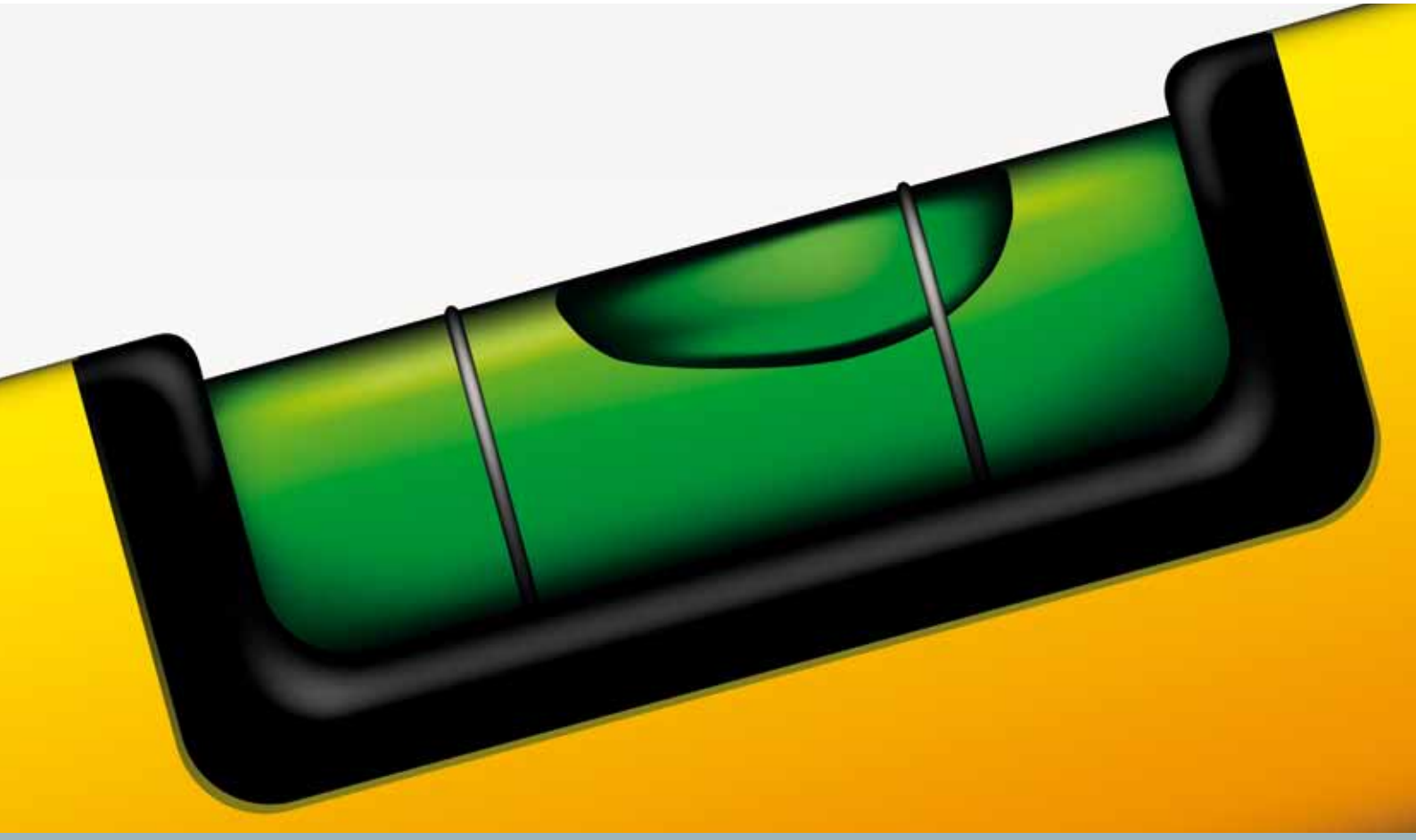
NUMBER 347 • JUNE 2011

THE SPANISH ECONOMY

Monthly Report



BALANCE OF PAYMENTS IMBALANCES

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	2.6	2.4	3.0	3.2	2.8	2.3	2.6
Japan	–6.3	4.0	–0.9	5.5	3.3	4.8	2.4	–0.7	–1.7
United Kingdom	–4.9	1.3	1.6	–0.4	1.5	2.5	1.5	1.8	1.4
Euro area	–4.1	1.7	1.9	0.8	2.0	2.0	2.0	2.5	1.7
Germany	*–4.7*	*3.5*	*3.3*	*2.3*	*3.9*	*3.9*	*3.8*	*4.8*	*3.2*
France	*–2.6*	*1.4*	*2.2*	*1.0*	*1.5*	*1.7*	*1.4*	*2.2*	*2.2*
Consumer prices									
United States	–0.3	1.6	3.2	2.4	1.8	1.2	1.2	2.2	3.5
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	4.3	3.3	3.4	3.1	3.4	4.1	4.4
Euro area	0.3	1.6	2.6	1.1	1.5	1.7	2.0	2.5	2.8
Germany	*0.4*	*1.1*	*2.4*	*0.7*	*1.0*	*1.2*	*1.5*	*2.1*	*2.4*
France	*0.1*	*1.5*	*2.2*	*1.3*	*1.6*	*1.5*	*1.6*	*1.8*	*2.2*
SPANISH ECONOMY			Forecast						Forecast
Macroeconomic figures									
Household consumption	–4.3	1.3	0.4	–0.3	2.1	1.5	1.6	0.7	–0.6
Government consumption	3.2	–0.7	–0.2	–1.1	–0.1	–0.7	–0.9	1.1	–0.6
Gross fixed capital formation	–16.0	–7.5	–4.4	–10.5	–6.7	–6.7	–6.1	–5.8	–6.0
Capital goods	*–24.8*	*1.9*	*1.5*	*–4.6*	*8.7*	*2.4*	*1.2*	*0.3*	*–2.7*
Construction	*–11.9*	*–11.1*	*–8.3*	*–11.4*	*–11.3*	*–11.2*	*–10.6*	*–10.2*	*–9.5*
Domestic demand (contribution to GDP growth)	–6.4	–1.2	–0.8	–3.1	–0.3	–0.7	–0.6	–0.6	–1.9
Exports of goods and services	–11.6	10.3	13.1	9.4	11.9	9.4	10.5	11.2	13.3
Imports of goods and services	–17.8	5.5	7.4	2.0	9.6	5.0	5.3	5.2	3.8
Gross domestic product	**–3.7**	**–0.1**	**0.5**	**–1.4**	**0.0**	**0.2**	**0.6**	**0.8**	**0.5**
Other variables									
Employment	–6.6	–2.3	–0.7	–3.9	–2.4	–1.6	–1.4	–1.4	–0.8
Unemployment (% labour force)	18.0	20.1	20.8	20.0	20.1	19.8	20.3	21.3	20.8
Consumer price index	–0.3	1.8	3.2	1.1	1.6	1.9	2.5	3.5	3.7
Unit labour costs	1.0	–1.5	–0.5	–0.9	–0.9	–1.9	–2.3	–1.2	
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	3.5	3.7	3.5	2.8	2.8	3.4	3.4
10-year German bonds	3.3	2.8	3.5	3.2	2.8	2.4	2.6	3.2	3.3
Exchange rate									
$/Euro	1.39	1.33	1.41	1.38	1.27	1.29	1.36	1.37	1.44

Contents

Balance of payments imbalances

In the last twenty years there have been sharp increases in current account imbalances at a global level. A country's external balance of payments, in accounting terms, is balanced; but if we break this down into its two most important components, the current account and the financial account, persistent deficits or surpluses in each of these can be seen in many countries. What's the problem? Persistent current account deficits mean an accumulation of external debt and can signal competitiveness problems. On the other hand, continued surpluses can lead to an excessive accumulation of reserves and point to an undervalued exchange rate.

The paradigmatic case is the United States and China. The former is suffering from a chronic current account deficit that peaked at over 800 billion dollars in 2006. A significant proportion of this deficit is the result of buying goods from China, a country posting high surpluses since the mid-1990s. These surpluses mean accumulating financial assets in the form of foreign reserves, largely made up of US debt. Thus the circle is completed: excessive spending on consumption by US households is financed by the Chinese government buying up US public debt.

Academics and politicians have debated the origins and consequences of global imbalances at great length. Two opposing positions emerge from this debate. In simplistic terms, some believe that these imbalances constitute an anomalous, unsustainable phenomenon that is jeopardizing the stability of capital flows and is a serious risk to the foreign exchange market. Others, on the other hand, estimate that imbalances are a result of structural factors or policies adopted by the economic authorities of other countries and, providing these determining factors don't vary, imbalances can continue for a long time.

What role or influence have these imbalances had on the global crisis that erupted in 2008? In general, they are not ranked among its main causes. However, the collapse of international liquidity had a direct effect on countries with high deficits and with a more negative external position (the United States being the exception to this rule, thanks to the privileged position of the dollar in the international monetary system). This destabilizing power of global imbalances has led the G-20 to target the reduction of current account imbalances to «sustainable levels», within a framework of actions aimed at achieving high, balanced growth in the world economy.

Imbalances have also warranted special attention at the level of the European Union. Increasing commercial and financial integration, helped by the creation of the euro, has been accompanied by growing external imbalances which have become a problem difficult to resolve once the crisis erupted and given the impossibility of devaluation within monetary union. Nonetheless, the crisis itself has led to a sharp fall in external deficits, both due to plummeting activity as well as the bursting of some asset bubbles. There is still the need, however, to redress deficiencies in external competitiveness in deficit countries, requiring significant changes in terms of relative prices, a better allocation of resources among production sectors and the elimination of rigid regulations in the labour and product markets. Otherwise, the growth potential of these countries will be seriously compromised and the exit to the crisis will be slower than is desirable.

EXECUTIVE SUMMARY

The world recovery continues to consolidate

Rising oil prices, Japan's earthquake and the heating up of emerging economies slow up the global recovery.

The global economy continues to advance apace, although the latest indicators suggest a scenario of slight moderation for the second quarter. The main causes are rising oil prices, Japan's earthquake and the tightening of monetary policies in emerging countries, which have yet to dispel the spectre of overheating. Signs of imminent moderation have already been seen in the commodities markets, where part of the rally started in mid-2010 has now been corrected. Of note in the financial markets are the new turbulences affecting the sovereign debt of the periphery of the euro area, set off by the uncertainty surrounding Greece's situation.

The United States grows less than expected but continues to generate employment.

