	57.3	58.6	57.6	55.2	57.9	60.8	61.4	61.2
Housing construction	–38.4	5.6	16.5	12.2	0.4	–5.4	1.0	–20.8	...
Unemployment rate (2)	9.3	9.6	9.7	9.6	9.6	9.6	9.0	8.9	8.8
Consumer prices	–0.4	1.6	2.4	1.8	1.2	1.3	1.6	2.1	...
Trade balance (3)	–374.9	–495.7	–398.3	–450.4	–483.7	–495.7	–508.1	–514.1	...
3-month interbank interest rate (1)	0.7	0.3	0.3	0.5	0.3	0.3	0.3	0.3	0.3
Nominal effective exchange rate (4)	77.7	75.3	74.8	77.6	75.9	73.0	73.0	72.0	70.8

NOTES: (1) Value.
(2) Percentage of labour force.
(3) Cumulative figure for 12 months in goods and services balance. Billion dollars.
(4) Exchange rate index weighted for foreign trade movements. Higher values imply currency appreciation.
SOURCES: OECD, national statistical bodies and own calculations.

THE UNITED STATES: STRONG RECOVERY IN PRIVATE CONSUMPTION

Real retail sales without vehicles or petrol. Base index 100 = December 2007 (*)



NOTE: (*) Data deflated by the consumer price index without energy or foods.
SOURCES: Department of Trade and own calculations.

and have accumulated a run of eight months of rises since August, with the exception of December. The national accounts also confirm that consumption is healthy. Although the end to the upswing in purchases of consumer durables will mean that growth in consumption will moderate in the first quarter, February's savings rate was once again below 6% of households' disposable income, indicating the predisposition to consume.

The optimism that has prevailed in business sentiment remained in March, although somewhat overshadowed by the expected effects of rising commodity prices on company earnings for the first quarter. Nonetheless, business sentiment continues to be optimistic, supported by relatively low debt, growing demand and a context of benign labour costs. In March, the Institute for Supply Management's business sentiment index for manufacturing lost just two tenths of a percentage point, leaving it at 61.2 points, although new orders declined. The production index fell more sharply in services, going from 66.9 to 59.7 points. In spite of these corrections, in both cases the indices continue to be consistent with a situation of strong economic growth.

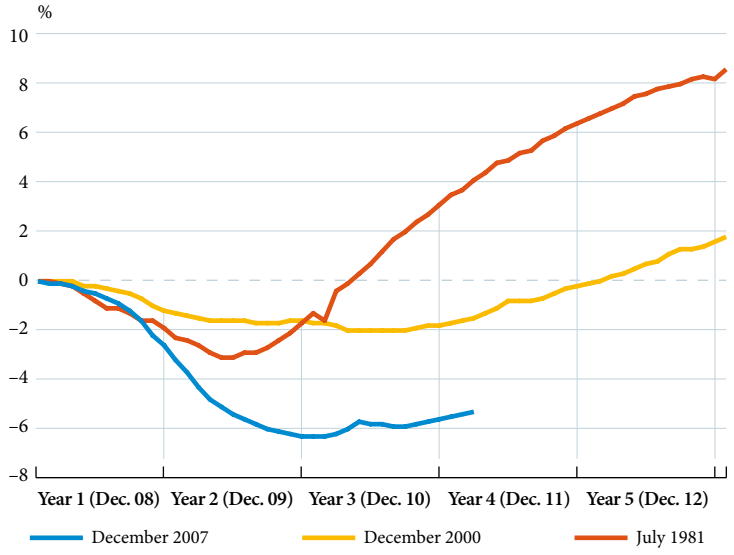
Business optimism continues high in spite of certain caution.

Whereas private consumption and business sentiment represent the positive face of economic activity, the housing and labour market, both closely interrelated, represent the negative. The recovery in employment is gaining strength early in the year but is still too slow and its growth prospects for 2011 mean that it's unlikely to improve significantly. In the first quarter there was a slight acceleration in employment with the net creation of 478,000 new jobs. However, seen over a longer timescale, the 1.5 million jobs created in the last twelve months up to March are clearly insufficient to offset the 8.75 million lost during 2008 and 2009. The unemployment rate also continued

The unemployment rate falls to 8.8% but employment still has a long way to go.

THE UNITED STATES: THE RECOVERY IN EMPLOYMENT IS SLOW

Job losses as percentage of total employed at the start of the decline (*)



NOTE: (*) The dates in brackets correspond to the last recession (December 2007).
SOURCES: Department of Labor and own calculations.

The excess supply of housing means that prices continue to fall.

to improve, falling slightly to 8.8%, but a significant proportion of this improvement is due to a smaller workforce resulting from the rise in the number of discouraged workers who, once they return to the market, will absorb a considerable number of the jobs created. We must also bear in mind that the high proportion of long-term unemployed, a large part of these due to the loss of jobs in construction, is another spanner in the works for the recovery in the labour market as they are more difficult to relocate.

High unemployment is resulting in defaults on mortgage repayments, very often ending up in foreclosures. In turn, these foreclosures boost the stock of housing available for sale and perpetuate the excess supply although construction has almost stopped, with new homes started still just one third of the normal figure in times prior to the real estate bubble.

This excess supply in the sector makes it difficult for prices to recover and these are still falling and have yet to bottom out, although they are falling at a slower rate than after the bubble burst. In this respect, the Case-Shiller second-hand housing price index for the twenty main cities fell in January and has accumulated, in seven consecutive months of decreases, a depreciation of 3.9%, 31.9% compared with the maximum of April 2006. The real estate wealth of households accounted for a substantial 110.1% of nominal GDP in the fourth quarter of 2010. The loss of wealth noted by the Case-Shiller index between July 2010 and January 2011 is therefore greater than 4% of GDP, comparable to the loss caused by Japan's earthquake and, if it doesn't pick up, may end up harming consumption.

Inflation continues to rise. The general consumer price index (CPI) increased by 2.7% year-on-year in March, well above

the 2.1% of February. This increase is mainly due to rising oil prices which, over the coming months, should continue to push up the general index. But, nonetheless, at present oil is more a problem of growth than of prices. The core CPI which, as it excludes energy and food prices, is a more accurate reflection of the underlying trend, rose by 1.2% year-on-year within an overall tone of greater moderation than in February. This is why the Fed is still more concerned about insufficient growth than rising inflation.

The CPI picks up to 2.7% but core inflation continues at a moderate 1.2%.

In the foreign sector, February's trade balance repeated the bad results of January with a deficit of 45,758 million dollars while the trade deficit excluding oil had a similar profile, standing at 19,942 million dollars. The recovery in exports has been overshadowed by the progress in imports, encouraged by the relative strength of private consumption and making it unlikely that the foreign sector will continue to contribute positively to growth in the fourth quarter.

The trade deficit still hasn't adjusted due to the recovery in imports.

Fiscal consolidation in the United States

The weak demand caused by the credit crisis has led advanced economies to accumulate huge public deficits in order to sustain demand. Having softened the blow, the key issue now is to correct these deficits and reduce government debts that are excessively high. Consequently, 2011 must be a year of fiscal consolidation. However, the United States and Europe are following different paths in this area, while Japan, forced to face the costs of reconstruction after the earthquake, is a case apart.

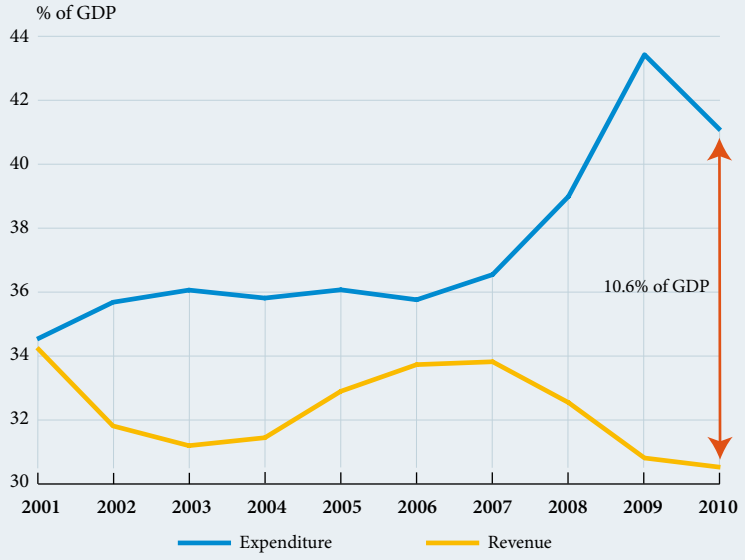
According to the International Monetary Fund (IMF), while the public deficit in the euro area will go from 6.1% of GDP in 2010 to 4.4% in 2011, in the United States it will increase from 10.6% to 10.8%. And this situation does not seem to sort itself out sufficiently in the medium term. The IMF expects the US public deficit to remain at around 6% of GDP in 2016, while in the euro area it expects this to fall below 2%. Consequently, for 2016, the American government's gross debt might reach 112% of GDP compared with 86% in the euro area. These figures raise serious doubts concerning the sustainability of American public accounts, as has been underlined by the S&P when it lowered the outlook for the US public debt rating from stable to negative.

The United States has become aware of the seriousness of the situation and the public deficit is already being debated at the centre of the political arena, as shown by the feverish negotiations to avoid a government shutdown in May. But the real debate lies in how to accomplish fiscal consolidation. Returning to a balanced, sustainable public treasury involves cuts in spending and increases in revenue.

Most proposals to date, both from the Democratic administration and the Republican opposition, emphasize the spending side of the equation. The problem, however, is that a large part of the federal government's spending, the level of government that uses the largest proportion of the public deficit, is dedicated to health, pensions and other transfer programmes where the margin for savings is limited, given demographic pressures and the political difficulty of carrying out reforms that modify benefits. The proposals therefore focus on reducing so-called discretional spending. However, this accounts for just 40% of the total expenditure and half is allocated to defence,

THE UNITED STATES: EXPENDITURE CLOSE TO A MAXIMUM, REVENUE MINIMUM

Government spending and revenue



SOURCES: IMF and own calculations.

also a highly delicate item politically. In summary, although part of the fiscal deficit adjustment will come from spending cuts, most of the estimates made, both by the IMF and by the Congressional Budget Office, limit potential savings to a maximum of 1%-1.5% of GDP over the next five years.

The other alternative to reduce the deficit is to increase revenue. This does not seem so ridiculous if we remember that, in the United States, revenue from all public administrations is at a relatively low level. In 2010, this totalled 30.5% of GDP, about 4 points of GDP below the level at the start of the decade, the last time the budget was closed to balanced. This ratio is also low if we compare it with the 35.7% for advanced economies as a whole or the 44.4% of the euro area in 2010. In part, the relative weight of revenue in GDP will grow automatically as the economic recovery advances and employment and corporate profits grow. But this inertia alone won't be enough to reduce the fiscal deficit to the level required to stabilize the public debt. According to various analysts, what's needed are revenue measures that could contribute around 2% of GDP in the medium term.

Not all tax hikes are equal. Some cause more distortions than others and there are even cases where a change in tax pressure can be associated with a reduction in distortions, such as when the taxable base is widened and the rate lowered. In this respect, there are three proposals on the table that would minimize the possible negative effect of a tax hike on economic growth: a reduction in fiscal deductions, the implementation of a value added tax (VAT) and the so-called ecological taxes.

Tax deductions in the United States are among the most costly in the world. According to the OECD, in 2010 their cost was equivalent to 8% of GDP, while in Germany this figure scarcely reached 1%. These figures are often highly distorting and complicate and obfuscate the taxation system. Specifically, there are two types of deductions

that could be redesigned. The first is a deduction for the interest paid on mortgage loans, designed to boost home ownership over renting but which, in practice, also encouraged the purchase of larger, more expensive properties. If eliminated, it could result in additional annual revenue equivalent to 0.4% of GDP, according to Congress Office estimates. Another similar proposal is to limit the deductions as a whole (including mortgage interest, medical costs, etc.) to 15% of personal income, which could increase public revenue by 1% of GDP.

Another important group of deductions is related to company tax, which in the United States has a top rate of 35% on company profits, one of the highest in the world. On the other hand, its deductions are among the most generous and certain types of firms are exempt from this tax. A reduction in these deductions would save 0.4% of GDP, leaving enough room to potentially lower the company tax rate.

The second way to increase revenue would be by introducing a VAT. In the case of a 5% tax rate, the Congressional Budget Office has estimated that revenue could reach 1.4% of GDP. One of the advantages of VAT is that it does not deter people from saving or investing. Its regressive nature, namely that low income households spend a larger proportion of their income, could be offset by excluding staples from those products with VAT.

Thirdly, green taxes could also be useful in an economy with such high energy consumption. An additional tax of 0.25 dollars per gallon (3.78 litres) of petrol, for example, would provide revenue of around 0.2% of GDP. It has also been estimated that auctioning permits to emit carbon dioxide, compatible with a 20% reduction in emissions, would generate an income equivalent to 0.6% of GDP.

It's clear that solutions to reduce the deficit exist, some better than others. We can only hope that, in a country that has been characterized by the success of its bipartisan committees, finds the right political way to ensure its public finances are sustainable.

This box was prepared by Jordi Singla
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Japan: counting on resolving a nuclear crisis

The Japanese economy will slow down significantly in 2011 once the effects of the upswing in exports from early in 2010 have disappeared. To this we should add the effects of March's earthquake and the nuclear crisis at the Fukushima plant, the greatest risk to Japan's growth in 2011. Added to the undeniable human tragedy are losses of wealth whose estimates have been increased over the last few weeks, going from 16 to 25 trillion yen, 3.0% and 5.0% of GDP. Nevertheless, the direct effects of the earthquake and tsunami on GDP growth, which is a measure of activity and not of wealth, might be moderate, as with the Kobe earthquake in 1995. But the complications at the Fukushima nuclear reactor are prolonging power cuts and therefore making it difficult for economic activity to recover.

The tragedy of Fukushima entails great human cost but its influence on GDP should be limited.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010				2011		
			1Q	2Q	3Q	4Q	January	February	March
Real GDP	–6.3	4.0	5.4	3.3	4.7	2.5	–	...	–
Retail sales	–2.3	2.5	3.8	3.7	3.2	–0.4	0.1	0.1	...
Industrial production	–21.8	16.0	27.1	21.1	12.9	5.0	1.8	2.9	...
Tankan company Index (1)	–40.8	0.0	–14.0	1.0	8.0	5.0	–	6.0	–
Housing construction	–27.7	2.7	–7.0	–0.8	13.7	6.8	2.3	10.2	...
Unemployment rate (2)	5.1	5.1	5.1	5.1	5.0	5.0	4.9	4.6	...
Consumer prices	–1.3	–0.7	–1.2	–1.0	–0.8	0.1	0.0	0.1	...
Trade balance (3)	4.0	7.9	6.7	7.4	8.1	7.9	7.3	7.2	...
3-month interbank interest rate (4)	0.6	0.4	0.4	0.4	0.4	0.3	0.3	0.3	0.3
Nominal effective exchange rate (5)	98.6	106.0	101.1	102.8	109.1	111.0	111.1	110.3	110.5

NOTES: (1) Index value.
(2) Percentage of labour force.
(3) Cumulative balance for 12 months. Trillion yen.
(4) Percentage.
(5) Index weighted for foreign trade movements. Higher values imply currency appreciation. Average in 2000 = 100.
SOURCES: OECD, national statistical bodies and own calculations.

If the nuclear risk stabilizes, the economy will pick up in the second half of 2011.

The effects are already being felt by the production of firms such as Sony, Honda and Toyota. In a country where nuclear energy supplies 29% of electricity, growth in the second quarter should be negative, while there should be a recovery in the second half of the year, leaving growth for 2011 as a whole at 0.7%. There is the risk that this forecast will be lowered, depending on developments at the Fukushima plant, which might result in a decline in GDP for the whole of 2011.

Reconstruction costs will pressurize the already hard hit public coffers. The Bank of Japan, which intervened to guarantee liquidity in the system and stop the yen from appreciating due to the repatriation of assets by insurers and speculation, refuses to monetize debt, but the fact that the government's main lenders are the Japanese themselves should ease pressure in the short term.

February's CPI once again had a zero year-on-year increase while the core CPI, which excludes energy and foods, fell again by 0.6% year-on-year. The end of deflation looks uncertain. The earthquake should have an inflationary effect for 2011 but consumers' caution given the power cuts could act in the opposite direction by paralyzing activity. Tokyo's prices fell in March by 0.3% compared with February, the highest month-on-month drop since September.

China: a soft landing?

China grew at a robust 9.7% year-on-year in the first quarter of the year, slightly below the 9.8% of the previous quarter although more than consensus forecasts. This strength has come with another upswing in inflation, reaching 5.4% in March, the highest level in almost three years. Nonetheless, our main scenario still predicts a soft landing for the Asian economy, with GDP growth of around 9% for 2011 and 2012, providing the risks of overheating hovering over the country do not take hold.

Within a context of strong growth and inflationary tension, the monetary authority has once again raised the official interest rate by 0.25 basis points to 6.31%, the fourth rise since October and the first for 2011. This is in addition to numerous increases in the cash reserve ratio, credit limitations and a more flexible currency. Given the aforementioned fears of overheating and with a still active fiscal policy, we expect monetary normalization to continue at a somewhat faster pace than expected a few months ago. In particular, we expect two further hikes before the end of the year, several increases in the cash reserve ratio and a somewhat higher appreciation of the renminbi against the dollar, albeit still gradual, than the appreciation observed over the last few months.

In a recent speech, Prime Minister Wen Jiabao promised to tackle the inflationary problem once and for all, as well as to cool down the real estate sector. With regard to this sector, a recent IMF study reveals a 70% cumulative rise in housing prices for 35 cities in the country over the last 5 years. The same article also states that, although there are clear indications of bubbles in some of these cities, especially those on the coast, it cannot be concluded that this is the case throughout the country. Nonetheless, other studies do suspect Chinese real estate bubbles. In this context, the government has taken several measures to cool down this sector: increasing the down-payment required to buy second and third homes, higher interest rates for mortgages for second homes, the already mentioned credit restrictions for real estate developers and the construction of state-supported housing.

Within this context of economic dynamism, the most recent business

China grows a robust 9.7% year-on-year in the first quarter of 2011.

Monetary normalization will have to continue at a faster pace to reduce the risks of overheating.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2009	2010	2010				2011		
			1Q	2Q	3Q	4Q	January	February	March
Real GDP	9.2	10.3	11.9	10.3	9.6	9.8	–	9.7	–
Industrial production	12.5	15.7	19.8	16.0	13.5	13.3	13.3	14.9	14.8
Electrical power generation	6.8	14.0	22.6	17.8	11.8	6.2	8.2	15.0	13.7
Consumer prices	–0.7	3.3	2.2	2.9	3.5	4.7	4.9	4.9	5.4
Trade balance (*)	196	184	148	155	182	184	176	162	169
Reference rate (**)	5.31	5.81	5.31	5.31	5.31	5.81	5.81	6.06	6.06
Renminbi to dollar	6.8	6.8	6.8	6.8	6.8	6.7	6.6	6.6	6.6

NOTES: (*) Cumulative balance for 12 months. Billion dollars.
(**) Percentage at end of period.
SOURCES: National Statistics Office, Thomson Reuters Datastream and own calculations.

The government is also looking to cool down the real estate sector.

indicators, corresponding to the month of March, merely corroborate this marked vitality. Industrial production grew strongly by 14.8% in March, above the 14.1% of January and February combined. Retail sales were up 17.4% year-on-year in current terms, also above the two previous months combined. Investment in fixed capital grew by 25%, above the 24.5% for December. Lastly, the purchasing managers' index (PMI) stood at 53.4 points, the first increase after three months of falls.

In short, the risk of overheating and of bubbles in the real estate sector, particularly in many of the large cities on the coast, are still the main concerns facing the Asian giant. However, in the medium term, the difficulty of encouraging domestic consumption and private investment as growth drivers, given the preponderance of the foreign sector, is the main risk facing the economy if it wants to sustain of its high growth rates.

The risk of overheating increases in Brazil.

Brazil: inflation and the real, out of control

The real was on the attack again in April, breaking through the resistance level of 1.6 reais per dollar. The markets have taken advantage of the Brazilian authorities' shift in priorities, which have temporarily ceased battling to stop the currency from appreciating to focus all their efforts on stamping out inflation; inflation that had already reached the maximum level of the central bank's target range in April, when it stood at 6.5% year-on-year.