In the United States, first quarter growth disappointed the consensus with gross domestic product (GDP) rising just 2.3% year-on-year, compared with 2.8% for the fourth quarter of 2010. This result leaves growth forecasts for the whole of 2011 clearly below 3%. Such a loss of vitality can be explained by the drop in two relatively volatile components, namely government defence spending and investment in construction. However, private consumption looked healthy, growing by an appreciable 0.7%, albeit within a general slowing up which has been corroborated by April's figures for retail sales. On the other hand, the good performance shown by corporate earnings and the relatively lower debt of non-financial firms helped capital goods investment to remain strong, accelerating in the first quarter and achieving growth of 3.9% quarter-on-quarter. With regard to the labour market, job creation is still slow compared with the previous recovery but is maintaining a reasonable rate.

In the area of prices, inflation continues to rise with April's general consumer price index (CPI) up by 3.2% year-on-year, when in January this was 1.6%. However, more than half this upswing can be put down to rising oil prices which, for the moment, are not being passed on to other sectors of economic activity. In this respect, the core CPI, which excludes energy and food prices, rose by a more moderate 1.3%, kept down by the low utilization of production capacity. For this reason we do not expect any immediate changes in the Fed's monetary policy and don't see interest rates being raised until early in 2012.

Japan enters into recession due to the earthquake and the downward turn suffered by the economy for several months.

Another eagerly awaited growth figure was Japan's, to assess the economic effects of the earthquake and subsequent tsunami. Its GDP fell by 0.7% year-on-year in the first quarter of 2011, not only due to the above-mentioned effects but also to the downward trend the economy has been suffering since mid-2010. This unhealthy economic activity is reflected in weak private consumption and the sharp slowdown in exports. The initial effects of the earthquake and Fukushima nuclear crisis have already been felt in inventories, contributing almost half the decline in the first quarter. To a lesser extent, capital goods investment also fell back and further shrinkage is expected for the second quarter of the year. All these

effects, in addition to the weakness of the preceding situation, mean that the Japanese economy is very likely to decline by close to 1% in 2011 as a whole, with a risk of a greater fall.

In contrast to Japan's situation, the large emerging economies of Asia have maintained sturdy growth within a situation of inflationary tension. The Chinese economy advanced 9.7% year-on-year in the first quarter of the year, while inflation, which resists going down, stood at 5.3% in April compared with 5.4% in March; to slow up the ever-heating economy, the authorities once again raised the cash reserve ratio, the fifth increase for the year, in addition to the four hikes in the reference rate since October, as well as to credit limitations and a slight appreciation in the exchange rate. In India, which at the end of last year was growing by 8.2%, the monetary authority surprised this month by once again raising the reference rate by 25 basis points to 7%, in an attempt to slow down rising inflation, standing at 9% in March.

China and India face up to the risk of overheating.

A large proportion of these inflationary tensions is due to trends in commodities. However, these have slowed up over the last few weeks. Oil prices reversed part of their rise after seven months of continuous increases. Between 20 April and 20 May, the price of crude fell by 10.5% to stand at nearly 110 dollars per barrel, an increase of around 19% since the start of the year. The rest of commodities have followed oil's example, with the exception of food. Base metals saw widespread drops, of note being the 10.3% loss for nickel. Among foods, sugar, tea and coffee fell but the forecast of a dry year meant that wheat, rice and barley rose. For its part, gold remained above 1,500 dollars per ounce, very close to its peak, thereby capitalizing on the uncertainty that continues to affect the global economy.

Commodities halt their price rises.

In clear contrast to what has happened in the United States and Japan, the euro area's economic growth clearly exceeded the expectations of the consensus of analysts. The GDP rate of growth for the first quarter increased by half a point to 2.5%, thanks to the pull from Germany and France, accounting for almost half the euro area. These results have led us to increase our growth forecast for 2011 from 1.5% to 1.9%. The bad news is that the three countries of the euro area that have been bailed out (Greece, Ireland and Portugal) reported drops in GDP in year-on-year terms for the first three months of the year.

In fact, the financial aid programme for Portugal was finalized in May, totalling 78 billion euros to be paid over three years providing there is a drastic fall in the public deficit (9.1% of GDP in 2010) and a series of economic and financial reforms. With regard to Greece, there's discussion regarding the possibility of adopting a second bail-out, given that the targets of the first are not being met. The country's economic and financial deterioration can be seen, among others, in the further cuts to its rating and a public debt that is expected to reach 158% of GDP in 2011. Another suggestion was to reprofile Greek debt in order to sort out its current situation but the European Central Bank (ECB) is against this measure due to the negative consequences not only for Greece but also for other countries in difficulty and for the euro area as a whole.

Europe enjoys strong growth but Greece's deteriorating situation sets off another turbulent episode in peripheral sovereign debt.

Within this context, turbulences in the sovereign debt market have been revived as a knock-on effect, taking the spread between the periphery and Germany to new highs. Spanish debt, which had

The ECB is concerned about rising inflation.

managed to narrow part of this spread over the last few weeks, has suffered an increase in its risk premium back up to the levels of March, close to 270 basis points. However, and in spite of these sporadic upswings in tension, the trend for the spread of Spanish debt with German debt has remained relatively stable over the last few months.

For its part, the ECB is concerned about safeguarding price stability at a time when the harmonized CPI for the euro area has risen to 2.8% and core inflation to 1.8% year-on-year. Part of the price rises resulting from the energy and food increases is being passed on to retail sale prices for end goods and services. After the hike in the reference rate to 1.25%, economists and investors believe that the next hikes, more than likely to be in the region of 25 basis points, might be carried out in July and in the last quarter of the year.

The Spanish economy's growth in the first quarter was better than expected.

The combination of reference interest rates hikes by the ECB and the persistence of a still appreciable spread between rates is not helping Spain's economy to sufficiently pick itself up after the far-reaching recession it has been through. Nevertheless, the Spanish economy also provided a positive contribution in the first quarter, with 0.3% growth in GDP compared with the end of 2010. The year-on-year growth rate stood at 0.8%, two tenths of a percentage point above the figure recorded the previous quarter. This advance was mainly due to the drive from exports, especially of goods, and was boosted by the French and German pull, as well as by an increase in public expenditure. In contrast, the contribution of private domestic demand to growth was negative due to the stagnation in consumption and the fall in investment.

The foreign sector is likely to contribute most of the growth in the coming quarters.

Given the trends in the different GDP elements from January to March, as well as the available indicators, economic recovery is likely to advance at a very slow pace. One of the keys lies in household consumption, highly conditioned by trends in income and rising inflation. In April, the upward trend in oil prices continued to affect the consumer price index (CPI), with its year-on-year rate of change increasing by two tenths of a percentage point to 3.8%, the highest rate since September 2008. However, we expect inflation to have reached a peak this month, gradually easing from then on. The poor state of the labour market isn't helping consumer spending either, with unemployment reaching 21.3% in the first quarter. In this period, employment fell by 1.4% year-on-year in terms of full-time equivalent jobs. However, the labour market is expected to improve slightly in the second and third quarter.

In short, given the fragile trends expected in the main components of domestic demand, Spain's capacity to recover will be at the mercy of the foreign sector. In this respect, the fact that Europe's two main countries, together with the Nordic countries, have enjoyed high growth rates in the first quarter improves the prospects for exports and the volume of tourists in the coming months. Outside the European Union, the high growth of emerging economies and a weaker euro will also help to sustain activity in a year that is crucial to consolidating the recovery.

26 May 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	**7**	The **European Central Bank** raises the official interest rate to 1.25%.
May	**17**	The Council of Economic and Finance Ministers of the European Union approves the **financial bail-out plan for Portugal**, totalling 78 billion euros.
	22	**Elections** are held in thirteen autonomous communities and in the municipalities.

AGENDA

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 HICP (May).
22 Foreign trade (April).
Fed Open Market Committee.
24 Producer prices (May).
28 Government revenue and expenditure (May).
30 Flash CPI (June).
Balance of payments (April).

July

4 Registration with Social Security and registered unemployment (June).
6 Industrial production index (May).
7 Governing Council of the European Central Bank.
13 CPI (June).
14 EU HICP (June).
20 Foreign trade (May).
22 Producer prices (June).
26 Government revenue and expenditure (June).
29 Labour force survey (second quarter).
Balance of payments (May). Flash CPI (July).
US GDP (second quarter).

INTERNATIONAL REVIEW

The United States: insufficient growth

The United States grows by a modest 2.3% in spite of fiscal stimuli.

The US recovery continues to advance but at a rate that is not enough for significant improvements to be seen in the labour market and housing in 2011. In the first quarter, gross domestic product (GDP) grew by a modest 0.4% quarter-on-quarter, 2.3% year-on-year, placing the growth forecasts for the whole of 2011 below 3.0%. This sluggish recovery is occurring in an economy that is still receiving significant fiscal stimuli. The public deficit will continue above 10% of GDP throughout 2011 and the gross debt of the public sector will approach 100% of GDP by the end of year.

Fiscal consolidation has been left for later, while the existence of a legal ceiling to public debt is threatening an unlikely suspension of debt payment by the government, as an agreement between the two large parties will prevent this from happening.

The risk of low growth therefore continues to be greater than the risk of inflation. In spite of this, the composition of growth in the first quarter means that the figure is better than it looks. The most