Given this situation, no-one was surprised when the Monetary Policy Committee decided to raise the Selic rate a further 25 basis points to 12% that same month. This was not surprising even though, after its last meeting, the COPOM had suggested that it was going to delimit and reduce its adjustment plan for the reference rate in 2011 and postpone its 4.5% inflation target to the

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010				2011		
			1Q	2Q	3Q	4Q	January	February	March
Real GDP	–0.7	7.5	9.4	9.1	6.8	5.0	–	...	–
Industrial production	–7.3	10.5	17.2	14.0	8.1	3.6	2.2	3.1	...
Consumer confidence (*)	138.3	157.9	158.1	154.6	159.5	159.3	159.9	162.2	158.2
General unemployment rate (**)	8.1	6.7	7.4	7.3	6.6	5.7	6.1	6.4	...
Consumer prices	4.9	5.0	4.9	5.1	4.6	5.6	6.0	6.0	6.3
Trade balance (***)	25.3	20.3	23.2	19.3	16.9	20.3	20.9	21.7	22.6
Interest rate SELIC (%)	9.92	10.00	8.75	10.25	10.75	10.75	11.25	11.25	11.75
Reales to dollar (*)	2.3	1.8	1.8	1.8	1.7	1.7	1.7	1.7	1.6

NOTES: (*) Value.
(**) Percentage of labour force.
(***) Cumulative balance for 12 months. Billion dollars.
SOURCES: Instituto Brasileiro de Geografia e Estatística, Banco Central do Brasil and own calculations.

end of 2012, attributing pressure on prices to the worldwide increase in commodity prices.

Although, certainly, these factors have a significant effect, there is no doubt that, at least in the case of Brazil, they are not the only reason why prices are rising. This is also due to the growing pressure exerted by demand on the production capacity and excessive delay in adjusting the expansionary economic policies deployed when the crisis hit. In short, as pointed out by the IMF in its last World Economic Outlook, there is a justifiable risk of the Brazilian economy overheating.

Recent trends in the labour market are merely a further sign that the Brazilian economy might be overheating too much. In March, the unemployment rate surprised again with a figure of 6.5%, a historically low level. It's therefore no surprise that, in addition to monetary policy, the traditional weapon against inflation, the Brazilian authorities are also resorting to the complete arsenal within their power to put an end to the pressures on prices.

In March, the government already announced new fiscal cuts and other steps are expected in the same direction, as well as additional measures to contain credit growth. In this respect, in April the government raised its Financial Transaction Tax (FTT) on credit to individuals from 1.5% to 3.0%.

The real breaks the resistance level of 1.6 reais per dollar and inflation threatens to exceed the central bank's target.

In spite of all its efforts, and although activity is starting to show signs of moderating, inflation is more than likely to exceed 7% by the middle of the year and will very probably end the year at levels close to the current 6.5%. Nonetheless, the evident determination of the Brazilian authorities to stop Brazil from becoming a victim of its own success is, in itself, a guarantee.

The authorities shelve their fight against the currency appreciating and focus their efforts on putting a stop to the pressure on prices.

Mexico: a tranquil report

In its last World Economic Outlook, the IMF upped its forecast for the Mexican

The last IMF World Economic Outlook confirms the healthy state of the Mexican recovery.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010				2011		
			1Q	2Q	3Q	4Q	January	February	March
Real GDP	–6.1	5.5	5.0	7.4	5.3	4.4	–	...	–
Industrial production	–7.1	6.0	5.5	7.6	6.5	4.6	6.7	5.2	...
Consumer confidence (*)	80.5	86.3	81.5	84.9	89.2	89.6	92.3	92.3	91.7
Leading business index (*)	110.9	117.2	115.3	116.9	117.7	118.8	120.3	120.7	...
General unemployment rate (**)	5.5	5.4	5.4	5.2	5.6	5.3	5.4	5.4	...
Consumer prices	5.0	3.9	4.8	4.0	3.7	4.2	3.8	3.6	3.0
Trade balance (***)	–4.6	–3.1	–1.9	–2.4	–2.0	–3.1	–2.6	–2.8	–1.7
Official Banxico rate (%)	6.75	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50
Mexican pesos to dollar (*)	14.2	12.3	12.3	12.8	12.6	12.3	12.2	12.1	11.9

NOTES: (*) Value.
(**) Percentage of labour force.
(***) Cumulative balance for 12 months. Billion dollars.
SOURCES: Banco de México and own calculations.

Activity speeds up without generating pressure on prices.

economy's growth in 2011, confirming that its scenario of macroeconomic prospects is still highly favourable. The recovery continues to consolidate, led by exports but also increasingly supported by domestic demand. And if this weren't enough, unlike other, not too distant economies with problems of overheating, Mexican economic growth is advancing free from inflationary pressures.

What is also advancing is the peso. In the last few months, the Mexican currency has speeded up its appreciation against the dollar, due largely to the good performance of manufacturing exports and the strength of capital inflows in relation to the small size (in relative terms) of the current account deficit. We do not expect this trend to reverse in the short term. The latest data on foreign trade show that exports without oil grew by a notable 23.7%. For its part, domestic demand is also showing clear signs of strength, boosted by the improvement in the labour market, the rise in the average real wage and improvements in credit.

Oil increases to 122 dollars per barrel.

Although economic growth is gaining momentum and inflation is likely to pick up over the coming months due to base effects and the volatility of food prices, we have not changed our interest rate scenario and do not expect any rise until early 2012. In any case, we still do not entirely rule out the risk of food prices soaring or domestic expenditure recovering too strongly. Should this happen, the first rise in interest rates might come sooner than expected.

The uncertainty in North Africa and the Middle East pushes up oil prices.

Not too many surprises are expected in the fiscal area either. The government and opposition are still immersed in a reform whose main aim is to reduce the treasury's dependency on oil revenue. After ruling out several proposals by President Calderón's party (PAN), the latest proposal presented by the PRI party appears unlikely to prosper either. However, a more constructive climate can be perceived between the government and opposition: without doubt, another piece of good news.

Oil and metal prices continue to rise

The scenario of expensive oil is becoming increasingly entrenched. Between 15 March and 14 April, the price of crude maintained its climb with a rise of 10%, reaching 122.15 dollars per barrel (Brent quality, for one-month deliveries), representing a 31.9% increase since the start of the year.

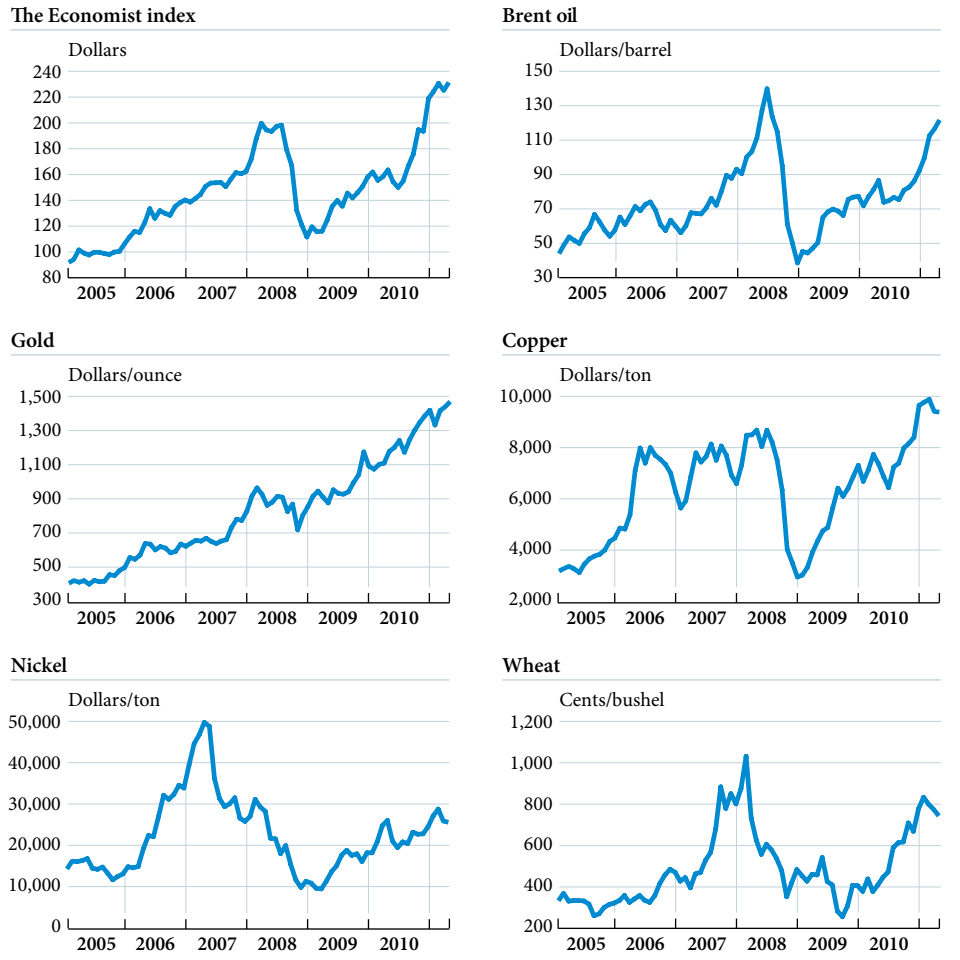
The instability in the regions of North Africa and the Middle East continues to push up oil prices within a context of great volatility. The renewed increase in world demand, with a greater relative weight of the emerging nations whose economies are based on the intensive consumption of oil and other commodities, will also continue to push up prices. In the case of food, this is a vicious circle as their higher prices lead to discontent and augment the political instability in countries that are often also commodity producers. These rising prices translate into inflation in many emerging countries that are already growing at the limit of their capabilities. They also entail the risk of low growth for advanced economies as consumers' purchasing power falls.

The rising cycle is continuing in other commodities and The Economist index rose by 8.0% between 15 March and 14 April. Base metals continued to rise, led by iron. China's expansion, which accounts for 40% of world demand for

base metals, is pushing up prices, although these should moderate throughout 2011. Food also saw rises except for rice. For its part, gold set a new record high: 1,470.7 dollars per ounce. This can be explained by it being a safe haven in uncertain situations.

Commodities start rising again.

TREND IN VARIOUS COMMODITIES (*)



NOTE: (*) Figures for last day of month (last date April 14).
SOURCES: The Economist, Thomson Reuters Datastream and own calculations.

EUROPEAN UNION

The euro area: on hold

Portugal asks for the financial support mechanism to be activated.

In football matches, half-time, in other words the interval between the two halves of the game, is essential for trainers to be able to talk more calmly with their players and define the game plan to be implemented, taking into account what has happened in the first half.

This is the current situation in the euro area, where economic policymakers are designing the bailout plan for Portugal after its acting Prime Minister, José Sócrates, made an official request.

Economic activity continues in the euro area, combined with rising inflation.

In fact, on 6 April Portugal informed the President of the European Commission, José Manuel Durão Barroso, of its intention to ask for the financial support mechanism to be activated.

The EU Monetary Affairs Commissioner, Olli Rhen, praised Portugal's demonstration of responsibility to achieve economic stability. The difficulty of the negotiations is two-fold. On the one hand, the plan's technical design will require Portugal to carry out strenuous fiscal consolidation but, on the other hand, the fact that there are elections on 5 June means that both the government and the opposition must be present in the negotiations to ensure the plan is seen to be more forcefully implemented.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010				2011		
			1Q	2Q	3Q	4Q	January	February	March
GDP	–4.1	1.7	0.8	2.0	2.0	2.0	–	...	–
Retail sales	–2.5	0.8	0.5	0.6	1.5	0.6	0.4	0.1	...
Consumer confidence (1)	–24.8	–14.0	–16.8	–16.7	–12.1	–10.4	–11.2	–10.0	–10.6
Industrial production	–14.7	7.5	5.3	9.5	7.2	8.1	6.3	7.3	...
Economic sentiment indicator (1)	80.7	100.8	96.4	99.1	102.3	105.6	106.8	107.9	107.3
Unemployment rate (2)	9.4	10.0	10.0	10.0	10.0	10.0	10.0	9.9	...
Consumer prices	0.3	1.6	1.1	1.6	1.7	2.0	2.3	2.4	2.7
Trade balance (3)	–16.7	14.1	23.5	20.0	8.2	4.6	–4.5	...	...
3-month Euribor interest rate	1.2	0.8	0.7	0.7	0.9	1.0	1.0	1.08	1.1
Nominal effective euro exchange rate (4)	111.7	104.7	108.7	103.2	102.3	104.4	102.4	103.4	105.2

NOTES: (1) Value.
(2) Percentage of labour force.
(3) Cumulative balance for 12 months. Billion euros.
(4) Change weighted for foreign trade flows. Higher values imply currency appreciation.
SOURCES: Eurostat, European Central Bank, European Commission and own calculations.

It's essential to redirect the Portuguese situation within a scenario of an economic climate defined by two very clear trends. Data indicate that, in the euro area's economy, the level of economic activity has continued, combined with price rises. In fact, the International Monetary Fund (IMF) itself, in its World Economic Outlook for April, states that the euro area's recovery is consolidating, although it's still growing below its potential. It also warns of the risk of financial fragility in the region, although it believes inflationary pressures are under control.

Recently published data support the IMF's view since, for example, industrial production has remained at cruising speed, growing year-on-year by 7.3%, one percentage point higher than the previous month's figure. If we analyze these data in more detail, the only fall in year-on-year terms, and a sharp one, is within energy, and the reason was the more limited use of heating given a warmer February than last year. The components with the best improvement have been capital and intermediary goods.

Industrial production grows at a rate of 7.3% year-on-year.

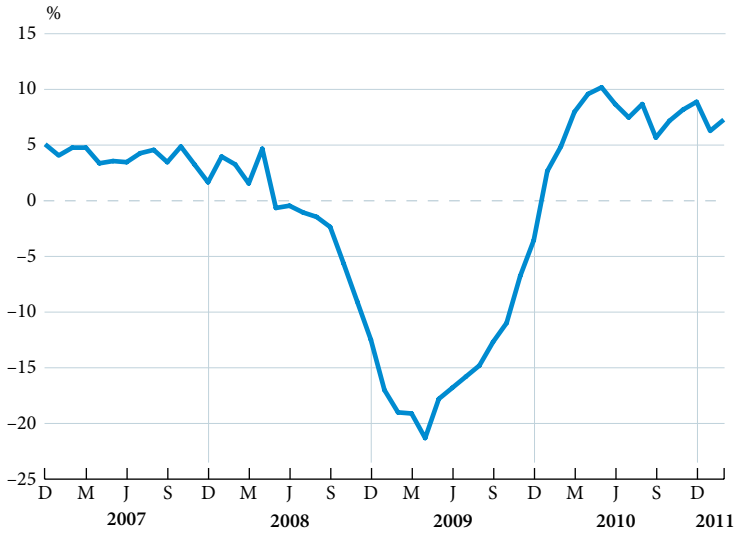
The trend recorded by industrial production in the last few months should remain over the coming quarters thanks to the high number of industrial orders indicated by entrepreneurs, one of the components keeping business sentiment indices at very high levels. This should contribute to a moderate fall in the unemployment rate in the euro area which, in February, already fell by one tenth of a percentage point to 9.9%.

But three combined factors are creating greater uncertainty regarding the path that will be taken by growth and inflation in the euro area. The first are the rising prices for commodities and particularly oil and its derivates. This trend is notably affecting the consumer price index. In fact, the euro area's inflation in March rose by 1.4% month-on-month, pushing the year-on-year figure up to 2.7%, an increase of three tenths of a percentage point compared with February. The

Oil prices, interest rates and the value of the euro cause uncertainty.

INDUSTRY IN THE EURO AREA IS HAVING A GOOD TIME

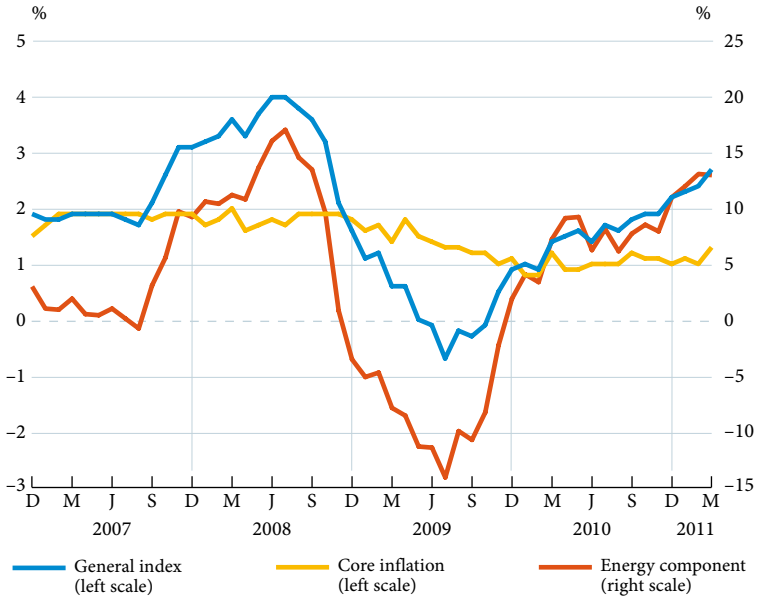
Year-on-year change in industrial production



SOURCE: Eurostat.

INFLATION RISES DUE TO ENERGY

Harmonized year-on-year change in CPI



SOURCE: Eurostat.

Rising energy and financial costs reduce households' disposable income.

components of clothing, footwear and especially the increase in energy prices had the greatest impact on the index. Core inflation (which excludes the most volatile components) increased from 1.0% to 1.3% year-on-year.

This trend is negative insofar as it erodes consumers' disposable income and also increases energy costs for firms. Moreover, it's leading to a second factor appearing on the scene, namely the tendency of interest rates to go up. The rising price of money, encouraged by the European Central Bank (ECB) with its first increase in the reference rate in April, is being passed on to all interest rate curves. For example, in the case of the interbank market, the 12-month Euribor interest rate has reached 2.10% when it was 1.50% at the beginning of the year. These are still low levels in absolute terms but it's certainly an additional factor that reduces consumers' disposable income. It also makes financing more expensive, not only for households but also for firms.

Lastly, the prospect of tougher monetary policy in the euro area is reinforcing the third element: the appreciation of the euro. This element, which in relative terms makes the euro area's goods and services more expensive compared with the rest of the world, harms European exports.

All these elements have led us to lower our 2011 growth estimate for gross domestic product (GDP) in the euro area to 1.5%. And we believe that these three elements will continue to apply pressure over the coming months. It's evident that one risk to our growth estimate would be if these trends intensified. However, the main scenario for our oil price estimate

assumes that the speed with which oil prices have risen over the last few months will not continue, while we also believe that the increases in interest rates in the euro area will be moderate, as the ECB is unlikely to raise the official interest rate above 1.75% by the end of year. By the end of 2011, this will have helped to achieve a more favourable euro exchange rate for European exports than our current rate.

Within this context, economic agents are adjusting their consumption and investment decisions, incorporating the greater uncertainty caused by these elements. In fact, rising energy and financial costs have led households to reduce their expenditure, as highlighted by the figures for retail sales for the months of January and February, with year-on-year growth of 0.4% and 0.1% respectively. Logically, given the greater uncertainty, consumers prefer to stick with a more prudent spending policy. However, consumer confidence has remained at the level reached in June last year; in other words, households have probably reduced their purchases tactically over the last few months due to precaution, before taking a decision on how they will spend in the future.

Given this situation, households have been reducing their spending slightly over the last few months.

The euro area team is intelligently using the half-time interval to prepare the strategy that will help them get into the next round without too much trouble. Whereas it managed to stop the shot at goal provided by Portugal's sovereign debt crisis in the first half, now the players must neutralize the aggressive play of the three forwards on the rival team: oil, interest rates and the euro, in order to avoid a slump in economic activity.

Pursuing sustainable and balanced growth: the role of fiscal reforms

Over the last few months, discussion has grown intense regarding the reforms that might help to guarantee sustainable growth. In fact, leading international organizations and G-20 meetings have promoted structural changes that would probably not have occurred had the world economy not suffered from such a strong slowdown. The reforms proposed cover a range of areas such as the labour market, fiscal system, the formation of human capital, financial system and regulating the market of goods and services. All these proposals aim to boost economic development over the coming years.

This Box focuses on the most important fiscal reforms. These have a twofold objective. In the short term, the most advanced economies are being forced to speed up their fiscal consolidation in order to rebalance their public accounts and this is precisely the aim of the reforms being implemented. In the medium and long term, fiscal reform must prevent excessive public deficits from being created in the future and, above all, must aim for an increase in economic efficiency without harming equity in society.

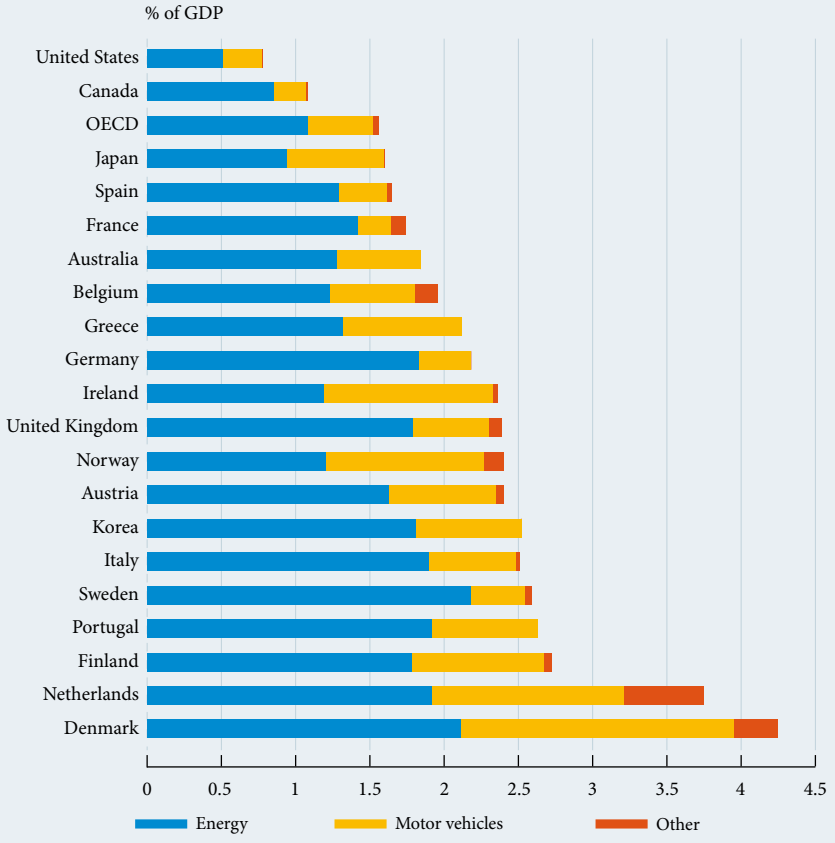
So which fiscal system reforms might help to balance the public accounts and stimulate growth? Broadly speaking, the changes to be implemented can be classified into three groups: those related to taxation, those aimed at increasing the efficiency of public spending and those designed to increase employment.

Firstly, one direct way of achieving fiscal consolidation is by reforming the tax system. In this respect, it's essential to ensure that any distortions caused to decisions regarding savings, work and investment are minimal, as this ends up determining an economy's productivity. The Box «After the crisis: should taxes be raised or lowered?» deals with this issue in depth but, broadly speaking, the tax that is most difficult to raise seems to be the one on companies. In fact, according to an analysis carried out by Arnold and Schwellnus, from the OECD, a hike in these taxes could reduce productivity and investment in firms in those countries where such taxes are already particularly high, especially in high tech companies.[1]

Along the same lines, the study by Johansson and other authors, also from the OECD, aims to determine the tax system structure with the least impact on per capita GDP. To this end, it compares tax distribution (and levels) with growth in GDP per capita in different countries and over time. The authors conclude that the most efficient

NOTABLE DIFFERENCES BETWEEN COUNTRIES IN REVENUE FROM ENVIRONMENTAL TAXES

Revenue from environmental taxes (2008)



SOURCES: «Economic Policy Reforms 2011: Going for Growth» (OECD) and own calculations.

(1) J. Arnold and A. Schwellnus. «Do Corporate Taxes Reduce Productivity and Investment at the Firm Level? Cross Country Evidence from the Amadeus Dataset.» OECD Economics Department Working Papers no. 641 (2008).

system is one where company tax has a relatively smaller weight, followed by personal income tax and consumption tax. Lastly, taxes on property are those with the least impact on growth.[2]

On the other hand, another relevant discussion is how negative externalities should be treated in fiscal terms; i.e. carrying out activities whose costs are passed on to society. It's usually preferable to tax these directly rather than finance the production of alternative products. For example, taxing the emission of contaminating gases and selling permits for their emission works better than subsidizing the production of renewable energy. The latter not only increases the budget deficit but is also inefficient in its aim to reduce pollution. Within this area, the graph above shows that revenue from environmental taxes varies considerably between countries and this suggests that some have room to raise their taxes along these lines.

Secondly, changes in the fiscal system must also aim to make government spending more efficient. Studies by the OECD (see «Economic Policy Reforms 2011, Going for Growth») recommend that, in certain cases, it might be appropriate to reduce aid to the agricultural, energy and real estate sectors, especially when these subsidies are not aimed at correcting any market failure.

But the two areas attracting the most attention, given their relative weight in government spending as a whole, are education and health. In this respect, these studies claim that, in certain cases, the quality of the service provided can be maintained at a lower cost. The key lies in accurately evaluating the efficiency of what is spent. For example, it's estimated that, if less efficient countries in terms of their educational system (i.e. those with worse average results in the international PISA tests related to their teacher rate per 100 pupils and the socio-economic characteristics of the students) adopted the practices of the most efficient countries, spending on this item would fall by between 0.2 and 0.4% of GDP and, in some countries, savings could even reach 1.3% of GDP. This study also calculates that spending on education is relatively efficient in Spain and its margin for savings compared with other countries is therefore limited, namely 0.3% of GDP.

It has also been estimated that the potential savings in government health spending could average 2% of GDP if less efficient countries imitated the procedures of the other, more optimal countries, without harming their population's life expectancy. In this case, this analysis shows that, if Spain adopted the health system structure of countries with the best results, it could save 1.6% of GDP. Although not insignificant, this figure is quite a lot lower than the OECD average and this suggests that healthcare spending in Spain is relatively efficient among the most advanced countries.

In addition to measures aimed at changing the taxation system and at getting rid of inefficiencies in government spending, another way of ensuring long-term fiscal consolidation is through policies that stimulate the labour market. A reduction in the unemployment rate not only reduces public expenditure but also increases revenue. According to several international organizations, countries must ensure that the system has minimal impact on incentives for unemployed people to look for work. Another option that various advanced economies have chosen consists of making the retirement age more flexible. In this case, moreover, the aim is also to comply with a criterion of inter-generational fairness within a demographic scenario where life expectancy is constantly rising.

(2) A. Johansson, *et al.* «Taxation and Economic Growth.» OECD Economics Department Working Papers no. 620 (2008).

COUNTRIES ARE FACING DIFFERENT PRIORITIES IN REFORMING THEIR TAX SYSTEM

Tax system reforms	Priorities by country
Improve tax system efficiency	Australia, Brazil, Canada, Germany, Japan, United States
Reduce implicit taxes on continued work at older ages	France, Spain, Turkey
Reduce the (average) tax burden on labour income	Australia, Brazil, Germany, France
Shift toward indirect taxes	Italy, Korea
Reduce impediments to full-time female participation	Germany
Phase out energy subsidies	Indonesia

SOURCE: OECD database «Going for Growth».

Consequently, the battery of measures aimed at ensuring fiscal consolidation and thereby economic progress are many. However, not all countries require the same fiscal reforms, at least not the most urgent ones, as these may vary according to their particular weaknesses. Within this context, the OECD has identified, in a comparative study, the priority policies by zone.[3] This analysis suggests that Spain, France and Turkey should reduce the taxes implicit in working at a later age (see the table above). On the other hand, for Germany it points out that it should encourage more women to join the labour market.

In short, the current process of reducing the public deficit in many countries is a chance to implement important structural reforms. However, differences between countries mean that there is no single recipe for these changes and they must be designed a la carte, according to each country's weak points. Although this requires an in-depth study for each country, it's certainly worth doing as the benefits are potentially huge.

(3) OCDE. «Pursuing Strong, Sustainable and Balanced Growth: the Role of Structural Reform» (2010).

This box was prepared by Maria Gutiérrez-Domènech
European Unit, Research Department, "la Caixa"

German economic growth speeds up in the first quarter.

The German engine continues its pull

The competitiveness of the German economy means that it's still in a good position and can take advantage of foreign demand, in particular from more dynamic countries such as China. But domestic demand is gradually taking over to boost the economy. Available indicators point towards an acceleration in economic growth in the first quarter of 2011 after a slight slowdown in the last few months of 2010, particularly because of the bad weather.

Household consumption looked good at the start of the year, with 2.4% growth in retail sales year-on-year in the first two months, more than one point above the figure recorded in October-December 2010. Automobile sales also rose by 13.9% in the first quarter of 2011 compared with the same period the previous year. The good prospects for the labour

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010				2011		
			1Q	2Q	3Q	4Q	January	February	March
GDP	–4.7	3.5	2.1	3.9	3.9	4.0	–	...	–
Retail sales	–3.2	1.4	1.0	0.5	2.6	1.1	3.4	1.6	...
Industrial production	–15.4	10.0	6.2	12.2	10.3	11.5	12.6	14.7	...
Industrial activity index (IFO) (*)	87.7	103.5	96.6	101.8	106.7	109.0	110.3	111.3	111.1
Unemployment rate (**)	8.1	7.7	8.0	7.7	7.6	7.5	7.4	7.3	7.1
Consumer prices	0.4	1.1	0.7	1.0	1.2	1.5	2.0	2.1	2.1
Trade balance (***)	142.8	149.2	143.3	150.2	149.9	153.4	153.8	152.6	...

NOTES: (*) Value.
(**) Percentage of labour force.
(***) Cumulative balance for 12 months. Billion euros.
SOURCES: Eurostat, European Central Bank, European Commission, national statistical bodies and own calculations.

market and expectations of a rise in family income have boosted consumption. However, the upswing in inflation over the last few months is affecting consumers' mood, so that the pace of growth in consumption will probably lessen.

For its part, investment is looking dynamic in view of attractive returns. In spite of the European Central Bank's hike in April, low interest rates continue to stimulate investment. The industrial production of capital goods is still expanding at a good rate and the IFO business activity index remains at a high level, although it has fallen a little in the last few months.

Exports are still buoyant, with a 21.0% rise year-on-year in February. Seasonally adjusted foreign sales of goods have already passed their level prior to the global crisis, while imports rose even further in the last twelve months, by 27.0%, and helped to boost the European economy.

On the supply side, industry is obviously full of life, while the prospects are also good for the coming months, judging by the order portfolios. In fact, in February new domestic orders rose by 15.8% and foreign orders by 23.9% in volume terms, compared with the same month in 2010. Moreover, construction picked up strongly in the first few months of the year, particularly in the residential sector. With regard to services, it should be noted that the number of overnight stays by tourists in February rose by 1% year-on-year.

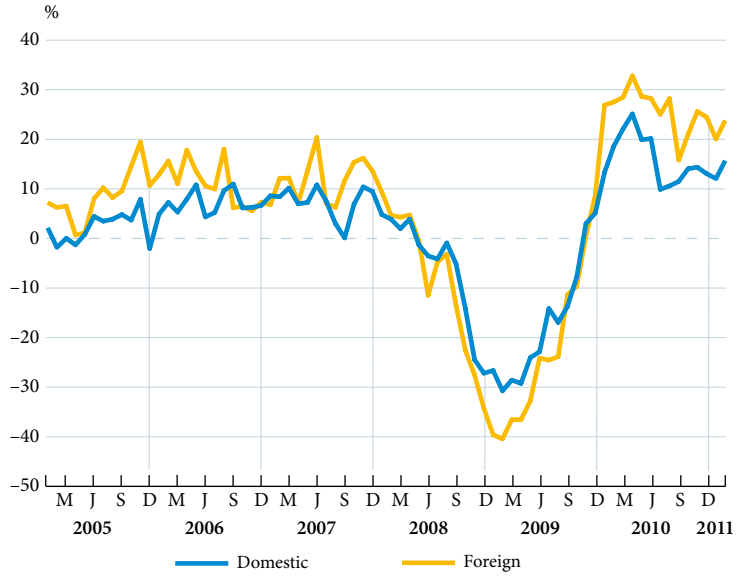
The economy's good performance has helped to create jobs. Within this context, in February the number of workers employed on the short-time working scheme or «Kurzarbeit» only represented 11% of the maximum number reached in May 2009. The unemployment rate therefore continued to fall, down to 7.1%, while demand for skilled workers has increased slightly, which is expected to be partly covered by foreign workers, particularly engineers.

The favourable trend in the labour market is supporting consumption.

The residential sector in construction picks up.

FAVOURABLE INDUSTRIAL PROSPECTS IN GERMANY

Year-on-year change in new orders for industry (*)



NOTE: (*) Data by volume and adjusted for calendar effects.
SOURCES: Statistisches Bundesamt Deutschland and own calculations.

The German government approves its 2011 National Reform Plan to boost competitiveness.

As a counterpoint, there has been an upswing in consumer price inflation from 1.3% in September 2010 to 2.1% in March, pushed up particularly by energy due to rising oil prices. In the month of March, and in spite of a monthly increase of 0.5%, the year-on-year rate remained at 2.1% due to a base effect. The appreciation of the euro has eased inflationary pressures due to rising commodity prices, but the tensions are plain to see in an 11.9% rise year-on-year for import prices. For their part, wages have also tended to rise, but only moderately and their increases can be absorbed by the greater advances in productivity.

To underpin the German recovery, the federal government approved its 2011 National Reform Plan at the beginning of April. This series of measures supports competitiveness, the opening up of markets, training and employability of workers, consolidation of the public accounts and the stabilization of the financial sector. This programme is part of the «2020 Europe Strategy» to boost employment and growth and also implements the Euro Plus Pact.

On the other hand, the federal government raised its 2011 growth forecast by 0.3 percentage points up to 2.6% and set its forecast for 2012 at 1.8%. In this way, the number of unemployed is expected to continue to fall, totalling 2.7 million in 2012 on average. However, it should be noted that some risks, such as commodity prices continuing to rise or the euro area's peripheral debt crisis getting worse, may lead to a bigger slowdown than expected for the German economy.

The French economy picks up

In the first few months of 2011, the French economy continued to recover at a slightly faster pace than the one recorded in the last quarter of the previous year. Consumption picked up and purchases of manufactured goods by households rose by 3.5% year-on-year in the first quarter. However, consumer confidence fell slightly in March, affected by the upswing in inflation and standing clearly below its long-term average, so that household consumption is likely to slow down later on. In the fourth quarter of 2010, the household savings rate stood at 15.4% of gross disposable income, half a point less than the previous quarter, although remaining within a reasonably stable range.

For its part, investment is looking quite dynamic. This can be explained by a slight increase in the rate of production capacity utilization, now close to its long-term average. An improvement in economic sentiment also helped in this respect.

From the point of view of supply, industrial activity slowed up in the month of March. However, high levels in order portfolios and the improved confidence in the secondary sector allow us to be moderately optimistic with regard to the development of industry over the coming months. There are also positive signs regarding construction, such as the 26.7% rise year-on-year in building permits granted in February. Services are also showing a rather favourable trend, with appreciable rises in business in most of the branches at the start of the year, particularly in information, communication and services to households. Confidence in the tertiary sector also rose in March, with a good outlook for the short term.

However, there are weaknesses in the French economy, pointing to certain problems of competitiveness. The current account external deficit widened in February, albeit influenced by the weight of the energy bill. And the unemployment rate still refuses to fall, holding steady at 9.6% in February, a relatively high level. Inflation didn't let up in March either, as the year-on-year rate of change in consumer prices rose by 0.3 percentage points to 2.0%, boosted by petrol and diesel, other fuels and food.

French consumption picks up but the outlook isn't buoyant.

The French public deficit falls to 7% of GDP in 2010 and must fall to 6% in 2011.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010				2011		
			1Q	2Q	3Q	4Q	January	February	March
GDP	–2.5	1.5	1.2	1.6	1.7	1.5	–	...	–
Domestic consumption	0.8	1.0	1.8	0.4	1.5	0.4	2.4	5.5	2.6
Industrial production	–12.3	5.7	4.7	7.5	5.0	5.8	5.4	5.6	...
Unemployment rate (*)	9.5	9.8	9.9	9.8	9.8	9.6	9.6	9.6	...
Consumer prices	0.1	1.5	1.3	1.6	1.5	1.7	1.8	1.7	2.0
Trade balance (**)	–49.2	–47.0	–43.0	–44.9	–49.4	–50.6	–53.5	–56.8	...

NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion euros.
SOURCES: OECD, Eurostat, INSEE, European Commission and own calculations.

Favourable prospects in the short term for Italian industry.

On the other hand, the public deficit recorded in 2010 was 7% of GDP, half a point less than in 2009 but still too high. The target for 2011 is to at least bring the deficit down to 6% of GDP, so that the current expansion will not be able to rely on support from the public sector. However, for the whole of the year we expect French GDP to grow a little more than the 1.5% recorded the previous year.

Italian consumers show caution

Relatively unclear prospects for the labour market and an upswing in inflation have influenced Italian consumers, who were very prudent in their spending at the start of the year. Retail sales recorded a slight drop in January compared with the previous month and vehicle registrations posted sharp year-on-year falls in the first quarter. In March, consumer confidence deteriorated slightly, so that consumption will probably continue to be weak over the coming months. In fact, a slight fall is predicted in domestic tourism spending for the Easter holidays compared with the same period a year ago.

There are highs and lows regarding supply. Industrial production picked up in February, with a seasonally adjusted monthly increase of 1.4%. Moreover, the new orders in portfolio showed a year-on-year rise of 16.2% at current prices. This increase occurred both for domestic orders, 17.4%, and foreign orders, 14.3%. Industrial confidence also improved in March, so that the outlook was favourable for the secondary sector in the short term. However, construction didn't start the year well, posting a 1.0% monthly drop in production in January, and confidence in the sector fell slightly in February.

Regarding the foreign sector, exports rose strongly in the first two months compared with the same period in 2010. However, imports rose more, considerably widening the trade deficit, although the non-energy balance posted a surplus. On the whole, the rate of progress of the Italian economy probably speeded up slightly in the first quarter.

The official forecasts for Italian GDP growth in 2011 and 2012 are lowered.

On the other hand, the public deficit stood at 4.6% of GDP in 2010, 0.4 points less than in the official forecasts of September,

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010				2011		
			1Q	2Q	3Q	4Q	January	February	March
GDP	–5.2	1.2	0.6	1.5	1.4	1.5	–	...	–
Retail sales	–1.7	0.0	–0.1	–0.3	0.6	0.1	0.1	...	...
Industrial production	–18.7	6.5	4.3	9.0	7.5	5.2	0.7	2.4	...
Unemployment rate (*)	7.8	8.4	8.4	8.5	8.4	8.5	–	...	–
Consumer prices	0.8	1.5	1.2	1.4	1.6	1.7	2.1	2.4	2.5
Trade balance (**)	–10.2	–16.2	–7.7	–13.2	–19.1	–24.8	–30.0	–30.8	...

NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion euros.
SOURCES: OECD, national statistical bodies and own calculations.

although the primary imbalance, i.e. without taking interest payments into account, was practically zero. Public debt continued to increase, up to 119% of GDP. To reduce these imbalances, the Italian executive confirmed its commitment to reduce its public deficit to 3.9% of GDP in 2011 and to 0.2% in 2014 in its 2011 Document of Economy and Finances. From then on, the surpluses should help to reduce the level of public debt. Moreover, there is a plan to introduce a mandate into the Constitution for more precise and direct budgetary balance. The government also presented its National Reform Programme, in line with the Euro Plus Pact.

At the same time, official forecasts for GDP growth in 2011 were reduced by 2 tenths of a percentage point to 1.1% and for 2012 by 7 tenths of a percentage point to 1.3%. This low growth seems logical if we take into account the planned budgetary consolidation policy and the problems of competitiveness suffered by the Italian economy.

The United Kingdom: between uncertainty and hope

Before cement was invented, bricks were set with mortar made from a mixture of lime, the most expensive material, and sand, more abundant and cheaper. The Spanish expression of «one of lime and another of sand» has come to mean the alternation of diverse or contrasting things. This concept can be perfectly applied to the United Kingdom's economy, whose economic figures as a whole are not following a single trend but are rather mixed.

Disappointing figures for retail sales and industrial production.