UNITED STATES: MAIN ECONOMIC INDICATORS

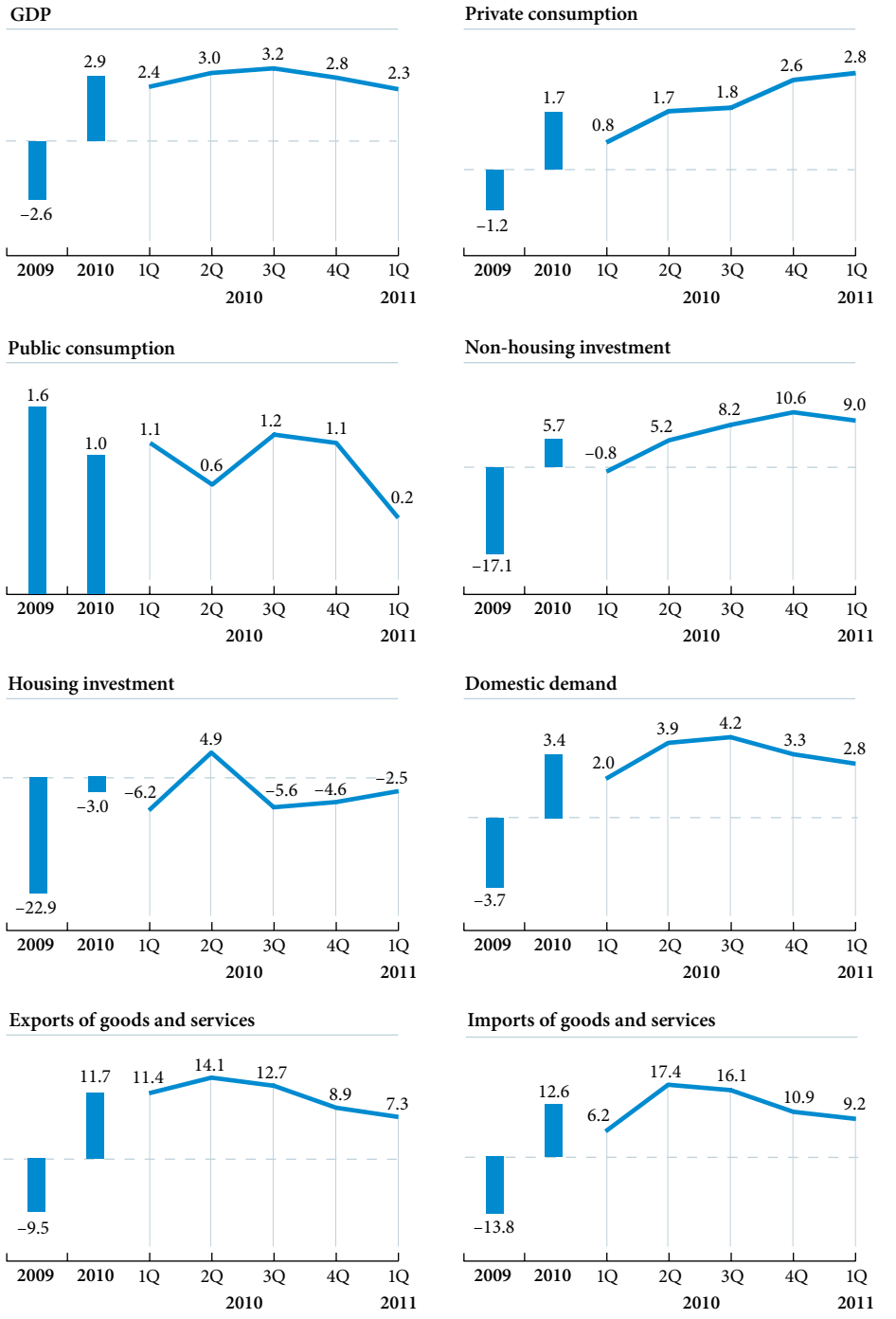
Percentage change over same period year before unless otherwise indicated

	2009	2010	2010			2011	
			2Q	3Q	4Q	1Q	April
Real GDP	–2.6	2.9	3.0	3.2	2.8	2.3	–
Retail sales	–7.0	6.4	6.8	5.6	7.7	8.2	7.6
Consumer confidence (1)	45.2	54.5	58.2	50.9	57.0	66.9	65.4
Industrial production	–11.2	5.3	6.5	6.9	6.2	5.4	5.0
Manufacturing (ISM) (1)	46.3	57.3	57.6	55.2	57.9	61.1	60.4
Housing construction	–38.4	5.6	12.7	–0.7	–5.1	–5.7	–23.9
Unemployment rate (2)	9.3	9.6	9.6	9.6	9.6	8.9	9.0
Consumer prices	–0.4	1.6	1.8	1.2	1.3	2.1	3.2
Trade balance (3)	–374.9	–495.7	–450.4	–483.7	–495.7	–522.4	...
3-month interbank interest rate (1)	0.7	0.3	0.5	0.3	0.3	0.3	0.3
Nominal effective exchange rate (4)	77.7	75.6	77.9	76.1	73.2	72.1	69.8

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.

TREND IN UNITED STATES GDP BY COMPONENT

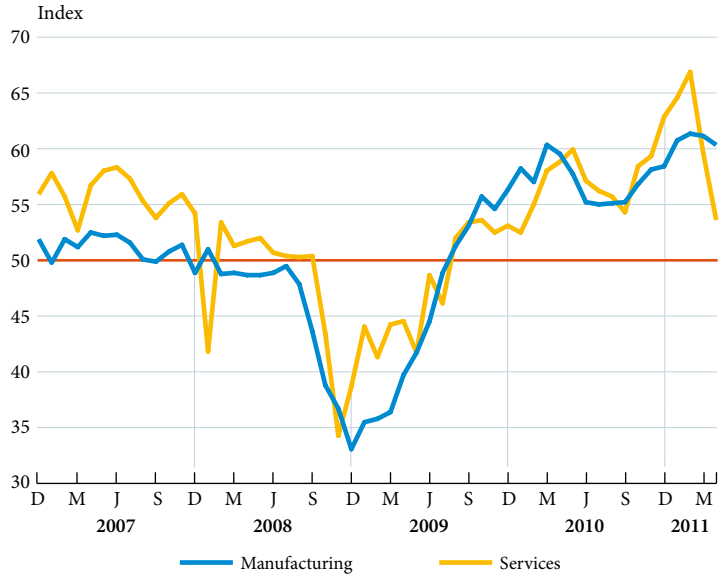
Percentage year-on-year change in real terms



SOURCES: Bureau of Economic Analysis and own calculations.

THE UNITED STATES: SERVICES WEAKEN

ISM index levels (*)



NOTE: (*) A level of 50 means that there are as many optimistic answers as pessimistic.
SOURCES: Institute for Supply Management and own calculations.

The positive note still lies in the underlying strength in private consumption, in spite of a certain slowdown.

positive note was provided by private consumption, up by an appreciable 0.7%. This indicates underlying strength, albeit within a slowdown due to the readjustment in savings, with gross household debt still anchored at a high level of 116% of disposable income at the end of 2010. This same pattern of slowdown while maintaining a certain vigorous tone could also be seen in April's retail sales that, without cars or petrol, grew by 4.6% year-on-year, a little below the average for the last nine months.

The good performance shown by corporate earnings and the relatively lower debt of non-financial firms helped capital goods investment to continue strong, accelerating in the first quarter and achieving growth of 3.9% quarter-on-quarter. In spite of this, business sentiment is no longer as clearly optimistic as it was a couple of months ago. The gap between stronger manufacturers, benefitting from a weak dollar and gains in productivity, and relatively fragile services continued to widen in April. The business sentiment index of the Institute for Supply Management of Manufacturing remained at 60.4 points, a level consistent with solid expansion, while the services index once again saw a sharp drop that left it at 53.7 points, more befitting anaemic growth in the economy as a whole.

The number of discouraged workers makes it difficult for the unemployment rate to fall, currently at 9.0%.

The problem with this greater weakness in services lies in the fact that they account for 83.4% of total private employment. In contrast, manufacturing strength has led to net gains of 250,000 jobs in one year and a half, although this figure is still small if we remember than 8.75 million jobs were lost during the crisis. In any case, the recovery in the job market is very slow. Although April was a good month with the creation of 244,000 net jobs, the large pool of discouraged

workers, as well as those working part-time involuntarily, means that these will gradually rejoin the labour force as demand for work improves. In spite of the rise in jobs, April's unemployment rate rose by two tenths of a percentage point to 9.0%.

While job creation in services is still relatively slow, employment in construction continues rock bottom, after having lost more than two million jobs during the crisis. The outlook for the sector continues to be gloomy. Construction continues to be paralyzed by the large number of empty homes, still being boosted by mortgage foreclosures, in a market with numerous households with mortgage debt greater than the value of the home. This excess supply is also forcing down prices, as shown by the Case Shiller index for second-hand homes that, in February, saw its eighth consecutive months of falls.

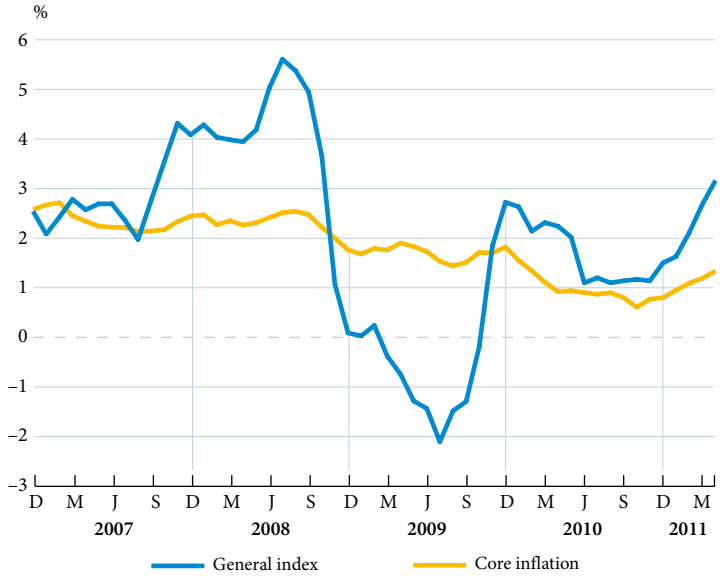
In the area of prices, inflation continues to rise, with April's general consumer price index (CPI) up by 3.2% year-on-year, when in January this rise was 1.6%. However, more than half this upswing can be put down to rising oil prices which, for the moment, are not being passed on to other sectors of economic activity. In this respect, the core CPI, which excludes energy and food prices, rose by a more moderate 1.3%, kept down by the low utilization of production capacity. In the United States, the most negative aspect of rising oil and other commodity prices is not so much inflationary pressure but the effect this has on the growth wheel. Firstly, the high oil prices which, in spite of the latest corrections, are still above their level at the end of 2010, could force down private consumption by reducing the spending budgets of households. In addition, expensive commodities put cost pressure on the margins of many firms.

Construction still in the dumps due to the high number of empty homes.

The CPI rises 3.2% due to rising oil prices. Core inflation is up 1.3%.

THE UNITED STATES: PRICES FOLLOW OIL

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



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

Exports look strong but oil prices mean it's difficult for the foreign sector to make a positive contribution.

The foreign sector still did not manage to capitalize on the improvement in manufacturing and the weak dollar. Its contribution to growth in the first quarter was minimally negative and, although good export figures for April suggest an improvement, the persistence of expensive oil will make it difficult for the sector to make any significant contribution to growth throughout 2011.

Japan falls by 0.7% within a sharp slowdown.

Japan: tragedy added to weakness

The Japanese economy has entered into recession before having accounted for a large proportion of the effects of March's earthquake and tsunami. GDP fell by 0.9% quarter-on-quarter and by 0.7% year-on-year in the first quarter of 2011. Apart from the earthquake, the downward trend suffered by the economy since mid-2010 also explains a large part of the weakness in the national accounts. Although growth for the whole of 2010 held steady at 4.0%, Japan's statistics office revised its growth profile throughout the year, outlining a more marked slowdown than previously announced. After an early part of the year with solid advances, the end of the rebound in exports and fiscal incentives for consumption left Japan's economy in a clearly weak position just before March's earthquake.

The economy will shrink in 2011 due to the weak start to the year and power cuts.

This unhealthy economic activity can be seen in the weak private consumption, accumulating a 1.5% drop in six months after having grown strongly in the third quarter of 2010. This weakness has also been caused by the sharp slowdown in exports, which were stagnant at the start of year while imports picked up. The initial effects of the earthquake and Fukushima nuclear crisis have already been felt in inventories, contributing almost half the decline in the first quarter. To a lesser extent, capital goods investment also fell.