Whereas, in 2009, the British economy saw a sharp decline in its GDP, namely 4.9%, and in 2010 the recovery started with gentle growth of 1.3%, in 2011 it is now fighting to withstand new adverse economic conditions. Two pieces of economic data have revealed the challenges faced by the economy. Firstly, February's drop in retail sales from the previous figure of 5% to 1.3% year-on-year. This has been brought about by

However, inflation is falling and the new budget contains fiscal reforms to underpin the recovery.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010				2011		
			1Q	2Q	3Q	4Q	January	February	March
GDP	–4.9	1.3	–0.4	1.5	2.5	1.5	–	...	–
Retail sales	1.0	0.4	0.1	0.8	0.7	0.0	5.0	1.3	...
Industrial production	–10.1	2.1	0.1	1.5	3.0	3.3	4.3	2.4	...
Unemployment rate (1)	4.7	4.7	4.9	4.6	4.6	4.5	4.5	4.5	4.5
Consumer prices	2.1	3.3	3.2	3.4	3.1	3.4	4.0	4.3	4.0
Trade balance (2)	–86.8	–88.7	–83.3	–85.4	–90.6	–95.5	–97.2	–97.5	...
3-month Libor interest rate (3)	1.2	0.7	0.6	0.7	0.7	0.7	0.8	0.8	0.8
Nominal effective pound exchange rate (4)	73.9	80.4	80.4	78.2	81.5	79.3	79.2	80.5	81.0

NOTES: (1) Percentage of labour force.
(2) Cumulative balance for 12 months. Billion pounds.
(3) Average for the period.
(4) Index weighted for foreign trade flows. Higher values imply currency appreciation.
SOURCES: OECD, Bank of England, ONS, European Commission and own calculations.

In 2011 and 2012 we expect the recovery to consolidate, albeit with differences between countries.

high inflation and low wage growth, leading to the first reduction in households' disposable income in the last 30 years. Secondly, February's figure for industrial production in the United Kingdom, which fell by 1.2% month-on-month, leaving the year-on-year rate at 2.4%.

But apart from these two negative pieces of data, we have one that is positive: inflation in March, which fell from 4.3% to 4.0%. Within a global context of rising prices and strong pressure on energy prices, this hiatus in inflation is good news.

Which is also the case for the presentation of the new budget. Although it does not contain anything particularly new, as the package on the whole is fiscally neutral, it does include a series of fiscal reforms that aim to stimulate the economy's recovery. Among these, of particular note is the reduction in corporate tax by two percentage points as from April, down to 26%, and by three percentage points as from 2014. Another interesting measure has been the reduction of one penny per litre in the tax on petrol in an attempt to offset the recent rise in fuel prices, although the rate on gas and oil will increase from 20% to 32%.

Given this situation, several institutions have reduced their growth forecasts for the United Kingdom. For example, in its World Economic Outlook, the IMF has reduced its GDP forecast for 2011 from 2.0% to 1.7%. It has justified this due to the fiscal consolidation being started by the government and its impact on the reduction in economic activity.

Poland and Slovakia will start to tackle problems typical of mature phases in the economic cycle...

The United Kingdom's Office for Budget Responsibility also expects growth in GDP of 1.7% and its argument is based on the lower growth in disposable income within a context of this being eroded by rising inflation, which it expects will fluctuate between 4% and 5% during 2011. Last month we commented on the risk of downgrading our growth forecast from 2.1% in 2011 for the United Kingdom. However, we prefer to do so once the growth figures for the first quarter have been published, and especially its composition. Although it might seem paradoxical, we expect good figures for the first quarter because of the problems experienced by several economic sectors in the last quarter of 2010 due to the bad weather.

Historically, the United Kingdom has shown that, when it's faced with economic challenges, it has the capacity to produce high quality mortar that allows the different economic agents to share the effort required to overcome such difficulties. This flexibility of the British economy is evident when we look at the unemployment rate, which remains at a low 4.5%. This time won't be any different.

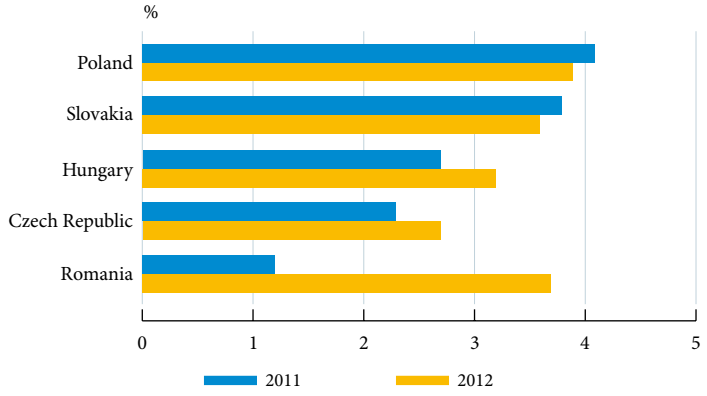
Emerging Europe: 2011 and beyond

So far, 2011 has been remarkable in terms of global impacts. To mention the most obvious, in a brief period of time we have seen the shock of commodity prices, increasing doubts regarding the debt of the euro area's peripheral countries, armed conflict in Libya and natural disasters in Japan. Within such a situation, what kind of economic prospects are we looking at for emerging Europe in 2011 and 2012?

Essentially, the scenario for 2011-2012 can be summarized in a single line: consolidation of the recovery... at differing speeds. Emerging Europe

CONSOLIDATING THE EXPANSION IN EMERGING EUROPE

Real growth forecast



SOURCES: National statistics offices, Eurostat and own calculations.

as a whole is enjoying notable growth, as witnessed by the dynamism of business indicators in the first part of the year. The available data also show that the expansion is more dynamic than expected some months ago and that, in certain countries, the recovery is starting to be supported by a growing contribution from domestic demand (a trend that suggests the recovery is more likely to be sustained).

Within this context, we need to differentiate between three large groups of economies according to their position regarding the recovery. The first group contains the most developed countries in the cycle, Poland and Slovakia, both benefiting from vigorous expansion in 2010 and from smaller macroeconomic imbalances before the crisis. For them, we predict two years of healthy economic growth, around 4% both years. Nonetheless, with the public deficit climbing to 8% of the gross domestic product (GDP) in 2010, growing inflationary tension and a tendency towards current imbalance, both economies will have to tackle a change in their economic policy in 2011-2012.

In the case of Poland, together with monetary normalization (already started and looking like continuing throughout the forecast scenario), the pressure for greater fiscal consolidation will intensify. Slovakia, not able to manage its own monetary policy as it forms part of the euro area, will have to make this effort of fiscal adjustment sooner and more comprehensively. The forecasts predict that, in 2012, the budget imbalance will have fallen to around 4% of GDP in Slovakia and 4.5% in Poland.

Compared with the situation of these two economies, whose problem is how to start to contain the usual tensions during expansionary periods in the cycle, a second group of economies made up of Hungary and Romania is faced with the challenge of fully consolidating their expansion. These are countries that must have carried out extensive economic adjustment at some time in the last few years and are taking advantage of a favourable climate to grow again. We expect these economies to appreciably accelerate their pace of growth in 2011, in 2012 reaching flash estimate GDP figures similar to those of Poland and Slovakia.

...while in Hungary and Romania the challenge will be to firmly establish their expansion, which is still in its early stages.

The Czech Republic has the most orthodox economic policy of the region.

The impact of commodities, their dependency on the euro area and the consolidation of foreign capital inflows are areas of concern.

They are almost certain to maintain a restrictive bias in their fiscal policy, nevertheless delaying the start of tightening up monetary policy to the second half of 2011.

Lastly, a third, differentiated position is held by the Czech Republic. Proclaiming its commitment to macroeconomic stability, the Czech Republic has opted for the most orthodox economic policy in the region, accepting a combination of lower growth in exchange for more contained inflation. We expect activity in the Czech economy to recover gradually, albeit far from the dynamism of its neighbours in the region. Should this scenario come about, the Czech Republic will go from growth of 2.2% in 2010 to 2.7% in 2012.

What can go wrong for these positive growth forecasts? One initial risk factor is the euro area seeing a reduction in activity of some size. In spite of the growing importance of domestic demand in the growth pattern of several of these economies, a sharp decline in exports to the euro area would take away a key factor that is boosting their economies, especially in countries such as Hungary and Romania, whose domestic demand is still suffering from the macroeconomic adjustment.

This worsening in the euro area would also probably affect the inflows of foreign capital which, after a sharp correction in 2009, picked up again in 2010, particularly in the category of direct foreign investment. Along the same line of reasoning, any significant friction in the international flow of capital towards the region would be dangerous. In particular, if there were a change in perception regarding regional risk, the effect could be highly negative. Something that could trigger such a change could be the loss of budgetary credibility in those countries with greater difficulty in this area (lately, the financial markets have focused their attention on Romania, Hungary and Poland in this respect).

Lastly, if commodity prices became entrenched at their current high levels or if they rose to new heights, the problem would not only be the direct impact on national prices, both for consumption and production, but also the erosion of growth. The first impact, purely inflationary, according to previous experiences, might hit Hungary, the Czech Republic and Romania the hardest, while the toll taken on growth might be more keenly felt in Slovakia, Poland and Romania. As can be seen, Romania is a candidate to be the weakest link in terms of the severe impact of commodity prices.

FINANCIAL MARKETS

Monetary and capital markets

The markets turn their attention to the United States

During the first few months of the year, the world's financial markets reacted surprisingly calmly to the various negative shocks occurring, particularly the conflicts in the countries of North Africa and Middle East, Japan's earthquake and nuclear accident and also Portugal's political crisis and request for financial bail-out.

The predominant interpretation among investors is that these events will not substantially alter the path taken by the recovery of the world's economy, nor progressive monetary and financial normalization. The basic movements observed in the markets since the start of the year have therefore been a gentle upward trend in interest rates, satisfactory performance by high risk securities (stock markets and corporate bonds) and relatively low levels of volatility. Logically, there have been appreciable upsets in certain countries and sectors but, on the whole, stability has reigned supreme.

Neither has this panorama been disturbed, in fact we could even say it has been strengthened, by the successive restrictive monetary policy measures applied in the emerging countries and more recently in the euro area. However, already in the second half of April, both the bond and stock markets reacted somewhat more nervously to news from the United States, specifically the debate concerning the most appropriate strategy to redirect fiscal and monetary policies, which are currently extremely lax. Given the country's importance and the challenges it is facing, this is actually a vitally important issue which will probably grab the attention of investors over the next few months.

The markets have reacted calmly to the various shocks of the last few months.

The ECB takes its first step towards getting monetary policy back to normal and the Fed thinks about it

As the year progresses, more regions and countries are starting to tighten up their monetary policies. Since it started, the revival of the world economy has been led by the emerging countries and subsequently underpinned by the consolidation of the recovery in the United States and countries in the centre and north of Europe. Moreover, the simultaneous appearance of conflict in the Middle East and North Africa and the earthquake in Japan have pushed up commodity prices, creating greater concern about inflationary risks. Economic authorities have varied in their response but always in the same direction (with the exception of special cases, such as Japan): the central banks of the emerging countries have already spent several months tightening up their monetary policies (in combination with other restrictive measures), the European Central Bank (ECB) joined this trend in April while the Fed seems to be preparing the ground for it.

How fiscal and monetary policies develop in the United States is crucial to stabilizing the markets.

In the United States, the Federal Reserve (Fed) has adopted a more optimistic tone

The Fed announces it's more optimistic regarding the sustainability of the recovery.

Fed members disagree on the right time to withdraw stimuli.

regarding the economic outlook. According to the minutes published from the last monetary policy meeting, the central bank believes that the data are consistent with a scenario where economic recovery is «proceeding at a moderate pace». Regarding the labour market, the recent fall in the unemployment rate has been welcomed, although committee members are cautious, noting that other indicators point towards job creation being moderate. An analysis of the inflationary risks becomes particularly important within this context. On the one hand, although the Fed's members realize that risks have increased concerning long-term inflation expectations, the main or majority opinion that still predominates is that these inflationary pressures will be temporary and that core inflation will remain under control. On the other hand, many public statements by various members of the Fed are stimulating lively public debate regarding when and how to start getting monetary policy back to normal. Some see this as a communication strategy to warn the markets, with as much advance notice as possible, that the Fed will begin to withdraw stimuli. In fact, Charles Plosser, President of the Fed in Philadelphia, gave

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5)		Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
		3-month	1-year						
2010									
March	1.00	0.63	1.21	0.25	0.29	0.24	0.50	0.65	0.28
April	1.00	0.66	1.24	0.25	0.35	0.24	0.50	0.68	0.21
May	1.00	0.70	1.26	0.25	0.54	0.25	0.50	0.71	0.13
June	1.00	0.77	1.31	0.25	0.53	0.24	0.50	0.73	0.28
July	1.00	0.90	1.42	0.25	0.45	0.24	0.50	0.75	0.42
August	1.00	0.89	1.42	0.25	0.30	0.24	0.50	0.73	0.59
September	1.00	0.89	1.43	0.25	0.29	0.22	0.50	0.73	0.32
October	1.00	1.03	1.52	0.25	0.29	0.20	0.50	0.74	0.23
November	1.00	1.03	1.53	0.25	0.30	0.19	0.50	0.74	0.20
December	1.00	1.01	1.51	0.25	0.30	0.19	0.50	0.76	0.20
2011									
January	1.00	1.07	1.64	0.25	0.30	0.19	0.50	0.78	0.26
February	1.00	1.09	1.77	0.25	0.31	0.19	0.50	0.80	0.10
March	1.00	1.24	2.00	0.25	0.30	0.20	0.50	0.82	0.28
April (1)	1.25	1.35	2.12	0.25	0.27	0.20	0.50	0.82	0.25

NOTES: (1) April 20.
(2) Marginal interest rate. Latest dates showing change in minimum rate: 6-11-08 (3.25%), 4-12-08 (2.50%), 5-3-09 (1.50%), 2-4-09 (1.25%), 7-05-09 (1.00%), 7-4-11 (1.25%).
(3) Latest dates showing change: 11-12-07 (4.25%), 22-01-08 (3.50%), 30-01-08 (3.00%), 18-03-08 (2.25%), 30-04-08 (2.00%), 8-10-08 (1.5%), 29-10-08 (1%), 16-12-08 (0%-0.25%).
(4) Latest dates showing change: 10-04-08 (5.00%), 8-10-08 (4.5%), 6-11-08 (3.0%), 4-12-08 (2.0%), 7-01-09 (1.5%), 5-02-09 (1.0%), 5-03-09 (0.50%).
(5) Interbank rate.
SOURCES: National central banks, Bloomberg and own calculations.

details in a public appearance of a possible sequence of measures to be adopted in the «exit strategy». In general lines, the first step would be to raise the official interest rate as well as the rate on banks' surplus reserves. The second phase would consist of reducing the size of the balance by selling off assets.

In the euro area, in April the European Central Bank (ECB) raised its official interest rate to 1.25%, a hike which had been clearly forewarned by Jean-Claude Trichet at the beginning of March. The reason given for this hike is the institution's concern for the upswing recorded in the rate of inflation. With interest rates getting back to normal, the reserve bank hopes to contain inflationary pressures in the medium term. Moreover, due to the ECB's repeated emphasis on the institution's firm commitment to avoiding any second-round effects (for example, this being passed on to wages), investors have modified their interest rate forecasts, anticipating that, by the end of the year, the monetary authority might have raised the reference rate to 1.75%. With regard to non-conventional monetary policy measures, the reserve bank announced that it will not alter its one and three-month liquidity facilities for the second quarter. However, analysts believe that, as from the summer, the monetary authority might introduce changes in the three-month liquidity facility scheme (abandoning full allotment and returning to competitive auctions at a variable interest rate) to help the money markets get completely back to normal.

The large emerging countries are already at an advanced stage in the growth cycle, have recorded a notable rise in inflationary pressures and they are also keen to achieve a gentle, orderly slowdown in their economies. This situation means that countries such as Brazil and China, as the most representative cases, are fully immersed in a process of monetary restriction, focusing on controlling the rate at which credit grows and therefore domestic demand and asset prices. However, some economists doubt, and not without reason, whether these countries' authorities will achieve their goal. In this respect, it should be noted that, both in Brazil and in China, the authorities are using an extensive arsenal of measures to accomplish their aim, some unorthodox and with an uncertain effect. Brazil, in addition to raising the official rate to 11.75%, is using measures aimed at strengthening the stability of its financial system and limiting credit volume. In the case of China, where increases in the official rate are very gradual (the rate for one-year loans was raised in April up to 6.31%), the ratio of the reserves required by retail banks has been increased to 20% in order to restrict their capacity to grant loans.

Within this overall context, where inflationary pressures are gaining ground and the central banks seem inclined to further the normalization process, the dollar and euro interbank markets have become much more normal in terms of the volumes being traded and the premia for credit and liquidity risk. It is precisely the expectations regarding the action of each central bank that are causing the greatest differences in movements recorded in interest rate curves. On the one hand, the ultra-lax monetary policy still being applied by the Fed is reflected in the prolonged stability of the Libor interest rate market in dollars. On the other hand, the recent hike in the official interest rate by the ECB has pushed up the Euribor rates, mainly the 12-month, which went above 2.1% in April.

The ECB raises its official interest rate, committed to keeping prices stable.

Inflationary pressures in emerging economies are forcing their central banks to tighten up monetary policies.

The ECB's actions have pushed up interbank interest rates in the euro area.

Debt yields for the United States and Germany remain on the up.

Public debt rates are becoming more volatile

For a few months now, the main trend in domestic yields for public debt from the United States and Germany has been upward, based on the gradual improvement in growth prospects and greater inflationary pressures. However, this trend has seen occasional corrections in response to different kinds of factors, such as the announcement or rumours concerning economic policy or ups and downs in risk aversion (either, in turn, due to the peripheral debt crisis or events such as those in Japan). April has been a compendium of all these elements.

In the case of United States, in mid-April the yields for two and ten-year public debt rose to almost 0.85% and 3.60% respectively, recovering their levels prior to the incidents in Libya and Japan. Then they fell again, which seems to be due to two factors. One of less importance: another episode of flight to quality given the problems of Greece and Portugal, as well as the downward turn in stock markets. And another, more substantial factor with regard to the future: the intensifying of debate concerning the readjustment of fiscal and monetary policy. One key event in this respect was the decision by the agency Standard & Poor's to downgrade the outlook for US public debt given the absence of any plan with sufficient political support to consolidate the budget in the medium term. For its part, the fact that no-one knows what the Fed will do in June when the QE2 ends is a source of notable concern among investors, aware that the Fed's bond purchases have significantly supported the markets over the last few

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

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

	Germany	France	Spain	Italy	United States	Japan	United Kingdom	Switzerland
2010								
March	3.09	3.42	3.82	3.98	3.83	1.40	3.94	1.88
April	3.02	3.29	4.03	4.02	3.65	1.29	3.85	1.78
May	2.66	2.92	4.26	4.14	3.28	1.27	3.58	1.54
June	2.58	3.05	4.56	4.09	2.93	1.09	3.36	1.48
July	2.67	2.95	4.21	3.95	2.91	1.07	3.33	1.46
August	2.12	2.47	4.05	3.83	2.47	0.97	2.83	1.13
September	2.28	2.66	4.12	3.88	2.51	0.94	2.95	1.40
October	2.52	2.91	4.21	3.94	2.60	0.94	3.08	1.49
November	2.67	3.15	5.50	4.67	2.80	1.19	3.23	1.56
December	2.96	3.36	5.45	4.82	3.29	1.13	3.40	1.72
2011								
January	3.16	3.53	5.37	4.72	3.37	1.22	3.66	1.87
February	3.17	3.55	5.39	4.84	3.43	1.26	3.60	1.90
March	3.23	3.59	5.18	4.76	3.35	1.22	3.56	1.85
April (*)	3.31	3.64	5.47	4.74	3.41	1.24	3.58	2.06

NOTE: (*) April 20.
SOURCE: Bloomberg.

months. The fact that yields' initial response has been moderate and even downwards (occurring after the announcement by Standard & Poor's) could be paradoxical, given the trends observed in other countries. Perhaps this can be explained by the fact that the United States and those in charge of economic policy enjoy particularly high credibility among the investor community. In any case, with a view to the coming months, analysts expect this market to become more volatile.