JAPAN: MAIN ECONOMIC INDICATORS

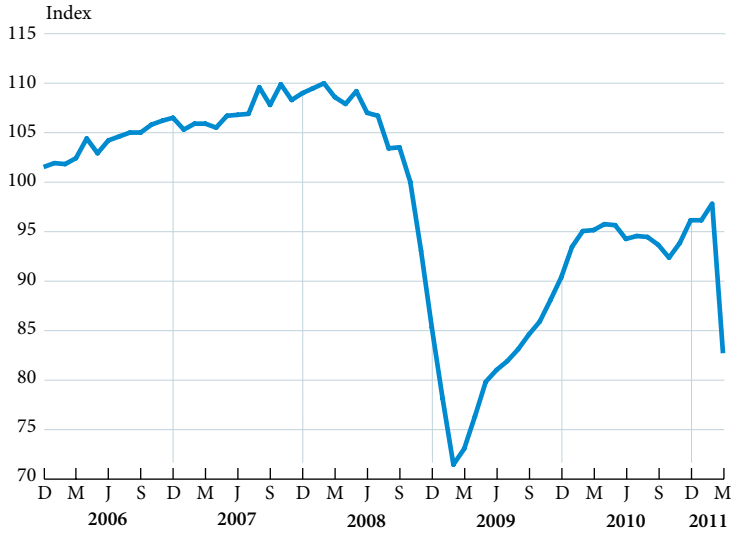
Percentage change over same period year before unless otherwise indicated

	2009	2010	2010			2011	
			2Q	3Q	4Q	1Q	April
Real GDP	–6.3	4.0	3.3	4.8	2.4	–0.7	–
Retail sales	–2.3	2.5	3.7	3.2	–0.4	3.0	...
Industrial production	–21.8	16.6	20.5	13.3	6.8	–2.5	...
Tankan company Index (1)	–40.8	0.0	1.0	8.0	5.0	6.0	–
Housing construction	–27.7	2.7	–0.8	13.7	6.8	3.2	...
Unemployment rate (2)	5.0	5.1	5.1	5.0	5.0	4.7	...
Consumer prices	–1.3	–0.7	–1.0	–0.8	0.1	0.0	...
Trade balance (3)	4.0	7.9	7.4	8.1	7.9	6.5	...
3-month interbank interest rate (4)	0.6	0.4	0.4	0.4	0.3	0.3	0.3
Nominal effective exchange rate (5)	98.6	106.0	102.8	109.1	111.0	110.3	106.9

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.

JAPAN: INDUSTRIAL PRODUCTION PLUMMETS

Industrial production index



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

Further shrinkage is expected for the second quarter of the year as a result of the power cuts due to the unresolved problems at the Fukushima nuclear plant. This should mainly affect investment and exports, the two driving forces behind last decade's growth. All these effects, in addition to the prior weak situation, mean that the Japanese economy is very likely to shrink by close to 1% in 2011 as a whole. But the risks involved in this scenario are of further decline, as it has been assumed that the power supply problems will have been largely resolved by the third quarter. This should give rise to a second half of the year with solid growth, although we cannot rule out the crisis lasting longer.

March's business indicators are already reflecting the effects of the earthquake and point to a recessive second quarter, where the greatest weaknesses should be on the supply side. Industrial production, which is closely linked to trends in GDP and exports in Japan, saw record falls in March, in just one month losing more than half of what it had recovered since February 2009. Also in March, the production capacity utilization went from 93.7% to 73.6%, the lowest figure since February 2009. Similarly, private machinery orders, which indicate future expenditure on capital goods investment, fell by 16.4% in March, while March's exports were down 7.7% compared with February.

Industrial production suffers a record drop in March.

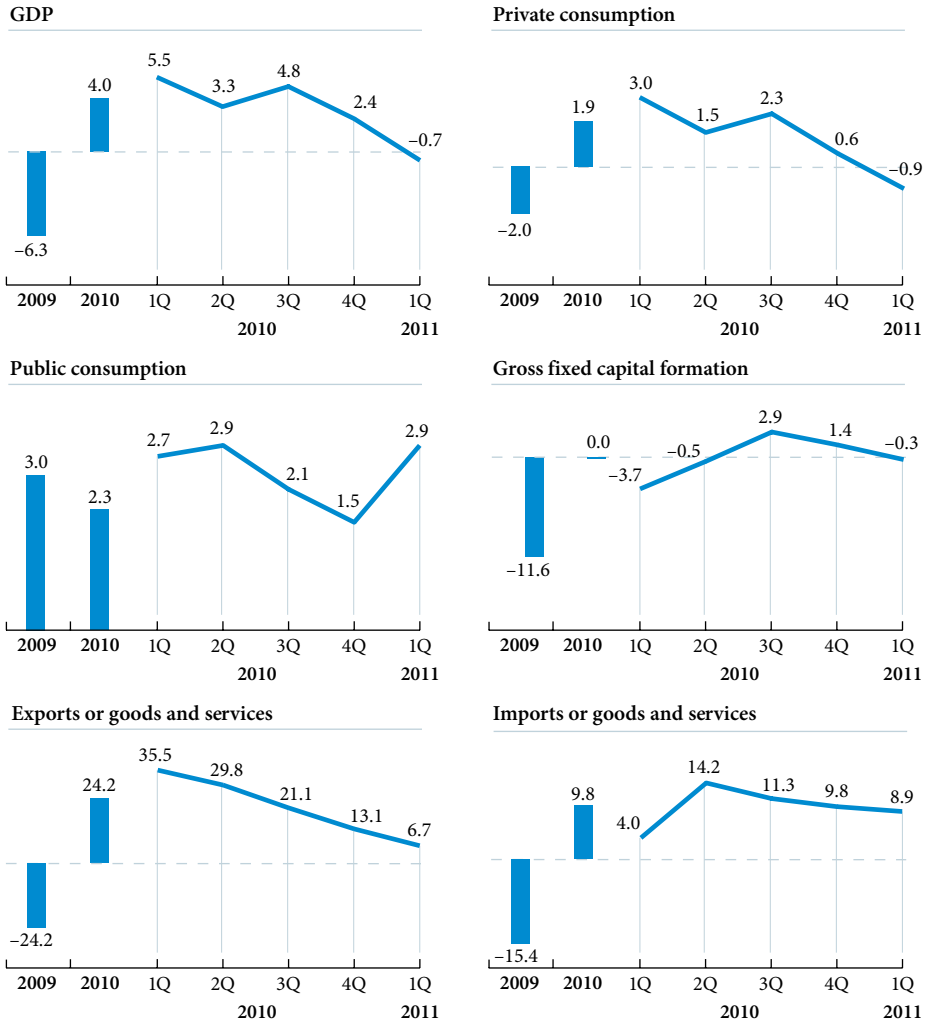
Domestic demand weakens while inventories already reflect the effects of the earthquake.

The effect of the earthquake on prices is quite deflationary due to consumer reticence, whose confidence index has fallen from 41.2 points in February to 33.1 points in April. March's CPI showed no change compared with the same period a year ago, while the core CPI, the general index without energy or food, intensified its drop a little, falling by 0.7% year-on-year.

Consumer confidence falls and deflation persists.

TREND IN JAPAN'S GDP BY COMPONENT

Percentage year-on-year change in real terms



SOURCES: Institute of Economic and Social Investigation and own calculations.

China increases its cash reserve ratio and India raises its reference rate again.

China: monetary tightening continues

Given that inflation is reluctant to fall, standing at 5.3% in April compared with 5.4% in March, China has once again raised the cash reserve ratio, the fifth rise this year so far, placing it at 21% for large banks. This is in addition to the four reference interest rate hikes since October, up to 6.31%, as well as credit limitations and a more flexible exchange rate. These containment policies to combat the risk of overheating are also spreading to other emerging countries. India's central bank surprised by once again raising its reference rate by 50 basis points to 7.25% in an attempt to slow down its rising inflation, standing at 9% in March.

Within this context of inflationary tensions and robust growth, the Chinese

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2009	2010	2010			2011	
			2Q	3Q	4Q	1Q	April
Real GDP	9.2	10.3	10.3	9.6	9.8	9.7	–
Industrial production	12.5	14.5	16.0	13.5	13.3	14.9	13.4
Electrical power generation	6.8	14.0	17.8	11.8	6.2	12.1	10.5
Consumer prices	–0.7	3.3	2.9	3.5	4.7	5.1	5.3
Trade balance (*)	196	184	155	182	184	169	179
Reference rate (**)	5.31	5.81	5.31	5.31	5.81	6.06	6.31
Renminbi to dollar	6.8	6.8	6.8	6.8	6.7	6.6	6.5

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

economy advanced 9.7% year-on-year in the first quarter of the year and the Asian giant approved, in March, its twelfth Five-Year Plan (2011-2015) since this started with Mao Ze Dong in the mid-1950s. The Plan's three main objectives are as follows: rebalancing the drivers of growth, restructuring the economy and improving the standard of living, as well as attempting to reduce inequalities in the population.

Regarding the first objective and in order to sustain the economy's high growth rates, private consumption needs to be promoted in detriment to the economy's dependence on the foreign sector and investment, mainly in this export sector. Regarding the second objective, the government plans to support a series of strategic, high value added industries as well as encouraging the services sector. Lastly, the country's authorities are working on ensuring that economic growth leads to notable increases in household incomes, as well as reducing the growing inequalities between regions and sectors. By way of example, while in 1981 the average income in large cities, especially on the coast, was double that of rural areas, by the mid-2000s this ratio had more than tripled.

The 12th Five-Year Plan focuses on rebalancing and restructuring the economy to improve the standard of living.

In spite of tightening its monetary policy, April's business indicators continued to show an economy expanding strongly. Retail sales advanced in current terms by 17.1% year-on-year compared with 16.3% in the first quarter of the year. Accumulated investment in fixed capital from January to April grew by 25.5% year-on-year compared with the same period a year ago, without showing any sign of slowing down. On the supply side, industrial production moderated a little and advanced 13.4% year-on-year compared with 14.9% the previous month. Along the same lines, the purchasing managers' index (PMI) fell slightly to 52.9 points. Nonetheless, this slowdown could be merely a reflection of the impact of Japan's earthquake on the country's car industry, which relies on Japanese components.

In terms of exports, and after closing the first quarter with a slight trade deficit of 0.7 billion dollars, April's surplus stood at 11.4 billion dollars, reviving the pressure on China to allow the renminbi to appreciate further. In particular, the

The new trade surplus revives exchange rate tensions.

bilateral imbalance with the United States continues to be a source of tension, as it exceeds the total trade surplus of the Chinese economy.

Brazil: the real, inflation and other setbacks

The Brazilian government reduces its growth forecast for 2011 to 4.5%, in line with our forecasts.