In April, debt from the central countries of the euro area performed similarly to debt for the United States. The positive effects of consolidated economic growth, as well as the advances made in resolving the debt crisis in the periphery of Europe were reinforced by the ECB's actions in the area of monetary policy, causing a rise in 2 and 10-year German bonds (reaching 1.90% and 3.50%, respectively, by mid-April). For its part, and as was already happening in March, Spain's risk premium narrowed thanks to investors welcoming the efforts made in the fiscal area and the progress in economic governance and financial solidarity in the euro area. However, and highlighting the fact that the crisis is still far from completely resolved, in the last few weeks of the month the impasse regarding Portugal and speculation concerning a possible restructuring of Greek debt once again increased uncertainty. As a result, the spread between Spanish and German debt widened again, albeit without reaching the previous levels and separating itself, at least partially, from the serious and reasonable doubts hovering over Greece and Portugal.

Spanish public debt reacts positively to the advances made in resolving the European sovereign debt crisis.

EXCHANGE RATES OF MAIN CURRENCIES

April 21, 2011

	Exchange rate	% change (*)		
		Monthly	Over December 2010	Annual
Against US dollar				
Japanese yen	82.1	1.3	1.2	–13.5
Pound sterling	0.607	1.1	5.3	6.5
Swiss franc	0.883	–2.4	–5.9	–21.2
Canadian dollar	0.949	–3.1	–5.2	–5.4
Mexican peso	11.583	–3.5	–6.5	–5.1
Against euro				
US dollar	1.462	–2.8	–9.2	–9.2
Japanese yen	120.1	4.0	9.7	–3.9
Swiss franc	1.292	0.4	3.2	–11.0
Pound sterling	0.887	1.6	3.3	2.0
Swedish krona	8.909	–0.1	–0.9	–8.0
Danish krone	7.457	0.0	0.0	0.2
Polish zloty	3.981	–1.2	0.4	3.0
Czech crown	24.21	–0.8	–3.3	–4.4
Hungarian forint	264.0	–3.0	–5.5	0.1

NOTE: (*) Plus sign indicates appreciation of dollar (first group) or euro (second group).
SOURCES: Bloomberg and own calculations.

Trends in the dollar-euro exchange rate reflect short-term monetary expectations.

The dollar continues to fall

Recent trends in the dollar exchange rate against the euro clearly reflect short-term monetary expectations. The ECB raising the official interest rate merely accelerated the loss in value that has been recorded by the dollar in the last few months. Since the level it held at year-end 2010, the euro has gained more than 8%, reaching around 1.48 dollars by the end of April. The ECB's change in direction has led to a widening of the interest rate differential between the United States and the euro area, encouraging a greater flow of investment towards assets held in Europe. However, according to the consensus of analysts, the euro only has a limited potential to rise any further in value over the coming months. The bulk of the evidence available suggests that, in the second half of the year, and as the Fed sees the recovery in the economy and labour market consolidating in the United States, it will start to withdraw monetary stimuli. As a result, the interest rate differential in the short and medium term between the two regions will start to gradually narrow and will therefore place the dollar on a firmer footing.

In the Asian region, the progressive, continual revaluation of the Chinese yuan is in line with the latest monetary policy actions. Over the last twelve months, the value of the renminbi has risen by 4.45%.

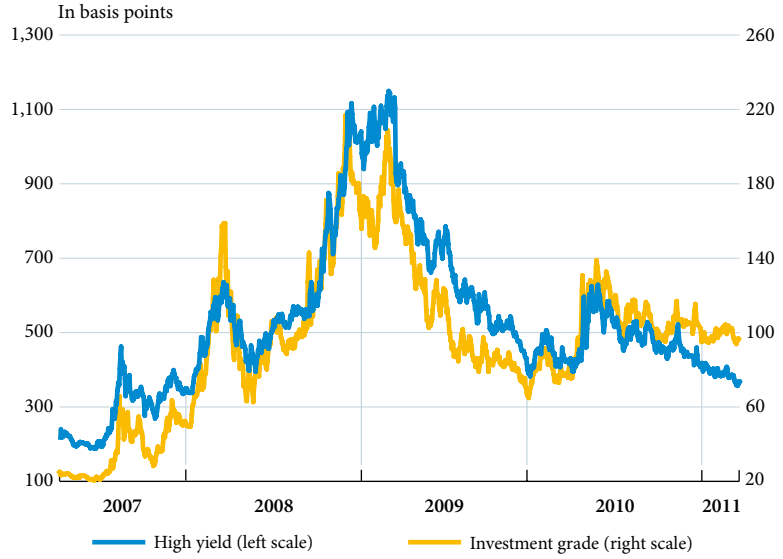
The decrease in credit risk boosts corporate bonds.

The corporate bond markets are swimming in abundance, for the moment

Global corporate bonds got back to performing positively and calmly in the first fortnight of April, once investors fully realized that the impact of the traumatic events happening in February and March would more than likely be

CORPORATE RISK PREMIA TRENDS IN THE EURO AREA

5-year Markit iTraxx



SOURCE: Bloomberg.

modest. In particular, and ignoring certain one-off cases, it seems that these events will be of little and limited effect given the favourable dynamic seen in the business area since the middle of last year. In fact, one of the most notable ingredients in the global economy recovering its tone is the solidity of the non-financial business sector and the consequent reduction (or at least containment) of corporate credit risk. This contrasts, for example, with the huge difficulties being experienced by the public sector.

Within this context, the total return indices for corporate bonds (which are immersed in a firmly upward trend that started last year) once again reached maximum levels, both in investment grade bonds and high yield. Interest rates (or, more precisely, yields) for both categories remain close to their historic minimum levels.

Particularly remarkable, and to some extent surprising, is the resistance to shocks exhibited by the high yield segment, traditionally very sensitive to any setback. On this occasion, neither the risks of Libya and Japan nor those related to inflation expectations and the possible monetary policy response have stopped the high yield sector from remaining positive, seen in very high trading volumes (issuance) and strong prices (low interest rates). In short, highly favourable conditions for firms to resort to the bond market as a source of financing, especially within this peculiar cycle where the growth potential for bank credit is lower given the need for financial institutions to become more solvent again.

At a global level, in addition to the consolidation of the economic recovery and the healthy business sector, one factor that some believe helps to explain the boom in the corporate bond market is the extreme lassitude of monetary policies, particularly by the Fed. The low level of monetary interest rates and the QE2 have probably pushed a lot of investors to look for higher returns in corporate bonds, tolerating a somewhat higher risk. In fact, the possibility that risks have been underestimated in some areas (within high yield, leveraged loans and structured financing) is a worrying element, which will be tested over the coming months if the Fed announces the start of the withdrawal of stimuli. On a small scale, in the second fortnight of April we could already observe modest disturbances in response to the debate arising among various members of the Fed concerning this issue. Although we are undoubtedly very far from the excesses accumulated in 2007 in the capital markets, this issue is certainly looking like the main challenge in the medium term for a market that, considering the general underlying fundamentals of firms, has good prospects.

Issuers of high yield bonds in the United States take advantage of the lax official rates to issue under favourable conditions.

In the case of Europe's corporate bond market, which is less developed than the North American one, once again the large number of bonds issued by the banking sector stands out. This has been possible thanks to the sovereign debt crisis in the peripheral countries being under control and in accordance with the underlying fundamentals of each country. However, the situation is still far from normal and bank debt spreads continue to be high and vulnerable. At the end of April, financial sector bonds were moderately penalized due to rumours concerning a possible restructuring of Greek public debt.

European banking sector bonds pick up.

Caution is knocking at the door of the stock markets

Global stock markets embark upon a more irregular phase.

With a similar trend to corporate bonds, international equity markets performed well on the whole up to mid-April (recovering from the losses immediately following the shocks of Libya and Japan), performing more irregularly in the second fortnight (due to concerns regarding the future economic policy of the United States and another outbreak of the sovereign debt crisis in Europe's periphery). This pattern might not be anecdotal but could reveal the underlying conditions faced by the market.

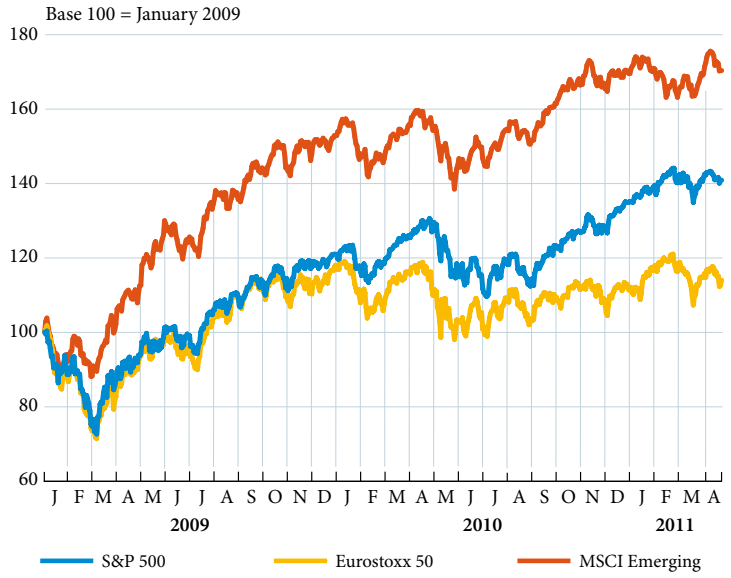
The upward trend of some indices could be limited in the short term.

In fact, although the basic scenario for investor strategies in the medium and long term is being benefited by already familiar factors (such as the consolidation of world economic growth, the business cycle continuing to expand and the fall in credit risk), a series of aspects have recently appeared that might limit index gains in the short term, both in advanced economies and emerging.

Within the context of North American stock markets, throughout the last quarter technical indicators reached high levels of overbuying. Moreover, the least favourable period of the year is now starting for stock markets. And, most significantly, sentiment indices are at levels that indicate a high degree of complacence and optimism among investors, so that there's more room for disappointment than pleasant surprises. This might be relevant regarding the earnings announcements for the first quarter, which will culminate in May and in which companies are unlikely to exceed the quite generous consensus forecasts. Lastly, one factor that could slow up stock market gains and

TRENDS IN THE MAIN INTERNATIONAL STOCK MARKETS

Stock market indices



SOURCE: Bloomberg.

introduce volatility over the coming months is the aforementioned debate concerning how and when to carry out budgetary adjustment and monetary policy normalization (after the end of the QE2).

In the euro area, the main obstacles in the short term to stock market gains are the delay in resolving the sovereign debt crisis of the peripheral countries and the recent upswing in uncertainty regarding the Greek economy. The task of dispelling doubts regarding solvency and the economy's capacity to recover will be key to improving the indices of those peripheral countries that are lagging behind, such as Spain.

Lastly, in the case of the emerging economies taken as a whole (see the graph above), the phase of applying monetary and financial restrictions in which they have been immersed since the end of 2010 is extensively limiting stock market gains. This process has yet to be completed, so that the possibilities of achieving returns similar to those two years ago look highly unlikely in the short term.

Economic and business aspects make equity an attractive prospect in the medium term.

INDICES OF MAIN WORLD STOCK EXCHANGES

April 20, 2011

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*12,266.8*	*3.4*	*6.0*	*10.3*
Standard & Poor's	*1,312.6*	*2.6*	*4.4*	*8.7*
Nasdaq	*2,745.0*	*3.8*	*3.5*	*9.8*
Tokyo	9,606.8	4.3	–6.1	–11.9
London	5,991.2	4.8	1.5	3.6
Euro area	2,891.6	3.5	3.5	–3.1
Frankfurt	*7,154.4*	*7.4*	*3.5*	*14.2*
Paris	*3,964.4*	*4.0*	*4.2*	*–1.5*
Amsterdam	*357.5*	*2.0*	*0.8*	*0.7*
Milan	*21,390.3*	*0.9*	*6.0*	*–8.1*
Madrid	*10,451.1*	*1.2*	*6.0*	*–7.6*
Zurich	6,405.7	5.0	–0.5	–6.4
Hong Kong	23,896.1	7.2	3.7	10.5
Buenos Aires	3,332.3	1.7	–5.4	37.3
São Paulo	66,158.1	–1.1	–4.5	–4.6

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

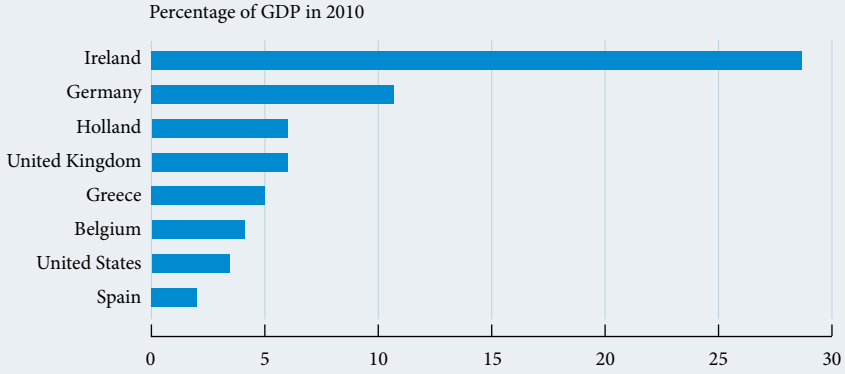
Financial fiscal policy: a lot of proposals, not much consensus

The financial crisis of 2007 led to the worst economic recession since the Great Depression. The nature of its trigger (the subprime crisis in the United States), the losses recorded by financial institutions around the globe and the contribution of public funds to sort it all out have resulted in an overall revaluation of the mechanisms to safeguard the stability of financial markets. Although the priority has been to set up suitable regulations and supervision, some wonder whether to complement this strategy with a new fiscal policy for the sector. The objective would be twofold: to correct negative externalities attributed to certain activities and to garner additional funds given the necessary consolidation of public accounts after the crisis. But is there any taxation formula that can achieve this dual bonus without creating new distortions? Is it viable or would it require too much sacrifice in terms of efficiency or implementation costs?

Several countries are considering changes of this type or weighing up the arguments for greater financial taxation. Their defence is based on two points: collecting revenue from the financial sector to meet the cost of future restructuring and to complement the regulations that aim to reduce systemic risk. Although the revenue argument is more or less supported depending on the forum (many central governments already get substantial revenue from the sector via company tax, while the public cost of the recent bail-out was very different depending on each country - see the graph below), after the Lehman bankruptcy few question the idea that certain financial activities involve negative externalities for the rest of the economy.

THE COST OF STATE AID TO THE FINANCIAL SECTOR HAS BEEN HIGHLY HETEROGENEOUS

Net cost of financial sector support



NOTE: Fiscal outlays of the central government cumulative since the beginning of the crisis, net of recovery. The latest available data ranges between end-December 2010 and end-March 2011. The data for Ireland do not include the asset purchases by the National Asset Management Agency, financed with government-guaranteed bonds. The data for Germany include 240 billion euros (9.5% of GDP) for asset purchases.
SOURCES: IMF *Fiscal Monitor* (April 2011) and own calculations.

The IMF estimates that the implicit public guarantee enjoyed by institutions that are «too big to fail» reduces the cost of their funding by around 20 basis points and encourages them to finance excessively risky investment without taking into account the external cost entailed. These externalities include the cost of bailing them out should the operation go wrong and the less than optimal channelling of resources towards activities that fail to

maximize the welfare of society.[1] The volatility introduced into the system by short-term and purely speculative movements, normally associated with derivatives and hedge funds, is also brandished in favour of a review of financial fiscal policy that doesn't prioritize revenue so much as the internalization of external costs and a reduction in systemic risk. Those who are against this do not question the argument's validity but the appropriateness of using taxation as a solution rather than changing the dual regulation-supervision system.

The alternatives under debate are currently limited to three: a Financial Stability Contribution (FSC), a Financial Activity Tax (FAT) and a Financial Transaction Tax (FTT) in the Tobin style.[2] At the G-20, the International Monetary Fund proposed the creation of a new two-level fiscal system including an FSC and an FAT, applicable to all kinds of financial institutions.[3] The tax rate for the FSC could be calibrated according to the systemic risk of each institution, its taxable base resulting from the external funding of financial institutions (excluding deposits, guaranteed reserves and Tier 1 capital) and its revenue being used to finance part of the direct cost of future restructuring. On paper, an FSC applied sufficiently widely could avoid distortion in financing decisions (such as excessive leveraging). In practice, its viability is compromised by the complexity and difficulty in defining a suitable tax rate that accurately reflects each institution's contribution to the aggregate risk.

Unlike the FSC, the taxable base for the FAT is not obtained from the balance sheet but from the profit and loss account; it would be taken from returns and profits of financial institutions, with the opportunity to choose between taxing these as a whole, this thereby becoming a pseudo value added tax, or taxing only «excessive» income, based on the idea that this comes from unjustified risk and the implicit guarantee of the central government. A well-designed FAT could align incentives to minimize unwelcome risk-taking but the viability of this kind of tax arouses even more controversy than the FSC. The IMF itself stresses that the effectiveness of this tax hangs on international coordination; if there is none, tax evasion by changing country and dual taxation might cancel out its effect or even make it counter-productive. Neither is it clear how to determine which level of income is excessive for the financial sector without ending up taxing gains that may actually come from greater effort or efficiency and not from greater risk.

Unlike the rest of the alternatives, the FTT is not a tax on the financial sector per se but on financial markets. Applied generally, its taxable base would include any financial transaction carried out in markets, whether these are organized or not (over the counter); in its limited version, it would only tax bonds and shares in organized markets. The tax rate would be relatively low as it would be applied each time the asset in question was traded.

Those who support this kind of tax claim that an FTT with a wide base would help to substantially reduce the volatility of financial markets. However, this premise has been called into doubt by empirical evidence and, moreover, involves serious implementation problems: defining the taxable base in derivative transactions is highly complex; the risk of moving to external jurisdictions is even greater than in the case of the FAT if this is not coordinated at a G-20 level, something not very likely considering that several countries, including the United States and the United Kingdom, have already rejected it; and its revenue would be distributed unevenly, concentrated in just a few financial markets that carry out most of the transactions. Nonetheless, the main drawback is that it doesn't differentiate between «beneficial» and «harmful» transactions, so that it would end up

(1) See the Box entitled «Guaranteed bail-out: a risky perception for the system» in the April Monthly Report.
(2) Tobin, J. (1978). «A proposal for international monetary reforms», Eastern Economic Journal, 153-159.
(3) «A fair and substantial contribution by the financial sector. Final report for the G20», IMF (2010).

reducing efficiency and liquidity in the system, hindering the correct channelling of resources and making it difficult to hedge risk without tackling the main problem: the misalignment of incentives.

In short, none of the proposals is without these unwelcome side effects or even possible legal interference with other measures or regulations currently in force. This explains why the ideal action has yet to be agreed, not even in terms of what should be taxed, let alone a definition of the taxable base, tax rate or scope of application.

Given this disagreement, and given that the regulatory reforms underway already place new demands on a still fragile financial system, a parallel reform of fiscal policy demands a large dose of caution. In any case, as in the regulatory area, international coordination is vital.

This box was prepared by Marta Noguer
International Unit, Research Department, "la Caixa"

SPAIN: OVERALL ANALYSIS

Economic activity

The gradual revival in the economy continues.

The foreign sector: key to the recovery

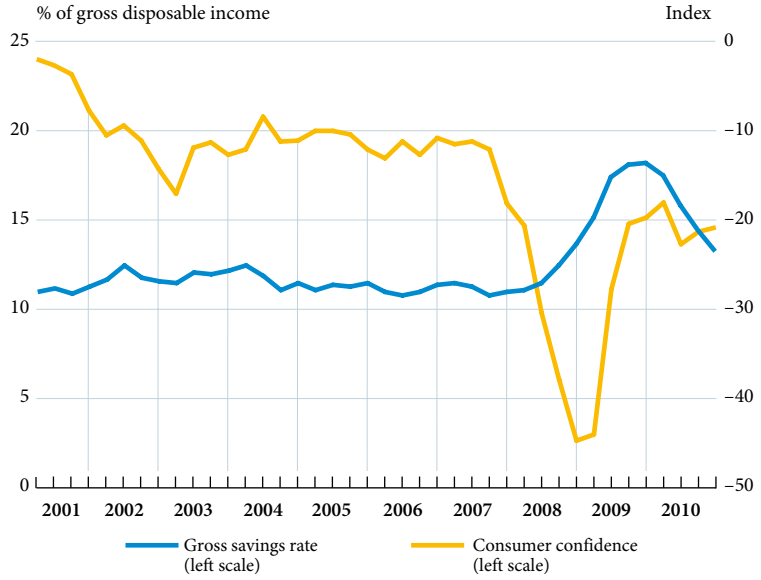
The data available for the first quarter of 2011 show that economic activity is progressing very gradually. The various indicators confirm that consumption's capacity to recover, the factor with the greatest relative weight in the economy, will still be quite limited in 2011. However, the figures for the foreign sector are somewhat better than expected, confirming the significant support this sector will provide to growth in the gross domestic product (GDP) this year.