In May, the Brazilian government reduced its gross domestic product growth forecast for this year by half a point, down to 4.5%, a figure that now coincides with our forecast. It also upped its forecast for inflation this year to 5.7% and revised the exchange rate from the previously expected figure of 1.70 reais/dollar to 1.61.

The Brazilian real is one of the currencies appreciating the most over the last few years (40% against the dollar since the end of 2008) and this has undoubtedly had its consequences. To start with, it has made imports cheaper, helping to boost domestic expenditure, something that helped the country get back on its feet more quickly after a very brief recession but ended up applying notable pressure on prices. On the other hand, the strong real entails a loss of competitiveness for Brazilian exports, especially for manufacturers seeing as the demand for raw materials continues to be very difficult.

Given this context, the Brazilian economic authorities are facing a dilemma: if they don't combat inflation with the entire arsenal they have available, the risk increases of an abrupt, forced adjustment in the future. But using their entire arsenal obviously means raising the official interest rate and, if they raise rates, the trend in the real's appreciation will get worse, complicating the performance of Brazil's export industry.

For now, they have opted for the middle way: interest rate hikes have been less aggressive than expected but supported by restrictive measures of a macroprundential and fiscal nature. On the other hand, the real has been contained particularly by intensifying capital controls.

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010			2011	
			2Q	3Q	4Q	1Q	April
Real GDP	–0.7	7.5	9.1	6.8	5.0	...	–
Industrial production	–7.3	10.5	14.0	8.2	3.7	2.1	...
Consumer confidence (*)	138.3	157.9	154.6	159.5	159.3	160.1	...
General unemployment rate (**)	8.1	6.7	7.3	6.6	5.7	6.3	...
Consumer prices	4.9	5.0	5.1	4.6	5.6	6.1	6.5
Trade balance (***)	25.3	20.2	19.3	16.8	20.2	22.5	23.1
Interest rate SELIC (%)	9.92	10.00	10.25	10.75	10.75	11.75	12.00
Reales to dollar (*)	2.3	1.8	1.8	1.7	1.7	1.6	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.

Nonetheless, exporters are still agitated. Recently, the Chairman and CEO of Siemens in Brazil demanded further measures to contain the currency as well as warning of the risk entailed for the export sector of a dollar being worth over 1.50 reais, and that this might even lead to «a deindustrialization of the Brazilian economy». This agitation might lie behind the reaction of the Brazilian authorities to the protectionist measures introduced by Argentina a few months ago, affecting foodstuffs from Brazil.

In mid-May, Dilma Rousseff decided to respond to these restrictions by introducing a licence system for importing vehicles and their parts. Although the measure is also applied to products from Mexico and South Korea, the repercussions for Argentina are significant as 82% of its car exports and 65% of its exports of car parts are aimed at Brazil. In the last few days, these two members of Mercosur have restarted conversations to resolve the trade conflict and the bulk of the evidence available suggests that this will result in their trade getting back to normal. However, this conflict is symptomatic of a competitiveness problem in both countries.

Brazil is taking measures against the Argentinean restrictions on imports of Brazilian food.

Mexico: cruising speed

In the first quarter of 2011, gross domestic product grew by 0.5% compared with the previous quarter thanks to the rise in services (0.9%) and secondary activity (0.6%) and in spite of a drop in the primary sector (–2.3%). In year-on-year terms, GDP growth was 4.4% and all three large branches of activity saw increases.

The economic recovery is therefore becoming solid in Mexico at the same time as settling down to more balanced growth, with the gradual replacement of its domestic engine and, for the moment, free from price pressures. The economy's good performance is sustaining the popularity of President Calderón with a 54% approval rating according to recent polls, although concern about public safety is on the increase.

Nonetheless, the latest report on Mexico by the Organisation for Economic Cooperation and Development (OECD) insists on the need to tackle far-reaching structural reforms to ensure this growth can be maintained in the medium and long term. Among these reforms, of note is the need for a more efficient tax system, the appropriateness of reducing the weight of the informal sector and the expediency of increasing competition in many sectors and improving education.

In this respect, the report points out that the new Competition Act passed by Congress is a very important step towards reducing the market power of incumbent firms. With regard to education, it recommends improvements both in teacher training and teaching centre management. And, with regard to firms operating outside the formal sector, it warns of the consequent burden on the Mexican economy's productivity. As informal firms have less access to credit, training and legal protection, they innovate less and don't grow as much. That's why the OECD recommends reducing legal and bureaucratic obstacles that make it difficult to set up and operate firms, as well as establishing a system of incentives to encourage these companies to become legal.

Nonetheless, the most crucial reform is still the tax system. Mexico has the lowest

The Mexican economy consolidates its recovery with growth of 4.4% in the first quarter of 2011.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010			2011	
			2Q	3Q	4Q	1Q	April
Real GDP	–6.2	5.4	7.3	5.1	4.2	4.4	–
Industrial production	–7.3	6.0	7.6	6.5	4.7	4.9	...
Consumer confidence (*)	80.5	86.3	84.9	89.2	89.6	92.1	89.7
Leading business index (*)	110.5	116.6	116.4	117.3	118.1	119.8	...
General unemployment rate (**)	5.5	5.4	5.2	5.6	5.3	5.1	...
Consumer prices	5.0	3.9	4.0	3.7	4.2	3.5	3.4
Trade balance (***)	–4.6	–3.1	–2.4	–2.0	–3.1	–1.7	–0.8
Official Banxico rate (%)	6.75	4.50	4.50	4.50	4.50	4.50	4.50
Mexican pesos to dollar (*)	14.2	12.3	12.8	12.6	12.3	11.9	11.5

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

The OECD insists on structural reforms to bolster medium and long-term growth.

tax revenue in terms of GDP of all OECD countries and a large part of Latin America, but this is not the main problem, however; the main problem is this revenue's high dependence on oil. This does not only make the revenue volatile but also hugely vulnerable in the future, given that Mexico's crude production is falling year by year. That's why the study recommends widening the tax base (e.g. by eliminating some of the exemptions that distort the system the most, as well as special regimes). The tax system would also benefit from the informal economy having less weight.

In short, Mexico should take advantage of the relatively calm outlook it is currently enjoying to reinforce both its pillars of growth and its defences against future setbacks.

Halt in the rising spiral of oil

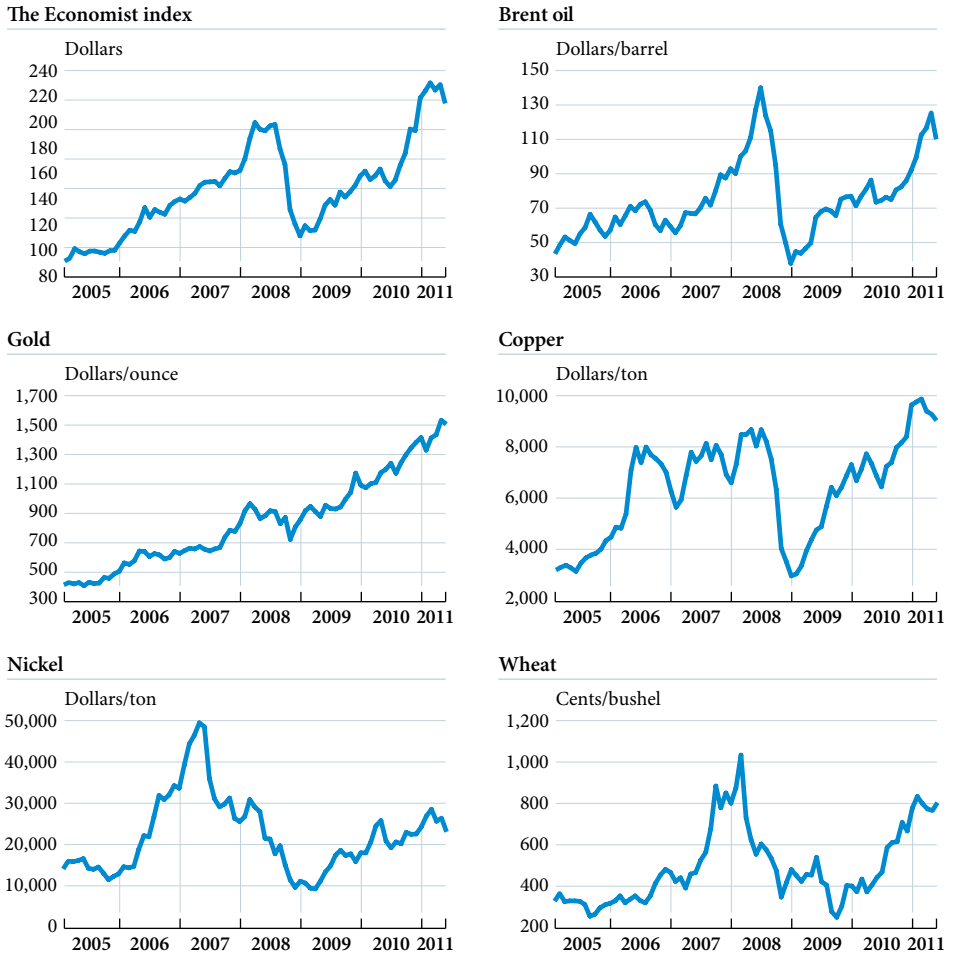
Oil falls to 110 dollars per barrel.

Oil prices fell after a run of seven months of continuous increases. Between 20 April and 20 May, the price of crude fell by 10.5% down to 110.61 dollars per barrel (Brent quality, for one-month deliveries), with a 19.4% rise since the year began.

The prospect of slightly less global growth than expected, with a US recovery that has yet to gain strength and with the emerging economies afflicted by overheating, and the forecasts of the International Energy Agency, which downgraded the growth in the demand for crude in 2011, helped to push oil prices down. The high levels reached, which had a speculative component caused by the uncertainty in North Africa and the Middle East, might have also played a part in correcting the price of crude. This fall should continue throughout the second half of 2011, bringing the price close to the benchmark of 100 dollars per barrel.

The rest of commodities have followed oil's example, with exceptions among foods. The Economist index fell by 5.7% between the 20 April and the 20 May. Base metals saw widespread losses, of

TREND IN VARIOUS COMMODITIES (*)



NOTE: (*) Figures for last day of month (last date May 20).
SOURCES: The Economist, Thomson Reuters Datastream and own calculations.

note being the 10.3% fall in nickel. Among foods, sugar, tea and coffee fell but the forecast of a dry year meant that wheat, rice and barley all rose. For its part, gold remained above 1,500 dollars per ounce, very close to its peak, thereby capitalizing on the uncertainty that continues to affect the global economy.

Commodities follow oil's example, with the exception of food and gold.

EUROPEAN UNION

The Euro area: more growth and inflation

Greece and Portugal focus the attention of the ECOFIN meeting.