The pressures on consumption are many and varied. Of note is the poor performance of the labour market, the fall in disposable income and the loss of purchasing power due to the upswing in inflation. All this is reflected in the erratic recovery seen by the consumer confidence index. In the month of March, in particular, it posted a considerable decline and fell back down to December's level. In fact, this indicator has remained very flat for the last few quarters.

Retail sales are failing to show signs of recovery as well. These fell again in February, placing the year-on-year rate of change at –4.4% and thereby continuing the downward trend of last year. The consumption of services is unlikely to offset the difficulties in goods consumption, so that growth in aggregate

IMPROVED CONFIDENCE LEADS TO LOWER HOUSEHOLD SAVINGS

Indicators for confidence and household savings



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

DEMAND INDICATORS

Percentage change over same period year before

	2009	2010	2010				2011		
			1Q	2Q	3Q	4Q	January	February	March
Consumption									
Production of consumer goods (*)	–8.2	0.8	0.4	2.5	0.4	0.1	1.2	1.8	...
Imports of consumer goods (**)	–6.1	–10.2	–10.8	2.8	–16.2	–15.1	–5.1	0.4	...
Car registrations	–17.9	3.1	44.5	35.3	–25.0	–29.3	–23.5	–27.6	–29.1
Credit for consumer durables	–11.5	–12.3	–5.6	–9.8	–19.2	–14.6	–	...	–
Consumer confidence index (***)	–28.3	–20.9	–18.2	–22.9	–21.5	–21.0	–21.0	–15.2	–22.6
Investment									
Capital goods production (*)	–22.1	–3.3	–2.4	–1.7	–6.3	–3.2	3.2	3.6	...
Imports of capital goods (**)	–27.0	6.0	–1.2	13.0	5.8	6.5	22.9	–3.5	...
Commercial vehicle registrations	–40.0	6.4	8.5	24.2	–9.3	1.4	–0.7	–2.7	–2.8
Foreign trade (**)									
Non-energy imports	–17.5	9.2	10.4	18.1	5.1	4.2	11.0	4.9	...
Exports	–9.8	14.5	17.4	14.9	11.7	14.1	24.6	15.4	...

NOTES: (*) Adjusted for public holidays.
(**) By volume.
(***) European Commission survey: difference between percentage of positive and negative replies.
SOURCES: ANFAC, National Institute of Statistics, Bank of Spain, Ministry of the Treasury, European Commission and own calculations.

Consumption grew in 2010 but savings fell.

demand will more than likely be slight in the first quarter of the year.

As has already been mentioned, the trend in gross disposable income is becoming crucial to the recovery in private consumption. In 2010, this fell by 1.8% according to the data for the fourth quarter of 2010 published by the National Institute of Statistics (INE). Given that the average annual inflation was 1.8%, the fall in income in real terms was even higher. In spite of this decline, nominal consumption grew by 4.1% in 2010 compared with the previous year. This was possible thanks to a significant drop in savings. As these had risen considerably in the period 2008-2009 due to the uncertainty caused by falling employment, the downward turn was sharp. At the end of 2010, savings stood at 13.1% of disposable income, a rate five percentage points lower than the one recorded in 2009. After this large correction, the boost savings can give to consumption is more limited.

Nominal disposable income won't offer much support to consumption either. Although, for this year, we do expect a slight increase in nominal terms, in real terms it will probably fall again by about 1%.

The limited progress made by household spending, together with the poor trend in public expenditure and investment, will mean that domestic demand's contribution to growth will more than likely be negative in 2011. With regard to investment, however, it's important to distinguish between the performance of investment in construction and of that aimed at the production of goods.

Investment in construction continues to fall...

Indicators as a whole point to the construction industry failing to turn the corner. One sign of this is the fact

that both cement consumption and confidence in construction were down again in the month of March.

However, variables related to the progress made by investment in capital goods are more favourable. In this respect, we should note the positive trend in the position of non-financial firms. According to non-financial quarterly accounts, while in 2007 these firms had a net borrowing of 11% of GDP, in 2010 they recorded a net lending of 0.4%. This improved financial situation should help to boost investment. In fact, leading indicators point in this direction. For example, in February, the production of industrial goods rose by 3.6% year-on-year, contrasting with the 1.9% drop recorded in the same month of 2010.

But given that domestic demand's contribution to growth, on the whole, will be negative, exports will continue to drive the economy this year. The progress made by exports is due to the improved global market, largely boosted by the strength of the emerging countries and the recovery in most developed economies. As the growth in imports in 2011 will be considerably more modest, the net foreign balance will contribute notably to GDP growth.

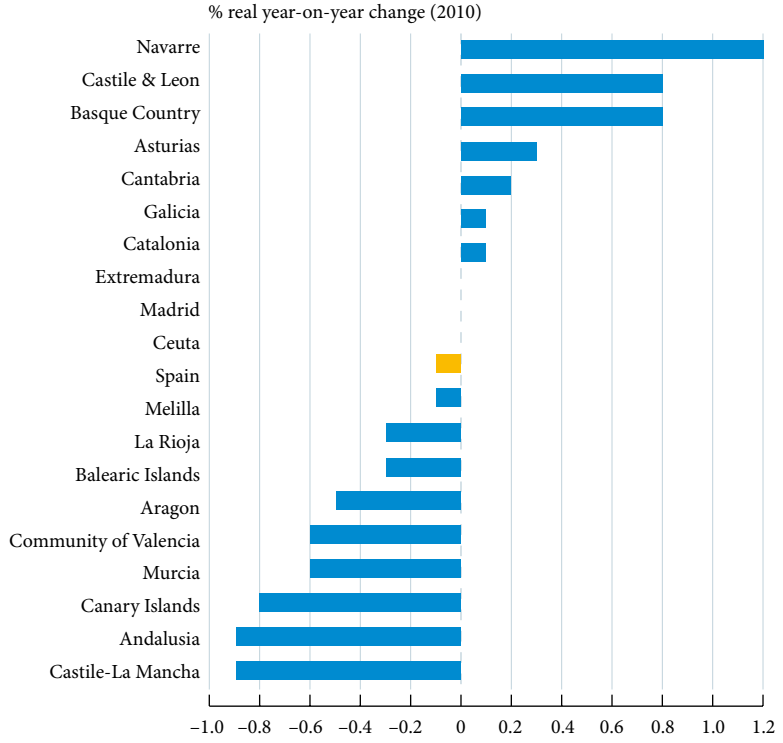
...while investment in capital goods picks up.

However, not all the regions in Spain are advancing at the same rate, as shown by the regional accounts published by the INE. According to this institute's estimates, Navarre saw the highest growth in 2010, namely 1.2%, much higher than the fall of 0.1% recorded for the country as a whole.

Exports remain strong.

NAVARRE LEADS GROWTH IN 2010

GDP growth by autonomous community



SOURCES: National Institute of Statistics and own calculations.

SUPPLY INDICATORS

Percentage change over same period year before

	2009	2010	2010				2011		
			1Q	2Q	3Q	4Q	January	February	March
Industry									
Electricity consumption (1)	–4.8	2.5	2.5	3.3	1.8	2.5	0.6	1.9	1.1
Industrial production index (2)	–15.8	0.8	0.3	2.9	–0.2	0.4	2.9	3.6	...
Confidence indicator for industry (3)	–30.8	–13.8	–18.4	–13.9	–13.5	–9.2	–8.3	–7.2	–10.2
Utilization of production capacity (4)	71.2	72.0	69.5	71.8	73.9	72.9	72.6	–	–
Imports of non-energy intermediate goods (5)	–21.6	22.2	26.9	28.4	18.8	15.8	16.9	8.0	...
Construction									
Cement consumption	–32.3	–15.6	–21.3	–12.3	–13.6	–16.1	0.3	2.7	–6.4
Confidence indicator for construction (3)	–32.3	–29.7	–25.6	–24.0	–27.8	–41.5	–50.7	–52.1	–59.6
Housing (new construction approvals)	–58.1	–17.3	–24.4	–10.3	–13.2	–20.3	7.2	...	...
Government tendering	–8.2	–37.9	–52.2	–18.1	–36.6	–34.8	–17.9	...	...
Services									
Retail sales (6)	–5.4	–1.0	0.7	–0.2	–2.5	–1.9	–4.6	–4.4	...
Foreign tourists	–8.8	0.9	0.3	–3.1	4.2	1.4	4.7	4.3	...
Tourist revenue inflows	–9.0	3.9	0.4	0.8	7.0	5.4	6.2	...	...
Goods carried by rail (ton-km)	–28.4	6.4	4.5	20.9	5.9	–4.2	1.2	11.3	...
Air passenger traffic	–7.9	2.8	3.7	–0.6	4.2	4.3	6.0	4.6	4.5
Motor vehicle diesel fuel consumption	–5.1	–1.2	–0.5	–0.5	–2.1	–1.6	2.3	...	...

NOTES: (1) Adjusted for number of working days and temperature.
(2) Adjusted for public holidays.
(3) European Commission survey: difference between percentage of positive and negative replies.
(4) Business survey: percentage of utilization inferred from replies.
(5) By volume.
(6) Index (without petrol stations) deflated and corrected for calendar effects.
SOURCES: Red Eléctrica Española, OFICEMEN, AENA, National Institute of Statistics, Bank of Spain, European Commission, Ministry of Public Works, Ministry of Industry, Commerce and Tourism, Ministry of the Treasury and own calculations.

Rising energy prices are the biggest risk to the recovery.

Although the recovery seems to be firmly on track, as well as a positive growth rate for 2011 as a whole, uncertainty remains high. Among the risks of a decline, of note is the possibility of a sharper rise in energy prices, which would proportionally hit harder those countries that are highly dependent on oil imports, such as Spain. This would have two big consequences: firms would become less competitive, taking the shine off the excellent recovery in exports and, perhaps more importantly, consumers would lose purchasing power. This last consequence could hamper the revival in purchases, harming growth in private consumption.

However, the economy may also perform better than expected. We cannot rule out a faster than expected improvement in Spain's risk premium once Portugal's bail-out has been specified and Spain's financial system has been restructured. Without doubt, improved confidence would boost business investment.

Labour market

The economy's growth is not enough to create jobs

The moderate dynamism of economic activity in the first quarter of 2011 was not enough to reverse the unfavourable situation in the labour market. In fact, the figures for March were slightly worse than expected, but still continue to show a slow recovery in the job market.

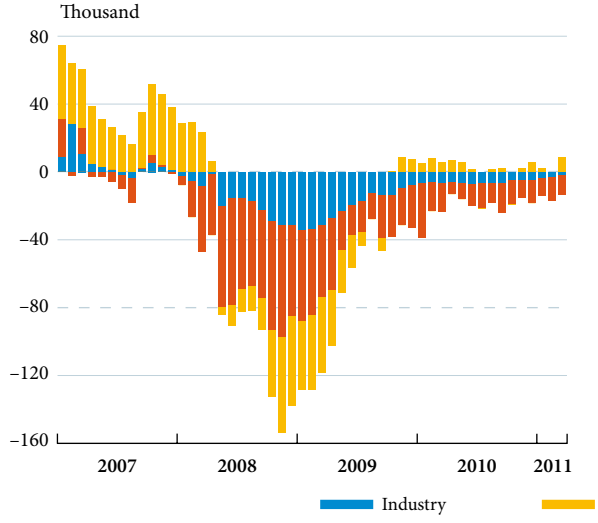
The total number of registered employed with Social Security in March actually increased by 45,660 people, reaching 17,392,754 and, as a result, the rate of decrease in employment fell by almost two tenths of a percentage point to 1.1%. However, the seasonally corrected figure reveals a fall of approximately 14,000 registrations. This suggests that the rise in employment in March was due exclusively to seasonal factors and not to any substantial improvement in the economy's rate of progress.

Over the coming quarter, the outlook is for the number of employed to rise as a consequence of favourable seasonal factors, such as the Easter holidays and the start of hiring for the summer period. The rate of decrease in employment will therefore moderate a little, close to one tenth of a percentage point, standing at 1.0% year-on-year in the month of June. During the second half of the year, the fall in the year-on-year rate for total

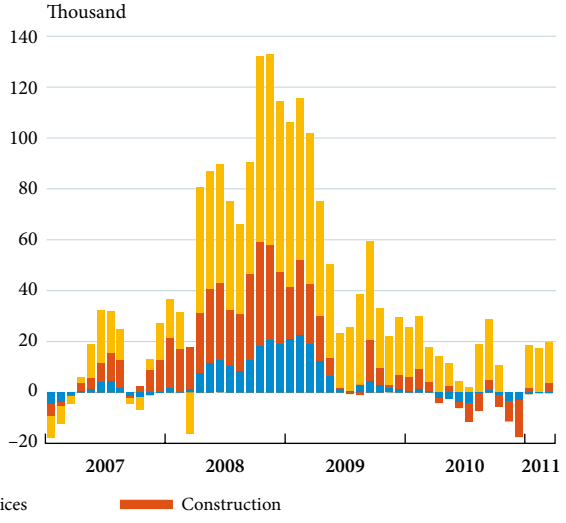
The rise in employment registrations in March is merely seasonal.

STAGNATION CONTINUES IN THE LABOUR MARKET

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



Monthly change in the number of registered unemployed (*)



Industry Services Construction

NOTE: (*) Series corrected for seasonal factors.

SOURCES: Ministry of Labour and Immigration, Public Employment Offices and own calculations.

EMPLOYMENT INDICATORS

Percentage rate of change over same period year before

	2009	2010	2010				2011		
			1Q	2Q	3Q	4Q	January	February	March
Persons registered with Social Security (1)									
Sectors of activity									
Industry	*–10.6*	*–4.8*	*–7.2*	*–4.9*	*–3.8*	*–3.2*	*–2.9*	*–2.9*	*–2.6*
Construction	*–23.1*	*–13.4*	*–16.4*	*–13.1*	*–12.5*	*–11.3*	*–9.6*	*–9.7*	*–9.3*
Services	*–2.6*	*0.0*	*–0.8*	*0.1*	*0.4*	*0.4*	*0.3*	*0.2*	*0.3*
Job situation									
Wage-earners	*–6.0*	*–1.8*	*–2.8*	*–1.7*	*–1.4*	*–1.2*	*–0.9*	*–1.2*	*–1.1*
Non-wage-earners	*–4.8*	*–2.8*	*–4.0*	*–3.0*	*–2.4*	*–1.9*	*–1.7*	*–1.7*	*–1.4*
Total	**–5.8**	**–2.0**	**–3.0**	**–1.9**	**–1.6**	**–1.3**	**–1.0**	**–1.3**	**–1.1**
Persons employed (2)	**–6.8**	**–2.3**	**–3.6**	**–2.5**	**–1.7**	**–1.3**	**–**	**–**	**–**
Jobs (3)	**–6.6**	**–2.4**	**–3.9**	**–2.4**	**–1.6**	**–1.4**	**–**	**–**	**–**
Hiring contracts registered (4)									
Permanent	–31.0	–6.4	–11.9	–5.6	–7.6	0.0	8.6	–6.8	–5.8
Temporary	–13.5	3.8	3.7	5.2	3.5	2.8	6.0	–1.1	–2.6
Total	**–15.5**	**2.8**	**2.0**	**4.2**	**2.6**	**2.5**	**6.3**	**–1.6**	**–2.9**

NOTES: (1) Average monthly figures.
(2) Estimate by Labour Force Survey.
(3) Equivalent to full-time work. National Accounting estimate; data adjusted for seasons and public holidays.
(4) At the Public State Employment Service.
SOURCES: National Institute of Statistics, Ministry of Labour and Social Services, Public State Employment Service and own calculations.

The rise in new employment registrations is concentrated in the services sector thanks to tourism's good performance.

employment will continue, albeit at a very slow pace, as reversals in employment are expected again once the summer season has ended. Given this situation, it won't be till the middle of 2012 when jobs will start to be created, once the economy is advancing somewhat more quickly.

One indication that the performance of the labour market is likely to improve in the coming quarter is offered by the employment trend in the services sector. The graph above shows that, in March, employment picked up slightly in this sector, which contains the largest number of employed. This was the case even after adjusting for a series of seasonal factors and, therefore, not all this sector's rise in employment was due to the time of year. These somewhat more favourable data from the services sector coincide with the improved performance by tourism, which rose by 2.4% in the first quarter of the year, partly thanks to travellers being diverted to Spain due to political tension in North Africa. The tourist sector is likely to remain strong and this should help to create jobs in the services sector in the coming months.

Employment in construction can't turn the corner...

However, the process of reactivating employment in construction was still at a standstill as a consequence of activity's bad performance in this sector.

Another example that the labour market is still quite listless is highlighted by the employment figures for the industrial sector, which fell again in the month of March. However, unlike construction, the rate of decrease in the total number of people employed in this sector slowed

up. Given that the economy's recovery is being supported by foreign demand, industry is likely to be boosted by its export orientation and this could have a positive effect on employment in this sector.

The weakness of the labour market is also evident when we look at the trend in registered unemployment. In the month of March, this grew by 34,406 people (around 20,000 seasonally adjusted), exceeding 4.3 million. This rise, somewhat higher than expected, placed the year-on-year increase at 4.0%, one tenth of a percentage point below that of the previous month. The seasonally corrected figures also show that, during the first quarter of 2011, the drop in the number of unemployed at the end of 2010 had been completely reversed. However, these data also reveal that, during this first quarter, unemployment in the industrial sector did not rise and this suggests that the adjustment had probably hit bottom, at least in this sector.

Although the trend in the number of contracts recorded over the last three months also points to some stagnation in the reactivation, we should bear in mind the fact that these data tend to be quite volatile. Moreover, this trend is expected to pick up over the coming quarter, especially after the government's announcement of measures to combat informal employment. One of the proposals being discussed is a preliminary period during which the legalization of informal workers would attract more lenient penalties. Subsequently, employment inspectors would penalize offenders more harshly through the reform of the Social Order Infractions and Penalties Act.

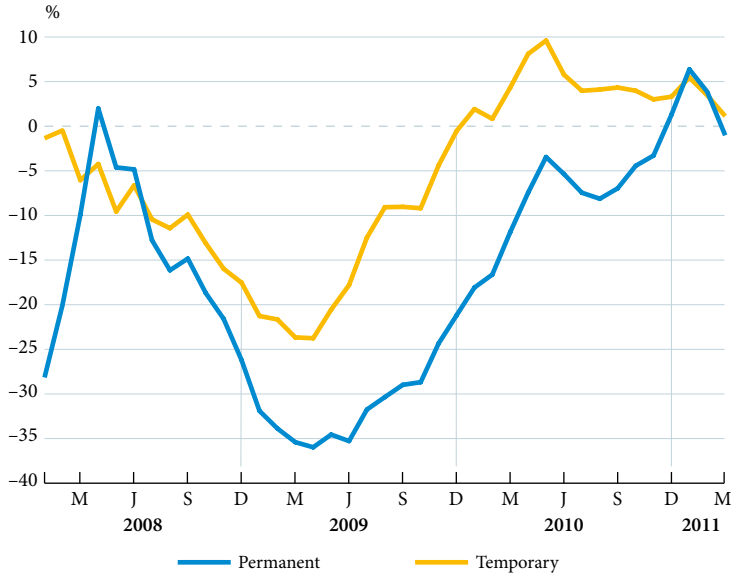
In short, the most recent figures for the labour market are not very favourable

...but industry's rate of job losses is slowing up.

No rise in industrial unemployment in the first quarter of 2011.

THE RECOVERY IN CONTRACT REGISTRATIONS EASES OFF

Year-on-year change (moving averages of three months)



SOURCES: Public Employment Offices and own calculations.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

March 2011

	No. of unemployed	Change over December 2010		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	143,431	16,602	13.1	22,752	18.9	3.3
Industry	505,173	13,535	2.8	–20,713	–3.9	11.7
Construction	762,528	9,461	1.3	–35,044	–4.4	17.6
Services	2,531,424	159,485	6.7	132,683	5.5	58.4
First job	391,113	34,513	9.7	67,378	20.8	9.0
By sex						
Males	2,150,248	97,060	4.7	36,683	1.7	49.6
Females	2,183,421	136,536	6.7	130,373	6.4	50.4
By age						
Under 25 years	483,251	49,477	11.4	211	0.0	11.2
All other ages	3,850,418	184,119	5.0	166,845	4.5	88.8
TOTAL	**4,333,669**	**233,596**	**5.7**	**167,056**	**4.0**	**100.0**

SOURCES: Public State Employment Service and own calculations.

on the whole. However, the fact that employment in the services sector has grown somewhat in March and the indications that the rising unemployment in industry could be coming to an end, augur better results for the coming quarter. These data are also relatively in line with our forecasts, namely that employment will end 2011 with a drop of 0.5% year-on-year and that the unemployment rate will stand at 20.4%.

Prices

The upward trend in prices continues

Rising oil prices are keeping inflation at relatively high levels. Specifically, the year-on-year change in the consumer price index (CPI) remained at 3.6% in March. Although inflationary pressures might continue in the short term, we expect them to recede gradually and the disappearance of the temporary effect caused by indirect tax hikes will help this come about. However, the future trend for oil prices is more difficult to predict, as geopolitical tensions in North Africa have become considerably more volatile. This has kept uncertainty high regarding the inflation forecast.

For the moment, the price of oil is showing no sign of falling in the short term, pushing up our forecast for average inflation for 2011 by one tenth of a percentage point to 3.0% annually. This forecast is highly dependent on what will happen with the price of oil. We believe that the factors pushing it up are unlikely to change in the short term, particularly the geopolitical factors. That's why we expect it to remain above 110 dollars per barrel over the coming months and it probably won't be until the summer when a downward shift will start. In accordance with this scenario, oil prices should be around 100 dollars per barrel by the end of the year.

Given the nature of the inflationary pressures and the expected scenario for oil prices, the rise in inflation will more than likely be temporary. This means

Consumer prices grow at a rate of 3.6% year-on-year in March.

Due to pressure from oil prices, the annual average CPI forecast for 2011 rises by one tenth of a percentage point to 3.0%.

CONSUMER PRICE INDEX

	2010			2011		
	% monthly change	% change over December 2009	% annual change	% monthly change	% change over December 2010	% annual change
January	–1.0	–1.0	1.0	–0.7	–0.7	3.3
February	–0.2	–1.2	0.8	0.1	–0.6	3.6
March	0.7	–0.5	1.4	0.7	0.1	3.6
April	1.1	0.6	1.5			
May	0.2	0.8	1.8			
June	0.2	1.0	1.5			
July	–0.4	0.6	1.9			
August	0.3	0.8	1.8			
September	0.1	0.9	2.1			
October	0.9	1.8	2.3			
November	0.5	2.4	2.3			
December	0.6	3.0	3.0			

SOURCE: National Institute of Statistics.

The ECB ups the interest rate by 25 basis points to 1.25% to combat inflationary pressures.

that, for the moment, no significant second-round effects can be noted. In fact, although the survey carried out by the European Commission on inflation expectations states that these are increasing, they are still within moderate limits.

Inflation expectations also seem to be quite well anchored for the euro area as a whole but the European Central Bank (ECB) moved away from the Fed and, in April, raised its official interest rate by 25 basis points to 1.25%. Moreover, it left the door open for further hikes over the coming months, should inflationary tension continue. For the euro area as a whole, inflation is not as high as in Spain, this being 2.7% in March, but it is at a level that's clearly higher than the limit set by the ECB. In accordance with the action taken by Europe's top monetary authority, inflation expectations on the European continent and in Spain should remain under control and therefore also any second-round effects.

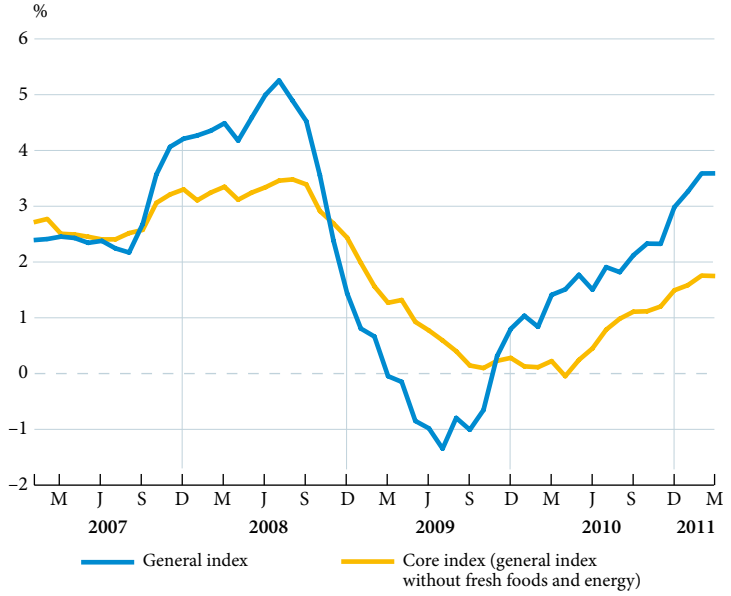
The ECB's action, however, might undermine the already weak recovery in domestic demand. In fact, core inflation, which excludes energy and fresh foods, fell by one tenth of a percentage point to 1.7% year-on-year in the month of March and has remained at a low level for months now. Given this scenario, it's likely to remain quite stable in the short term.

Production costs continue to rise.

The upswing in inflationary pressures is making it difficult for the Spanish economy to become more competitive. A good example of this is the producer price index, which reflects the growth in prices of industrial goods charged by manufacturers. Figures show that these prices continued their upward trend and rose significantly in February, eight tenths of a percentage point to 7.6% year-on-year,

THE GAP WIDENS BETWEEN GENERAL AND CORE INFLATION

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

INFLATION INDICATORS

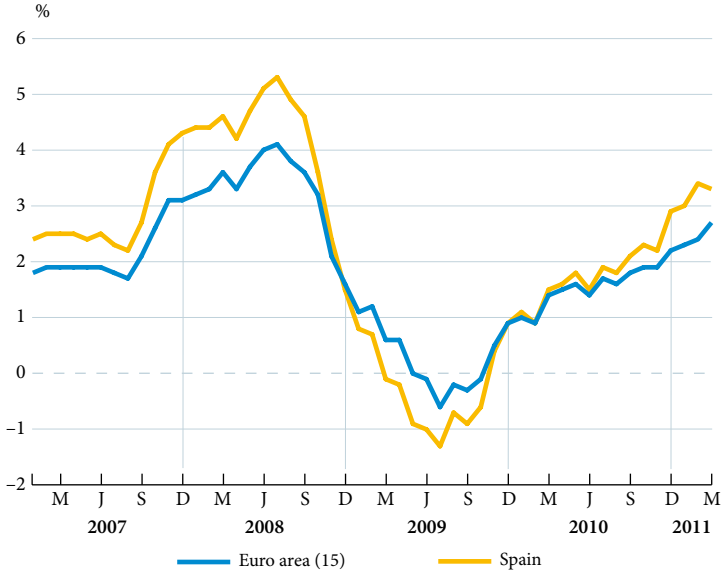
Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflactor (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods (**)	
2010											
January	–5.5	0.9	–0.5	–0.3	–0.9	6.3	3.4	–0.9	0.2	0.2	–
February	1.0	1.1	–0.6	0.0	–0.4	6.8	4.8	–0.5	0.3	1.5	0.6
March	5.6	2.3	–0.1	0.0	0.4	10.1	7.4	1.2	0.5	4.3	–
April	2.8	3.7	0.1	–0.1	2.4	13.1	8.5	2.1	0.7	6.7	–
May	13.7	3.8	0.2	–0.1	3.5	12.0	10.2	4.2	1.6	9.9	0.5
June	8.6	3.2	0.3	0.1	3.7	8.7	10.1	5.3	2.0	10.9	–
July	4.5	3.3	0.2	0.2	3.2	9.8	9.3	4.9	2.0	10.5	–
August	5.1	2.7	0.0	0.5	3.4	7.0	8.7	6.0	1.8	10.2	1.3
September	8.0	3.4	0.2	0.5	4.0	9.1	9.2	6.9	1.8	10.7	–
October	10.3	4.1	0.6	0.5	4.3	10.5	8.6	6.4	1.7	10.5	–
November	10.3	4.4	0.9	0.6	5.1	10.7	9.2	7.7	2.2	11.0	1.4
December	8.5	5.3	1.3	0.7	5.7	13.5	10.3	8.1	2.4	11.8	–
2011											
January	...	6.8	1.5	1.0	6.8	17.3	11.9	7.6	2.0	12.4	–
February	...	7.6	1.9	1.0	7.9	18.3	11.1	6.3	1.4	13.1	–

NOTES: (*) Seasonal and calendar effects adjusted data.
(**) Except energy.
SOURCES: National Institute of Statistics, Ministry of the Treasury and own calculations.

THE INCREASE IN THE INFLATION DIFFERENTIAL WITH THE EURO AREA SLOWS UP

Harmonized year-on-year change in CPI



SOURCES: National Institute of Statistics, Eurostat and own calculations.

The price differential with the euro area falls in March.

boosted especially by energy goods. However, on average, the euro area's rise in producer prices during the last few months was more gradual. In the month of February, in particular, the annual rate of year-on-year growth was one point lower in the euro area than in Spain.

Another alternative measurement of competitiveness is provided by the consumer price differential with the euro area. After several months recording an upward trend, this fell slightly in February and thereby gave some relief to the recent loss of competitiveness. According to Eurostat data, the year-on-year change in the harmonized price index for the euro area stood at 2.7%, while the figure recorded in Spain was 3.3%.

Foreign sector

Opposing trends for the trade deficit's components

The trade imbalance reached its peak in June 2008 with a deficit of 104,238 million euros accumulated over the previous twelve months. Two years later, improvements in both the energy and non-energy component had helped to partly correct this imbalance. The trade deficit stood below 5% of gross domestic product (GDP), remaining almost at a standstill from then on. This absence of change is due to the opposing trends presented by both components of the deficit. Persistent rises in the price of crude have hit the energy balance hard, whereas the correction of the non-energy deficit, boosted by the increase in trade with euro area countries, the destination of more than half Spain's exports, has neutralized this energy imbalance. Which of these two effects will win out in the medium term?

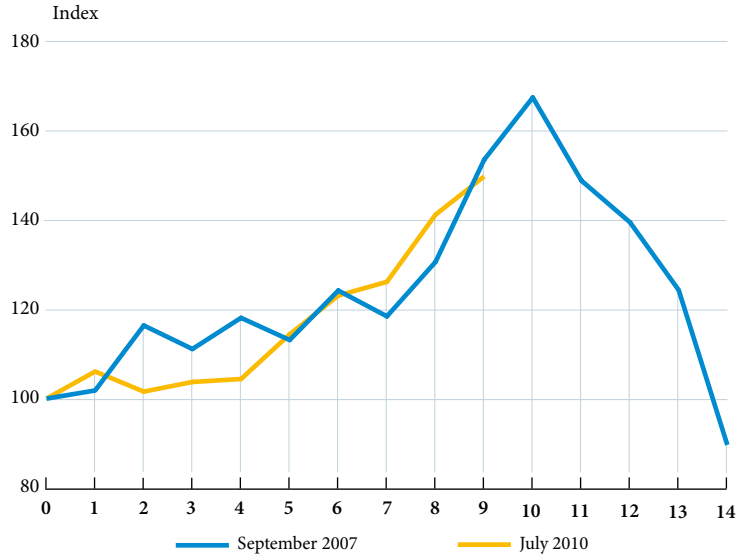
The trade deficit remains at a similar level to June 2010.

In February 2011, the non-energy balance posted a surplus of 125.9 million euros, unheard of since 1986. This improvement is due to the higher year-on-year rise in exports, namely 19.7%, compared with the 12.6% recorded by imports. As a result, the non-energy deficit accumulated since March 2010 fell to 15,033 million euros, 77% below the maximum reached three years ago.

The non-energy component posts a surplus after 25 years.

THE RECENT RISE IN OIL PRICES RESEMBLES THAT OF 2008

Price of oil at base 100 = Month prior to growth in oil prices



SOURCES: Thomson Reuters Datastream and own calculations.

FOREIGN TRADE

January-February 2011

	Imports			Exports			Balance	Export/ Import rate (%)
	Million euros	% annual change by value	% share	Million euros	% annual change by value	% share	Million euros	
By product group								
Energy products	9,174	45.8	22.2	1,820	107.3	5.5	–7,354	19.8
Consumer goods	9,088	5.1	22.0	11,311	14.5	34.2	2,224	124.5
Food	*2,288*	*12.7*	*5.5*	*4,302*	*15.0*	*13.0*	*2,014*	*188.0*
Non-foods	*6,800*	*2.8*	*16.5*	*7,009*	*14.2*	*21.2*	*209*	*103.1*
Capital goods	2,628	5.1	6.4	2,800	33.4	8.5	172	106.5
Non-energy intermediate goods	20,379	21.9	49.4	17,161	29.7	51.9	–3,219	84.2
By geographical area								
European Union	21,584	13.1	52.3	22,296	22.5	67.4	712	103.3
Euro area	*17,536*	*14.3*	*42.5*	*18,220*	*21.1*	*55.1*	*684*	*103.9*
Other countries	19,685	30.7	47.7	10,796	37.2	32.6	–8,889	54.8
Russia	*1,571*	*78.5*	*3.8*	*350*	*72.4*	*1.1*	*–1,221*	*22.3*
United States	*1,736*	*34.6*	*4.2*	*1,279*	*59.5*	*3.9*	*–457*	*73.7*
Japan	*572*	*2.0*	*1.4*	*270*	*24.3*	*0.8*	*–302*	*47.2*
Latin America	*2,145*	*31.8*	*5.2*	*1,881*	*52.7*	*5.7*	*–264*	*87.7*
OPEC	*4,649*	*41.1*	*11.3*	*1,130*	*38.4*	*3.4*	*–3,519*	*24.3*
Rest	*9,013*	*21.6*	*21.8*	*5,887*	*27.9*	*17.8*	*–3,126*	*65.3*
TOTAL	**41,269**	**20.8**	**100.0**	**33,092**	**26.9**	**100.0**	**–8,177**	**80.2**

SOURCES: Ministry of the Economy and own calculations.

High oil prices will continue to harm the deficit in the short term.

At the same time, the energy trade balance accumulated over the twelve months prior to February recorded a deficit of 37,315 million euros, coming close to the maximum of 2008. This increase in the energy imbalance is due to two factors: Spain's high dependency on energy, much higher than the European average, and the progressive rise in oil prices. Regarding this rise, in April the price of a barrel of Brent quality crude exceeded 87 euros (120 dollars). As can be seen in the graph above, this represents a 49.8% increase since August 2010. This trend resembles the one recorded in 2008. However, unlike in 2008, our forecasts point towards a slower fall in the price of crude, so that a much more gradual correction in the energy deficit is expected than the one two years ago.

With regard to the future, we therefore expect a further deterioration in the trade deficit over the next few months, still affected by the trend in the energy component. However, the gradual easing of pressure on the price of crude and the correction in the non-energy balance remaining on track could start to reduce the trade imbalance in the medium term.

Tourism, the only good news for the current balance

The deterioration in the income balance increases the current deficit.

The imbalance accumulated over the last twelve months for the balance of payments increased slightly in January, up to 49,194 million euros. The main reason behind this deterioration was the higher deficit in the income balance,

as well as in the goods balance. In the first case, this higher deficit put an end to more than twenty consecutive months of shrinkage, which might represent a change in trend in the income balance, caused by higher debt interest payments. However, we will have to wait until more data are published in order to verify this hypothesis.

What is certain is the positive trend enjoyed by the services balance, this rising to 28,257 million euros in January. The good news regarding the number of tourists visiting Spain during the first quarter of the year leads us to expect further rises in the surplus of the services balance. Nevertheless, our forecasts place the current account balance at 4.3% in 2011. This represents a deficit correction of two tenths, much lower than the one recorded over the last two years.

The recovery in tourism suggests further increases in the services surplus.

With regard to financial flows, foreign portfolio investment in Spain totalled 15,714 million euros in January. This was the only source of net foreign capital inflows to meet the Spanish economy's financing needs. For its part, the relaxation of the risk premium that month meant that Spain's financial institutions decreased their reliance on European Central Bank lending.

Portfolio investment is the main source of financing in January.

BALANCE OF PAYMENTS

January 2011

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	–4,516	9.9	–47,505	–5,354	12.7
Services					
Tourism	*1,688*	*7.9*	*27,082*	*1,110*	*4.3*
Other services	*–123*	*–60.4*	*1,175*	*1,893*	–
Total	1,564	24.9	28,257	3,003	11.9
Income	–2,531	121.2	–23,081	4,677	–16.8
Transfers	–1,093	–14.1	–6,864	1,934	–22.0
Total	**–6,576**	**24.7**	**–49,194**	**4,259**	**–8.0**
Capital account	**186**	**–85.6**	**5,360**	**218**	**4.2**
Financial balance					
Direct investment	–2,820	471.4	–3,219	–6,804	–
Portfolio investment	15,714	14.3	32,380	–17,453	–35.0
Other investment	–4,612	–22.4	–467	10,441	–95.7
Total	**8,282**	**13.3**	**28,694**	**–13,815**	**–32.5**
Errors and omissions	672	–	–1,311	3,172	–70.8
Change in assets of Bank of Spain	–2,565	–22.7	16,451	6,422	64.0

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

Public sector

Fiscal consolidation not without its risks

The IMF considers the sustainability of public debt as a priority for advanced economies...

Advanced economies must ensure the sustainability of their public debt. This is the message given by the latest report from the International Monetary Fund (IMF). According to this organization, public debt in developed countries will exceed, on average, 100% of their gross domestic product (GDP) over the next few years, far from the 60% recorded before the last crisis broke out. That's why the IMF believes a renewed effort is required to enable fiscal consolidation in the long term. An aim that coincides with the agreement reached last March by the seventeen leaders of the euro area countries in the Euro Plus Pact. The measures adopted by the Spanish government suggest that its public accounts will gradually improve over the next few years. However, recent tensions in European sovereign debt markets and their effect on the Spanish risk premium show that this improvement in fiscal consolidation is still fragile and not without its risks.

...for Spain it forecasts a reduction in public debt of around 3 percentage points.

The IMF forecasts that Spain's fiscal deficit will increase its rate of correction in 2011, reaching 6.2% of GDP. This represents an improvement in the fiscal balance of three percentage points compared with that of a year ago, the biggest fall recorded among the main developed economies. This forecast is in line with that of the Bank of Spain and is only two tenths of a percentage point more pessimistic than the government's. It therefore seems that there's unanimous consensus regarding the good results being achieved by the fiscal adjustment measures.

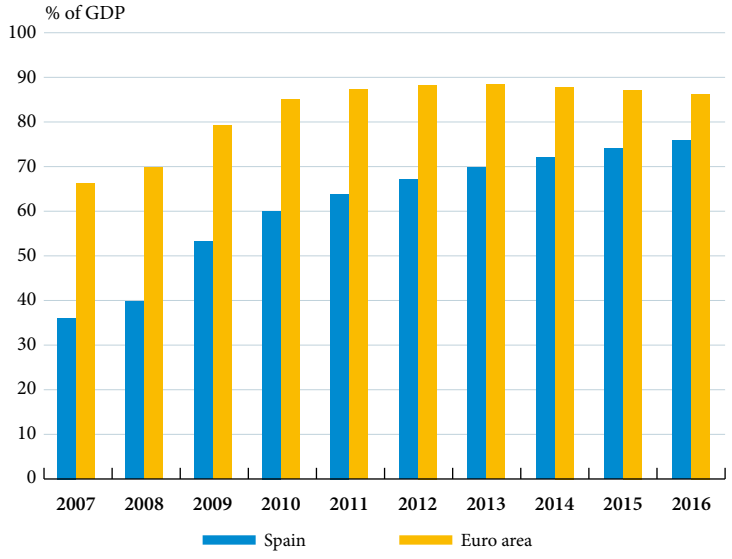
Lower government spending helps to correct the fiscal balance.

The figures for the central government's cash deficit accumulated over the first two months of the year confirm this perception, falling by 28.1% compared with the same period in 2010. This fall has occurred at a time when the regime financing system for the autonomous communities has changed, starting as from 2011. With this new system, central government cash flows (revenue and expenditure) are smaller. A clear example is that of central government revenue, which fell by 16.7% year-on-year. A large part of this fall can be explained by the higher percentage of advance payments received by autonomous governments from the taxes managed by the central government. This means that these data cannot be compared directly with those from the previous year. However, the bulk of the evidence suggests that a reduction in public spending was the main reason for the deficit correction in the first two months of 2011.