The word «sceptic» comes from the Greek «skeptikoi» (which means to examine) and is the name given to the followers of the Greek philosopher Pyrrho, founder of the sceptic school of philosophy. This is a school of thought based on doubt. The members of this school merely gave an opinion and avoided asserting anything because they believed it was impossible to know the truth. This school of thought seems to be enjoying a renaissance, as the financial markets meet its philosophical requirements in terms of the financial solvency of Greece. Doubts centre on the capacity to redirect the Greek situation without restructuring its sovereign debt.

Approval for Portugal's financial bail-out plan, totalling 78 billion euros.

This was precisely one of the issues dealt with at the European Union Council meeting held in May. In addition to the Greek situation, the Brussels meeting had an agenda full of important topics. Among these was the approval of Portugal's financial bail-out package. In fact, the Economy and Finance ministers (ECOFIN) approved the plan, which totals 78 billion euros, of which two thirds will be provided by the European Union and the rest by the International Monetary Fund (IMF). Of the European part, 26 billion euros are being granted via the European Financial Stability Facility.

The plan will be implemented through an aid programme with a three-year timescale up to mid-2014 and is based

EURO AREA: MAIN ECONOMIC INDICATORS

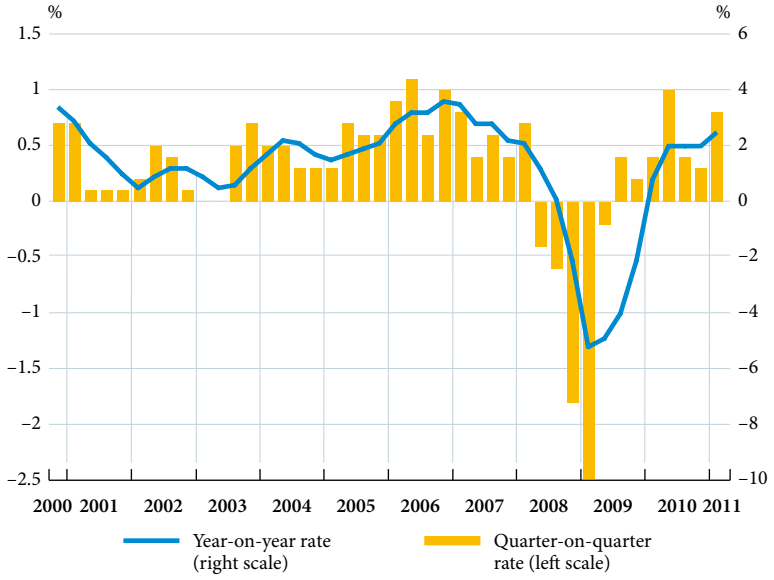
Percentage change over same period year before unless otherwise indicated

	2009	2010	2010			2011	
			2Q	3Q	4Q	1Q	April
GDP	–4.1	1.7	2.0	2.0	2.0	2.5	–
Retail sales	–2.5	0.8	0.7	1.4	0.6	0.1	...
Consumer confidence (1)	–24.8	–14.0	–16.7	–12.1	–10.4	–10.6	–11.6
Industrial production	–14.7	7.5	9.4	7.1	8.1	6.4	...
Economic sentiment indicator (1)	80.7	100.8	99.1	102.3	105.6	107.3	106.2
Unemployment rate (2)	9.4	10.0	10.1	10.1	10.0	9.9	...
Consumer prices	0.3	1.6	1.6	1.7	2.0	2.5	2.8
Trade balance (3)	–16.7	14.1	20.0	8.2	4.6	–9.3	...
3-month Euribor interest rate	1.2	0.8	0.7	0.9	1.0	1.1	1.3
Nominal effective euro exchange rate (4)	111.7	104.7	103.2	102.3	104.4	103.7	107.0

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.

ECONOMIC RECOVERY SPEEDS UP IN THE EURO AREA

Change in GDP



SOURCE: Eurostat.

on three basic pillars. Firstly, an ambitious but credible fiscal adjustment plan. The second pillar is the implementation of measures to help the country grow and gain competitiveness, this being one of Portugal's most serious problems. Lastly, introducing measures to help the deleveraging of its financial system and strengthen its capital levels. Regarding this last point, 12 billion euros of the total sum of the plan have been reserved to implement this support for the Portuguese financial system.

Fortunately, both Greece and Portugal could benefit from the acceleration of economic growth in the euro area. In fact, data on the gross domestic product (GDP) were published for the first quarter, which grew by 0.8% quarter-on-quarter, so that the year-on-year growth for the euro area as a whole rose by half a point to 2.5%.

Although a breakdown has yet to be released for these data, it can already be seen that disparities continue in this growth, in geographical and composition terms. For example, those countries with the highest quarter-on-quarter growth rates have been Germany (1.5%), France (1%) and Austria (1%), while a second group of countries have recorded more modest figures, among them Italy (0.1%) and Spain (0.3%). The bad news comes from Portugal (–0.7%), which is entering into recession with two consecutive quarters of negative growth, unlike Greece, which has recorded a positive figure (0.8%). Regarding the composition of growth, while exports have contributed positively in Germany and Spain, in France these have been negative due to rising oil prices and the consequent higher bill for energy imports for this country.

First quarter growth in the euro area is higher than expected...

Given these strong economic increases experienced by France and Germany, which account for 27% and 21% of the euro area's GDP, respectively, and Spain's pleasant surprise, which accounts for 12%

...although the rate of growth will slow down due to the euro's appreciation and the erosion of households' disposable income.

of GDP in the euro area, the GDP estimate for all the countries in the euro area has been revised from 1.5% to 1.9% in 2011.

And this is in spite of the fact that we expect the euro area's growth to moderate, for three reasons. The first factor is that part of the growth in the first quarter was the result of economic activity that had to be postponed due to the heavy snowfalls that paralysed several countries in Europe during the fourth quarter of last year. On the other hand, the contribution of foreign trade should ease in the coming quarters after the euro has appreciated. Lastly, consumption will moderate due to the deterioration of disposable income of households, given the moderate growth in wages within a context of rising inflation and an unemployment rate that remains anchored at 9.9%. In fact, the latest figures for general inflation in April grew by 2.8% year-on-year.

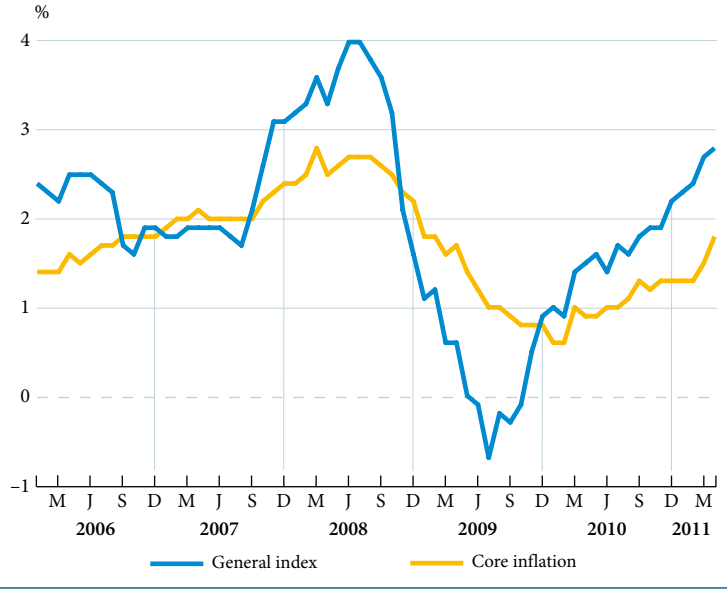
Inflation continues to rise and reaches 2.8% year-on-year in April.

But, if we exclude the most volatile components of the index such as energy and food, inflation still rises. Core inflation, specifically, stood at 1.8% year-on-year in April. A trend that shows that some of the rising energy and food prices experienced in the euro area are being passed on, partly, to the final retail price of goods and services.

Neither can we ignore three factors that have led to us revising our inflation forecast upwards for the euro area in 2011, from 2.3% to 2.6%. Firstly, a methodological change incorporated by the official European statistics office, Eurostat, in calculating the component of seasonal product prices for the consumer price index (CPI). On the other hand, the sharp rise in oil prices during the months of February to April which, although part of this increase has since been lost, continues at higher levels than expected at the beginning of the year. Lastly, the rise in prices of items that come under

THE RISING TREND IN PRICES REMAINS

Year-on-year change in harmonized CPI



SOURCE: Eurostat.

the services sector, as this indicates that companies have a little more power to set prices. We believed that a large part of these price rises would be offset against business margins at such a difficult time for consumers and that companies would be reluctant to raise their prices for fear of losing sales, but the rise in underlying inflation indicates that companies are trying to defend the margins in their income statements.

This is merely an increase of three tenths of a percentage point in inflation. But in some countries inflation is high and this is harming households' disposable income. This is probably one of the reasons for the slight decline in consumer confidence in the euro area, down one point in April.

The second pressing issue that was pending a solution in the European Union is the possibility of a second financial bail-out for Greece. But a decision wasn't taken at the ECOFIN meeting in May as it seemed more prudent to wait for the findings of the report by the expert committee of the European Central Bank (ECB), the IMF and the European Commission which, having gone to Greece, are studying its capacity to sustain debt and comply with the bail-out programme.

To understand the challenge facing the Greek economy, it's useful to look at four figures that can provide us with an outline. In 2010, Greece's GDP was 230,173 million euros, while its public debt totalled 328,588 million euros. So the ratio of public debt stock to GDP was 142.8%. The European Commission itself stated that it expected this debt stock level to rise to 166.1% by the end of next year. Moreover, Greece has received a financial bail-out to the tune of 110 billion euros.

The Greek economy is facing a huge challenge.

The difficulty lies in the fact that the terms of the financial bail-out plan require Greece to return to the capital markets in 2012 to finance part of its financial needs. Nonetheless, the interest rates demanded for Greek bonds mean that it is not very realistic to issue government bonds, as 2-year Greek bonds require a yield of 26.1%.

The Commissioner for Economic and Financial Affairs, Olli Rehn, has insisted that the adoption of new fiscal adjustment measures and the acceleration of the privatization programme by the Greek government (valued at around 50 billion euros) are necessary conditions that must be met before a second bail-out by the European Union can be considered. However, at the ECOFIN meeting several ministers of Economy reflected on the possibility of what they called a «reprofiling» or restructuring of Greek debt, interpreted as an extension of its maturities. Nevertheless, the ECB has firmly opposed any kind of reprofiling, as it believes this would have negative consequences not only for Greece but also for the euro area as a whole.

The scepticism of the capital markets limits Greece's possibility to issue public debt.

Current investors in Greek sovereign debt seem like followers of the Greek philosopher Pyrrho, founder of the sceptic school, as they are questioning whether the situation of Greek sustainability can be redirected without reprofiling. However, they might be convinced if Greek politicians showed an uncompromising desire to implement the necessary reforms, as they have been asked to do by Olli Rehn.

Talk has started of «reprofiling» Greek public debt.

Imbalances in a monetary union

Before formally installing monetary union among a part of the member states of the European Union, at the end of the 1990s there were doubts regarding how far economic convergence and integration could go among these countries. As monetary union matured throughout the first decade of this century, empirical evidence revealed the advances being made in terms of integration. On the one hand, a series of studies concluded that monetary union lay behind the considerable rise in intra-community trade, highlighting the growing commercial ties between countries belonging to the single currency, benefitting from lower transaction costs and the disappearance of exchange risk premia. On the other hand, in the years following the creation of the euro there was also a relatively high cyclic synchronization between the different economies of the monetary union. This meant that the spread of output gaps as from the mid-1990s was tending to narrow.(1)

Such growing economic integration was highly relevant when evaluating the soundness of the single currency project, given that close commercial ties and high cyclic synchronization smoothed the path of single monetary policy. This was particularly important as everyone was well aware that the project of Economic and Monetary Union approved by the Maastricht Treaty in the early 1990s had its faults. Essentially the lack of fiscal integration: state taxation continued to be a strictly national concern. The Stability and Growth Pact, an instrument that was supposed to discipline euro governments in fiscal terms, failed completely. There were numerous violations of this pact but no pecuniary fines were ever applied; and when, in 2003, these penalties should have been applied to the big guns (Germany and France), these countries insisted that its rules should be toned down.

Meanwhile, the belief in the growing integration of economies within an expansionary cycle took attention away from a development that was becoming increasingly evident: increasing external imbalances. Spain, Greece, Portugal, Ireland, France and Italy, on the one hand, suffered notable deterioration in their current account positions. On the other hand, Germany, the Netherlands and Austria saw considerable improvement.

Was this a worrying development? Considering the economic policy responses adopted, it cannot be said that this was seen as a matter of priority. Most current account divergences between countries were attributed, correctly, to differences in the drive provided by domestic demand. In deficit countries, factors were in force that stimulated expenditure: the fall in real interest rates, growing private sector debt and marked growth in property markets. The rest of this divergence could be explained by differences in terms of foreign competitiveness. In surplus countries, weak domestic demand was patent and foreign competitiveness traditionally high.

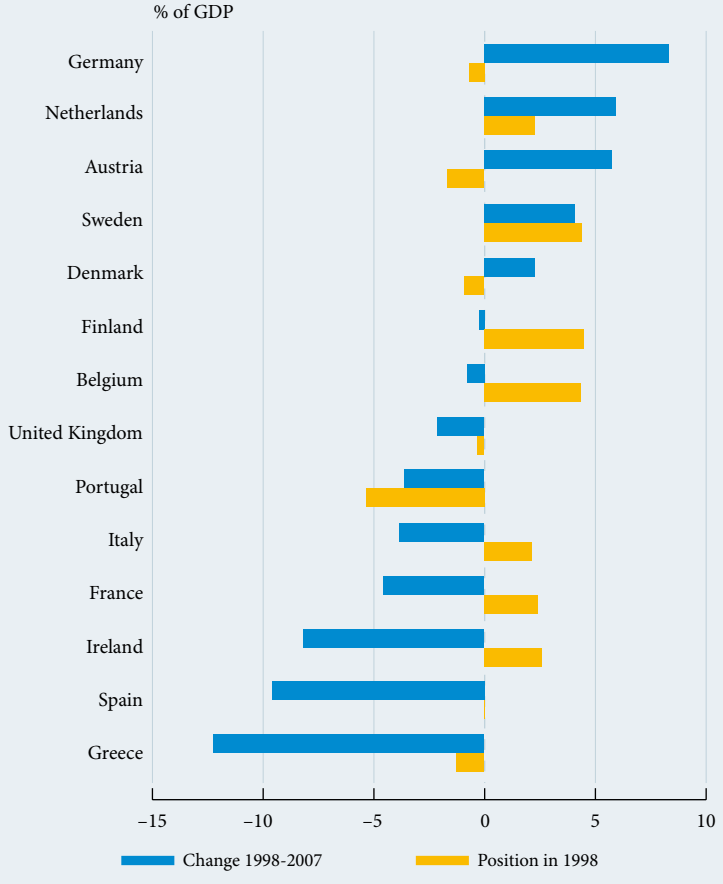
In fact, current account imbalances were able to increase beyond previous levels because they were easy to finance. The creation of the euro led to the creation of a European capital market where capital flowed freely without the hindrance of currency exchange and where interest rates converged. Within a financially expansionary context and with a low perception of risk, a scenario of collapsing wholesale markets, sovereign debt crisis and the bail-out of member countries was not on the radar of lenders and borrowers.

Moreover, why should the persistence of imbalances be of any concern? The existence of imbalances within a monetary union is not exceptional. In many European countries, regional asymmetries (by current account, unemployment, etc.) persist, as shown by cases such as Spain, Germany and Italy. The difference lies in the fact

(1) Quarterly Report on the Euro Area. «How has the financial crisis affected cyclical differences within the euro area?». Volume 9 No 2 (2010).

DIVERGENCE IN THE EURO AREA

Net lending (+) or borrowing (–) in some countries of the European Union



SOURCES: AMECO and own calculations.

that a national state has mechanisms to rebalance its fiscal area which the euro area lacks. As its detractors have always claimed, the euro area is far from being an optimum monetary area in economic theory terms, and that's why it's at risk of failing. The unification of monetary policy and the putting in place of a single financial market might not be enough to cement monetary union if fiscal transfer between countries is minimal, there's almost no employment mobility and the commitment to solidarity fades as soon as significant conflict arises in national interests. The economic and financial crisis that started in 2007 has brought this brutally to light, forcing a rethink in the design of monetary union.

However, it should be noted that the collapse of national domestic demand has helped to considerably correct current account deficits. Now the problem is not so much current account imbalances but their repercussions: deterioration in some countries' external positions and the high debt of their private and public sectors. A large proportion of the sovereign debt problems originate in the years of «spend, spend, spend» resulting from the

implementation of the single currency. Given this experience, European institutions are immersed in a process of reforms that should prevent such events from being repeated. One alternative would be to further the construction of Europe, making advances in fiscal integration and political union. However, this alternative does not seem feasible for the moment, beyond the mechanisms to financially assist member states in the euro area that are being put into action, in an attempt to safeguard the stability of the euro area as a whole. However, mechanisms to coordinate and supervise economic and particularly fiscal policy multilaterally are converging, with the idea of preventing another crisis. The rest remains in the hands of national economic authorities, which will have to implement the necessary reforms in product and factor markets and in their economic policies to improve their competitiveness and facilitate internal adjustment in the case of crisis. Reforms that are, in themselves, positive, providing a solution that is not very «community-based» but which, nonetheless, seems to be the only one possible for the present.

This box was prepared by Joan Elias
Research Department, "la Caixa"

German GDP posted 4.8% year-on-year growth in the first quarter, the highest since the reunification of Germany.

The German economy exceeds its pre-crisis level sooner than expected

The favourable expectations of acceleration in the German economy in the first quarter of 2011 were exceeded by the flash figure for GDP growth published by the Federal Statistics Office. In fact, the initial estimate was of 1.5% quarter-on-quarter growth, the largest since the second quarter of 2010. The year-on-year increase in the first quarter of 2011 was 4.8%, the largest since German reunification. The German economy's GDP has therefore exceeded its level prior to the crisis, an achievement only managed by few developed countries.

Although the detailed figures from the national accounts are still not available, it has been announced that investment in capital goods and in construction made a clear contribution, as well as consumption, both private and public. The foreign sector made a positive but lower contribution. It has therefore been confirmed that domestic demand is taking over from the foreign sector as the driving force behind economic activity.

A healthy labour market is supporting consumption. Employment rose by 1.4% in the first three months of the year compared with the same period the previous year. At the beginning of the second quarter, the favourable trend in job creation continued and the BA-X employment demand indicator continued to rise. Within this context, the unemployment rate stood at 7.1% in April, 7 tenths of a percentage point less than twelve months earlier. Although unemployment is not very low, there are cases of unfilled vacancies for highly qualified jobs in some sub-sectors, so that the labour market is expected to resort to Germans abroad or immigration.

In this respect, it should be noted that, as from 1 May, the last restrictions were

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010			2011	
			2Q	3Q	4Q	1Q	April
GDP	–4.7	3.5	3.9	3.9	3.8	4.8	–
Retail sales	–3.2	1.4	0.5	2.6	1.1	0.3	...
Industrial production	–15.4	10.1	12.1	10.3	11.7	12.8	...
Industrial activity index (IFO) (*)	90.7	107.8	106.3	111.1	113.3	114.8	114.2
Unemployment rate (**)	8.1	7.7	7.7	7.6	7.4	7.3	7.1
Consumer prices	0.4	1.1	1.0	1.2	1.5	2.1	2.4
Trade balance (***)	142.8	149.2	150.2	149.9	153.4	153.5	...

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

withdrawn on free circulation in the European Union, and therefore in Germany, for the workers of eight member states: Poland, Hungary, the Czech Republic, Slovenia, Slovakia, Estonia, Latvia and Lithuania, which joined in 2004. This could help to relieve the workforce problems of some segments of the job market, especially when the level of wages in these countries is significantly below that of Germany. In fact, the average wage level for this group of countries, measured in purchasing power parity compared with the German figure, ranged between 67% in Slovenia to 31% in Latvia and Lithuania in 2008, revealing just how attractive the German market could be.

Investment is still dynamic. This is due to the fact that production capacity utilization is above the long-term average given the expected profits, the robust financial situation of firms and low real interest rates in spite of the recent hike by the European Central Bank.

From the point of view of supply, industrial production looks dynamic, up 13.7% year-on-year in February-March. The outlook is favourable given the high level of orders. However, the slowdown in these suggests that industrial production might moderate to some extent over the coming months. For its part, construction has picked up strongly in the first few months of the year after being affected by the bad weather in the previous quarter. Housing demand seems to be assured given the improvement in the labour market and disposable income, as well as the low interest rates. With regard to the services sector, in the first quarter hotels and restaurants increased their real turnover by 2.1% compared with the first quarter of 2010.

Confirmation that domestic demand is taking over from the foreign sector as the economy's driving force.

In the foreign sector, exports benefitted from Germany's good position, especially in the medium technology segment and particularly from the demand of emerging countries. In March, exports of goods reached their highest figure since the Federal Republic was created, with a year-on-year rise of 15.8%. Imports also set a record high and rose by 16.9% compared to March 2010. Consequently, imports are

In March, exports of goods hit the highest level in the history of the Federal Republic.

Favourable prospects for the industrial sector, given the high level of orders.

boosting the growth of other countries, including those in the European Union. In the future, the greater role played by domestic demand will mean that the foreign sector will contribute less to German GDP.