Although this correction does not allow us to come to any definitive conclusions regarding how the deficit will perform throughout the year, it is in line with the fiscal consolidation forecasts provided by the main organizations. Moreover, the new structural reforms adopted by the Spanish government in the areas of finance, employment and pensions are expected to maintain the adjustment in the fiscal imbalance over the next few years. As a consequence, according to the IMF, Spain's public debt will stabilize at

STABILIZATION OF SPAIN'S PUBLIC DEBT BELOW THE AVERAGE FOR THE EURO AREA

Gross public debt



SOURCE: International Monetary Fund.

around 75% of GDP in 2016, more than ten percentage points below the average for the euro area.

This favourable outlook reduced pressure on the risk premium for Spanish public debt (measured as the spread between the interest rate for Spanish bonds and German bonds at 10 years). By mid-April, this reached 175 basis points, a level not seen since October 2010. However, the spread then widened again up to 230 basis points. This increase is mainly due to rumours regarding the restructuring of Greek sovereign debt and the outcome of the Finnish elections. The rise of a Eurosceptic political party in this country is threatening the bail-out for the Portuguese public sector and has increased uncertainty regarding Spanish sovereign debt. It also complicated the new issues of bonds.

In addition to the tensions appearing at a European level, there are also other factors of a national nature that are taking the edge off investors' confidence regarding the consolidation of the public accounts. There are three main risks. Firstly, the economy's weak recovery in 2011, which might lead to further deterioration in the labour market. Secondly, an increase in the capitalization requirements for the Spanish financial system. And lastly, a greater deterioration in the accounts of the autonomous communities would stop the fiscal adjustment targets from being reached.

Undoubtedly, whether these risks materialize over the coming months will be key to determining the sustainability of Spain's public debt. Our main scenario predicts that tensions will ease in the European sovereign debt markets. In Spain, doubts regarding the solvency of its public sector will also fade gradually. The gradual recovery of the economy, stress tests on the banking system and autonomous elections in May will correct the recent overreaction by the risk premium. In short, we believe that the fiscal consolidation recommended by the IMF will be met in Spain's case.

Doubts regarding public debt solvency will gradually fade.

After the crisis: should taxes be raised or lowered?

The coordinated measures of economic stimuli to alleviate the Great Recession of 2008-2009 stopped it from becoming a depression. However, as a consequence, the public deficit of the developed countries that comprise the Organization for Economic Cooperation and Development (OECD) stood at 8% of gross domestic product (GDP) in 2010. The level of public debt will also exceed 100% of GDP in 2011. These levels are not sustainable and put pressure on long-term interest rates, jeopardizing balanced economic growth.

Hence the need to withdraw fiscal stimuli and for budget consolidation plans. Even the government of one of the advanced countries that's performing the best, namely Germany, has postponed the reduction in taxes that formed part of the governing coalition's election manifesto for the sake of responsible fiscal policy, in accordance with the new mandate entered into the German constitution.

However, budget adjustment measures can affect expenditure or revenue (see the Box «Pursuing sustainable and balanced growth: the role of fiscal reforms» on page 23). In general, there's empirical evidence that spending cuts are less harmful to economic growth in the long term than tax hikes,[1] especially if we take into account the level reached after the upward trend throughout the last century. In fact, the stimulus plans of developed countries during the Great Recession focused on boosting public spending. However, this Box will concentrate on discussing taxation alternatives.

Which countries could raise taxes? In principle, the candidates appear to be those with huge public deficits, particularly if they are being targeted by the financial markets, and whose relative level allows them to do so. This would complement government spending cuts in order to sufficiently reduce the public deficit. However, a number of considerations must be taken into account. Firstly, the fiscal system per se is more than the sum of a series of taxes as there are interactions to be considered. Moreover, when raising a tax rate, we must take its level into account since a hike might encourage fraud and could even lead not to higher revenue but lower. Similarly, the issues of equity and efficiency must also be borne in mind.

Any tax on capital earnings has to deal with the high mobility of capital, boosted by globalization, and securing significant increases in revenue from this area is not considered to be very feasible, given its great sensitivity to tax rates. However, significant progress has been made recently in tackling this problem, controlling the so-called «tax havens» even further and with the implementation of bilateral or multilateral agreements between countries to exchange tax information.

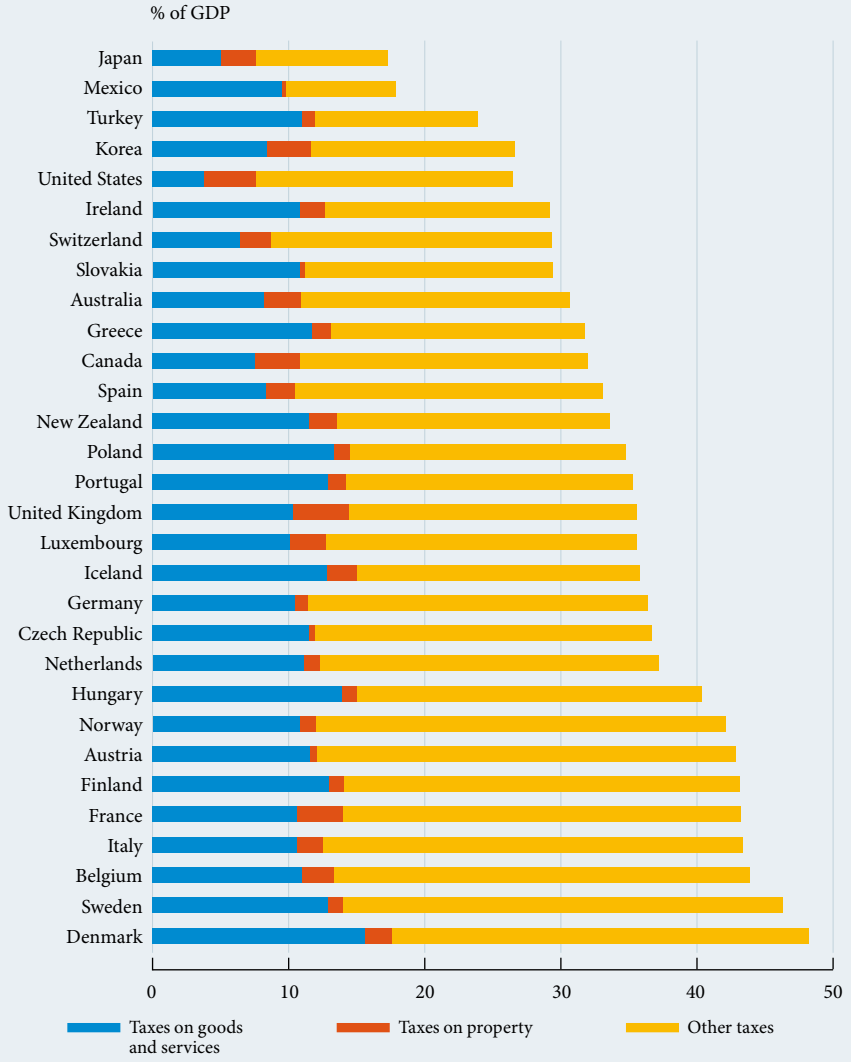
Raising revenue by taxing companies is also hindered by the mobility of firms within a globalized environment. Moreover, in order to attract investment, quite a few countries have embarked upon a dynamic of fiscal competition that makes it more complicated to raise tax rates. Nonetheless, supranational organizations prefer to increase revenue not so much by raising tax rates but reducing deductions or tax credits, as some may not be justified in terms of efficiency or may cause distortions. Of course, this does not mean they must be eliminated entirely. For example, tax deductions for R&D might be an attempt to internalize positive externalities; in other words, situations in which social gains exceed the private.

(1) See IMF, World Economic Outlook, October 2010.

The employment factor is not considered to be so movable. Nonetheless, too high an increase in personal income tax could harm investment in human capital and consequently economic growth. To raise taxes via this area, experts from the International Monetary Fund particularly recommend revising the expenditures for this tax, which might not always be appropriate. For instance, it's estimated that the main effect of the current mortgage deduction in the United States was that larger houses were bought.

BREAKDOWN OF TAXES

Year 2008 (*)



NOTE: (*) 2007 for Australia, Belgium, Mexico, Netherlands and Poland.
SOURCE: OECD (2010), *Tax Revenue Database*.

Social Security contributions also affect employment. It has been argued that a reduction in company contributions to Social Security could increase the demand for employment as it lowers labour costs. This would be more or less feasible depending on each country's contribution level although its effect on Social Security financing would still have to be considered.

Given this situation, taxes on consumption appear to be the least harmful to economic growth in the medium and long term, according to some economic studies.[2] Among these, the most important tax is value added tax, which could represent quite a significant source of higher revenue, within certain limits, especially for those countries below the average. However, we must not forget that, in the short term, tax hikes would push up consumer price inflation and might increase company costs if passed on to wages.

Experts from the International Monetary Fund[3] therefore recommend withdrawing some preferential treatments, if these are not sufficiently justified. This, together with more efficient tax administration and greater fulfilment, would help to notably boost public revenue.

On the other hand, in some cases special taxes might be raised. For example, energy efficiency could be encouraged and the environment protected (see the Box «Pursuing sustainable and balanced growth: the role of fiscal reforms» on page 23), although the impact on competitiveness would also have to be considered. It has also been proposed that a hike in taxation on alcohol or tobacco, as well as increasing revenue, would meet public health targets.

In any case, as far as the taxable base is concerned, the least mobile area is real estate and some studies[4] claim that taxes on this are less harmful to economic growth than special taxes. However, taxes on real estate are usually decided at a level lower than the state and, moreover, are generally especially unpopular.[5]

In economics, as in medicine, there are no remedies without a side effect. That's why, depending on each country and the economic stage it's at, a certain «cocktail» of measures might be recommendable, after a cost-benefit analysis. This is ultimately a political decision given that, in short, fiscal structure depends on each society's choice of how to finance the level of public spending it believes to be suitable.

(2) See Myles, G. D., 2009, «Economic Growth and the Role of Taxation – Theory», OECD Economics Department Working Papers 713. OECD Publishing. Doi: 10.1787/222800633678.
(3) See IMF, Fiscal Monitor, November 2010.
(4) See OECD, Tax Policy Reform and Economic Growth, 2010. OECD Publishing. http://dx.doi.org/10.1787/9789264091085-en.
(5) See European Economy. Occasional Papers 45. March 2009. «The quality of public finances and economic growth: Proceedings to the annual Workshop on public finances». Brussels, 28 November 2008.

This box was prepared by Pere Miret
European Unit, Research Department, "la Caixa"

Savings and financing

2011: the year of private sector deleveraging

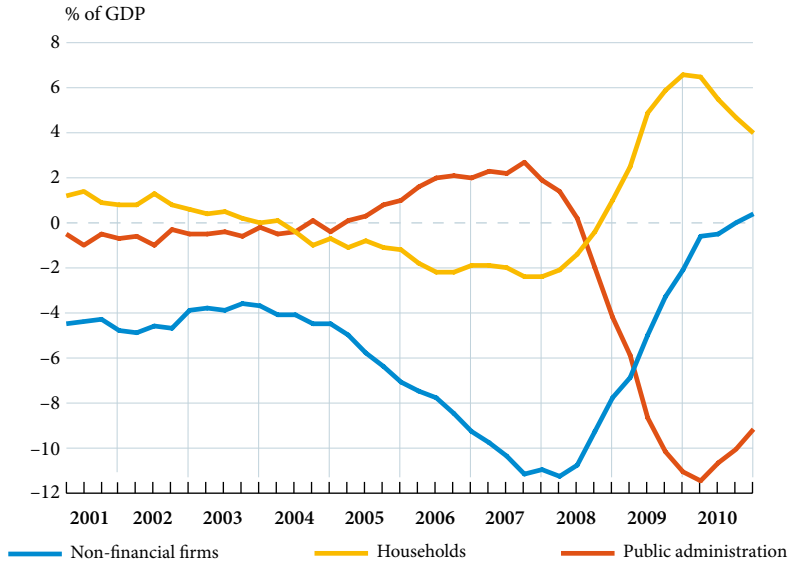
Spain's non-financial private sector was a net lender in 2010 with net lending totalling 4.4% of the gross domestic product (GDP). Nevertheless, the debt it had accumulated by the end of this period was almost the same as it had been in 2009. Will 2011 finally be the year of private sector deleveraging in Spain? Some indicators point towards this scenario. However, numerous factors could affect future trends for debt in this sector. Undoubtedly, the pace of economic recovery and the trend in interest rates will play an important role; all within a context of consolidation of the Spanish financial system and intense tension in sovereign debt markets.

In fact, as can be seen in the graph below, both non-financial firms and households were net lenders in 2010. The net lending of households, at 4.0% of GDP, was much higher than the 0.4% of firms. But both series had very different trends. The net lending of households fell by more than one percentage point compared with that of a year ago. The fiscal changes introduced, encouraging people to buy consumer durables and housing in advance, would explain part of this phenomenon. This contrasts with the improvement in the accounts of non-financial companies in 2010, which recorded positive net lending for the first time in the 21st century. However, this was not enough to meet the total capital required by the government, namely 9.2% of GDP.

Net lending in the non-financial private sector totals 4.4% of GDP in 2010.

HOUSEHOLDS AND FIRMS WERE NET LENDERS IN 2010

Net borrowing (–) and net lending (+) by sector



SOURCE: National Institute of Statistics.

FINANCING OF NON-FINANCIAL SECTORS (1)

February 2011

	Balance	Change this year	Change over 12 months	% share
	Million euros	Million euros	% (2)	
Private sector	2,197,487	–14,703	0.4	76.7
Non-financial corporations	1,306,946	–6,437	1.1	45.6
Resident credit institution loans (3)	*885,653*	*–11,820*	*–1.4*	*30.9*
Securities other than shares	*66,420*	*1,869*	*14.9*	*2.3*
External loans	*354,872*	*3,514*	*5.3*	*12.4*
Households (4)	890,541	–8,266	–0.5	31.1
Housing loans (3)	*672,959*	*–6,908*	*–0.4*	*23.5*
Other (3)	*213,962*	*–1,386*	*–0.8*	*7.5*
External loans	*3,620*	*28*	*4.2*	*0.1*
General government (5)	667,415	28,649	13.7	23.3
TOTAL	**2,864,933**	**13,977**	**4.2**	**100.0**

NOTES: (1) Resident in Spain.
(2) Year-on-year rates of change calculated as effective flow/stock at beginning of period.
(3) Include bank off-balance-sheet securitized loans.
(4) Include those non-profit institutions serving households.
(5) Total liabilities (consolidated). Liabilities among public administrations are deducted.
SOURCES: Bank of Spain and own calculations.

Debt in the private sector is expected to fall in 2011.

The data available for the first two months of this year show a clear drop in non-financial private sector financing, particularly in bank loans. In February, the debt in the hands of the private sector fell by 14,703 million euros compared with December 2010, a drop of 0.7%. For non-financial firms, this shrinkage was 0.5% over the same period, particularly due to companies in the real estate and construction sectors. For its part, household debt fell by 0.9%. This private sector deleveraging is expected to continue in 2011.

This forecast is reinforced by the rise, in April, of the ECB's reference rate to 1.25%, putting an end to two years of standstill at a historically low level of 1.0%. The persistence of inflationary pressures will probably mean the ECB will continue to raise the official interest rate, although it is unlikely to be above 2% by the end of the year. Within this context, the interest rate for new credit transactions rose again in February, standing at 44 basis points above the year-end figure for 2010. Similarly, the interbank market rate (Euribor), the reference rate for the vast majority of mortgages in Spain, continued to rise in April, to 2.1%.

Interest rates and the weak economic recovery reduce credit demand.

As a consequence, credit demand is likely to remain low for the remainder of the year. This effect might be amplified by the weak recovery of the Spanish economy, which will hinder any improvement in the labour market during 2011 and keep up the pressure on the doubtful debt rate, which in February stood at 6.19%, a level not seen since 1995.

This process of private sector deleveraging will take place within a context of reforms of Spain's financial system. The increase in the minimum core capital requirements introduced by the Financial Sector Reinforcement Plan

(up to 8% or 10% according to the institution's legal status) is encouraging the sector to reorganize. April saw announcements of the recapitalization strategies of the thirteen financial institutions that do not meet the capital requirements. These strategies essentially included three kinds of measures: placing capital with third parties, special stock market operations (such as selling shares or portfolios) and support from the Fund for Orderly Bank Restructuring (FROB). In the case of savings banks, this last option involves transferring their financial business to private banks.

This reform is expected to consolidate the solvency of the Spanish financial sector, a goal that should help the banking sector pass the stress tests to be carried out in June. These will be more demanding that the ones carried out a year ago, both due to the definition of the capital affected and the severity of the scenarios. A good result would dispel doubts regarding Spain's financial sector and help to open up wholesale financing markets to its banks. In fact, the latter already started in the first quarter of 2011, helping to reduce the sector's dependency on the ECB's lending.

New measures to put an end to the deposit war

The savings rate of Spanish households fell to 13.1% of gross disposable income in 2010, four percentage points below the level reached one year ago. Part of this fall can be put down to a reduction in savings due to families being cautious. Some fiscal reforms also encouraged households to bring forward their purchases. Among these are the hike in value added tax, the Plan 2000E and the withdrawal of the tax deduction for housing. Nevertheless, the savings rate for 2010 remained at eight tenths of a percentage point above the average for the last few years. Household savings may fall again in 2011. This will be a result of the loss in household purchasing power given the price rises and interest rate hikes, which will increase the burden of their debts.

The data for bank debt in the hands of families and firms are in line with this assumption, falling 1.7% year-on-year during the first two months of 2011. This shrinkage took place within a context of a reduction in interest rates, which fell for the third consecutive month. This might be a result of wholesale financing channels opening up again to Spanish

Bank reforms consolidate the system's solvency before the stress tests.

The household savings rate falls to 13.1%.

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

February 2011

	Balance	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	259,459	–2,307	–0.9	–462	–0.2	18.3
Savings deposits	207,439	–3,848	–1.8	768	0.4	14.7
Term deposits	740,425	–3,142	–0.4	33,462	4.7	52.3
Deposits in foreign currency	19,590	208	1.1	–2,889	–12.9	1.4
Total deposits	**1,226,914**	**–9,089**	**–0.7**	**30,879**	**2.6**	**86.7**
Other liabilities (*)	**187,671**	**–15,340**	**–7.6**	**–12,697**	**–6.3**	**13.3**
TOTAL	**1,414,585**	**–24,429**	**–1.7**	**18,182**	**1.3**	**100.0**

NOTE: (*) Aggregate balance according to supervision statements. Includes asset transfers, hybrid financial liabilities, repos and subordinated deposits.
SOURCES: Bank of Spain and own calculations.

The government's proposal to limit the interest rate on deposits might reduce competition between institutions to attract financing.

banks, reducing the need to attract funds from customers and consequently the competition between institutions.

Such competition might be reactivated over the coming months. The large volume of fixed term deposits taken out by individuals a year ago, which will mature in the next few months, and the new disturbances in the sovereign debt markets could push up interest rates. However, this process might be slowed up by the government's new proposal, which is studying the possibility of limiting the interest rate on sight deposits and accounts with credit institutions. According to this proposal, the yield on deposits with a term equal to or less than three months will not be able to exceed 150 basis points above the average 3-month Euribor. For those deposits with a longer term, only the reference index changes, which will be the 6-month Euribor. Should these thresholds be exceeded, institutions would have to increase their contributions to the corresponding Deposit Guarantee Funds.

This scenario could quicken the upswing in subscriptions to mutual funds that is being recorded in 2011. In fact, March's figures show an increase in net subscriptions of 712 million euros, a figure that has not been reached since March 2006.

"la Caixa" Research Department

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As of December 31, 2010

FINANCIAL ACTIVITY	Million euros
Total customer funds	247,897
Receivable from customers	189,546
Profit attributable to Group	1,307

STAFF, BRANCHES AND MEANS OF PAYMENT	
Staff	28,651
Branches	5,409
Self-service terminals	8,181
Cards (million)	10.3

COMMUNITY PROJECTS: BUDGET FOR ACTIVITIES IN 2011	Million euros
Social	335
Science and environmental	68
Cultural	64
Educational and research	33
TOTAL BUDGET	**500**

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