In contrast, inflationary tensions are being recorded. In April, consumer price inflation was up to 2.4%, 0.3 percentage points more than in March and returning to the level of October 2008. Rising prices in the last period were basically due to energy prices. In the last twelve months, service prices rose slightly less, by 1.7%. However, 2 tenths of a percentage point of April's increase can be attributed to package trips, because of the Easter holidays.

We have upped our forecast for growth in German GDP in 2011 to 3.3%.

On the other hand, it seems as if the pull by demand is making it easier for firms to pass on higher costs to their sale prices. Nonetheless, the progress made by productivity will offset wage increases, so that underlying inflation, without fresh foods or energy products, will probably remain contained.

The first quarter's rapid growth in GDP does not seem sustainable. Fiscal consolidation and the disappearance of the rebound effect of the exit to the crisis will tend to slow down economic expansion. In any case, given that it was greater than expected, we have upped our forecast for 2011 to 3.3%. However, this prediction might be revised downwards, perhaps due to further rises in commodity prices or the effects of a possible upsurge in the sovereign debt crisis of the peripheral countries in the euro area.

Investment and consumption lie behind a 2.2% year-on-year growth of French GDP in the first quarter, larger than expected.

France: strong acceleration of economic activity in the first quarter

Activity picked up more than expected in the first quarter of 2011. According to initial estimates, French GDP increased by 1.0% in the first quarter compared with a rate of 0.3% in the fourth quarter of 2010. This growth was boosted by domestic demand as foreign demand, unlike the previous quarter, contributed negatively by 4 tenths of a percentage point, burdened by imports of oil and other manufactured goods. Of note within domestic demand was the strength shown by investment, up 1.1% thanks to the gross fixed capital formation of firms, which increased by 1.9%, especially for information and communication. Household consumption also speeded up but to a lesser extent, due to service costs. Consequently, GDP posted a year-on-year change rate of 2.2%, 8 tenths of a percentage point more than in the fourth quarter of 2010.

The consolidation of the exit to the crisis continues to be seen gradually in the labour market. In the first quarter the number of contracts lasting longer than one month regained its pre-crisis level. Similarly, registered unemployment fell for the third consecutive month in March. To accelerate this improvement in the labour market, in May the government approved a new subsidy for SMEs employing young people under 26 as apprentices or supplementary job experience up to the end of the year. Moreover, it also implemented a new subsidy for job experience contracts for people older than 45.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010			2011	
			2Q	3Q	4Q	1Q	April
GDP	–2.6	1.4	1.5	1.7	1.4	2.2	–
Domestic consumption	0.8	1.0	0.3	1.5	0.4	3.5	...
Industrial production	–12.4	5.2	7.1	4.3	4.8	4.9	...
Unemployment rate (*)	9.5	9.8	9.8	9.8	9.6	9.5	...
Consumer prices	0.1	1.5	1.6	1.5	1.7	1.8	2.1
Trade balance (**)	–49.2	–46.9	–44.8	–49.4	–50.5	–56.0	...

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

Available indicators point to this economic expansion continuing in the second quarter, albeit at a slightly slower rate. The general index of business sentiment continued to rise in April. Industries reported that their investment would increase by 15% annually in value for the year as a whole. The secondary sector appeared buoyant in April. The overall situation seemed to improve in services and also construction. On the other hand, consumer confidence stabilized below its long-term average in April, affected by rising inflation. In this same month, automobile sales fell by 11.1% compared with twelve months before, affected by the withdrawal of aid for purchases in 2011. However, the improvement in the job market will probably support the expansion of consumption over the coming months.

Within this context of more dynamic domestic demand, especially of investment, and given that the greater growth expected in Germany might also boost the French economy, we have raised the growth expected for French GDP for 2011 to 2.2%. However, it should be noted that there are some risks that might lower this forecast, resulting from the slowdown in the global economy being greater than expected.

We have raised our 2011 growth forecast for the French economy to 2.2%.

Italy: *andante, ma non troppo*

The provisional growth figure for Italian GDP in the first quarter of 2011 was in line with expectations: a quarter-on-quarter rise of 0.1%, and of 1.0% compared with the period of January-March the previous year, half a point less than the corresponding year-on-year rate for the fourth quarter of 2010. This modest increase in GDP in the first quarter was due to the good performance of agriculture, as industry and services were relatively flat compared with the previous quarter.

In fact, industrial production fell by 0.1% in the first quarter compared with the previous one, albeit maintaining a 1.9% year-on-year rise, adjusted for calendar effects. However, in March industrial orders were up 8.1% compared with the previous month, resulting from the more dynamic foreign sector, increasing 21.2% in the first quarter compared with the same period last year. We can therefore be somewhat optimistic with regard to the prospects for the secondary sector. In particular, the chemical-pharmaceutical and metal-mechanics sectors hold great hopes of improvement, boosted by foreign demand. With regard to construction, in the first two

Modest increase in Italian GDP in the first quarter.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010			2011	
			2Q	3Q	4Q	1Q	April
GDP	–5.2	1.2	1.5	1.4	1.5	1.0	–
Retail sales	–1.7	0.0	–0.3	0.5	0.0	–0.3	...
Industrial production	–18.7	6.5	9.0	7.5	5.2	2.2	...
Unemployment rate (*)	7.8	8.4	8.5	8.4	8.5	...	–
Consumer prices	0.8	1.5	1.4	1.6	1.7	2.3	2.6
Trade balance (**)	–10.2	–17.1	–13.6	–20.2	–26.7	–33.1	...

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

No signs can be seen of a change in weak consumption but investment looks more promising.

months this posted a very moderate year-on-year increase of 1.0%.

From the point of view of demand, behind the slight growth in activity in the first quarter lies weak domestic consumption. In April, consumer confidence continued to decline due to inflationary fears and the expectations of small wage rises, so that the current feeling of caution is unlikely to change to any great extent. Inflation continued to pick up in April with the year-on-year rate reaching 2.6% in April, 0.1 percentage point more than in March, mostly due to energy prices. Core inflation, without energy or fresh food, was appreciably lower, namely 1.8%.

On the other hand, investment is looking livelier, stimulated by foreign demand. In this respect, exports of goods rose by 18.4% in the first quarter compared with the same period the previous year, although imports rose even further, by 23.1%. However, in volume terms exports increased more than imports. Within this context, the level of employment increased in March by 0.6% compared with the same month the year before. However, the unemployment rate rose one tenth of a percentage point to 8.3%, due to the return to the job market of discouraged workers.

The Italian government approves a package of measures to boost the economy and improve competitiveness.

On the whole, the Italian economy therefore shows some positive signs but these seem insufficient to lead to any significant acceleration in economic activity. Given this situation, in May the government approved a series of measures to boost the economy, but which should not pressurize the state budget, which is currently being consolidated.

Among these decisions to improve competitiveness are tax credits for investment in research, support for tourism, a simpler tax system and a reduction in bureaucracy. This package is undoubtedly moving in the right direction and means that the Italian economy may enjoy greater potential growth but, for the moment, we have not varied our predictions for this year or the next regarding a rise in GDP that is lower than that of the euro area.

The United Kingdom: less growth and more inflation

In reply to criticism for having changed his position regarding monetary policy during the Great Depression, the economist John Maynard Keynes allegedly said that «When the facts change, I change my mind. What do you do, sir?». In fact, when there is more information on an economy, this must be used to adjust the economic growth forecast to ensure it remains a reflection of the main scenario according to those hypotheses that, *a priori*, appear to be the most reasonable.

In fact, the Bank of England itself, in its report on inflation, recognizes that the growth forecasts for the United Kingdom have got worse. This report was published on 11 May, after announcing the growth for the first quarter of the year, which was 0.5% quarter-on-quarter. Although this figure seems good, two provisos should be made. Firstly, the overall balance of the last six months is one of stagnation, because growth in the fourth quarter last year was –0.5%. Moreover, the performance by construction is worrying as, although this could be put down to the bad weather at the end of last year, its drop quickened in the first quarter.

Given the publication of macroeconomic data, and after the nasty shock provided by growth in the first quarter of the year, we have to go back to the drawing board to do our calculations and include the facts in our estimates. And, as we have suggested over the last few months, the GDP growth forecast for 2011 needs to be reduced from 2.1% to 1.6%.

What are the reasons for changing our forecast? There are several, but the most important ones are: less dynamism in private consumption, public spending cuts, lower investment and exports that will not offset lower domestic demand. The economic situation is delicate enough for several supranational organizations to advise the British government to slow up the pace of its fiscal adjustment. And a large part of the cuts in public spending is likely to be concentrated in the second quarter.

The Bank of England recognizes the deterioration in the United Kingdom's growth profile.

Fiscal adjustment, the logistics crisis in supplies and additional bank holiday will cut growth in the second quarter.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010			2011	
			2Q	3Q	4Q	1Q	April
GDP	–4.9	1.3	1.5	2.5	1.5	1.8	–
Retail sales	1.0	0.4	0.8	0.7	–0.1	2.5	2.8
Industrial production	–10.1	2.1	1.5	3.0	3.3	2.5	...
Unemployment rate (1)	4.7	4.7	4.6	4.6	4.5	4.5	4.6
Consumer prices	2.1	3.3	3.4	3.1	3.4	4.2	4.5
Trade balance (2)	–86.8	–88.7	–85.4	–90.6	–95.5	–97.3	...
3-month Libor interest rate (3)	1.2	0.7	0.7	0.7	0.7	0.8	0.8
Nominal effective pound exchange rate (4)	73.9	80.4	78.2	81.5	79.3	79.2	78.6

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 April, inflation rises by 4.5% year-on-year.

In addition, there are two more minor but still relevant issues that will also hinder growth in the second quarter. The first is the impact of the interruption in the logistics chain of industrial components after Japan's earthquake and tsunami. The second is the economic impact of the royal wedding. Evidently, the additional bank holiday will have helped the economic sectors of hotels and restaurants but this won't be enough to offset the lower economic activity for the country as a whole. In summary, the impact of the fiscal adjustment plan, the logistics crisis in supplies and the additional bank holiday will restrict growth in the second quarter.

On the other hand, prices are not helping households, which have seen their real disposable income fall over the last three years due to the rise in inflation being greater than wage increases. For example, in April inflation rose from 4% to 4.5% year-on-year. A situation that explains why three of the nine members of the Bank of England, at their monetary policy meeting, voted in favour of raising the official interest rate, currently at 0.5%. According to the meeting's minutes, the rest of the members preferred to keep the rate at its present level to avoid harming consumer confidence as, within such a tough context, it would be hard hit by higher financial costs.

In short, having included the economic information for the last few months in our forecasts, we can conclude as follows: the United Kingdom's economic growth profile has deteriorated, which will also be accompanied by higher inflation.

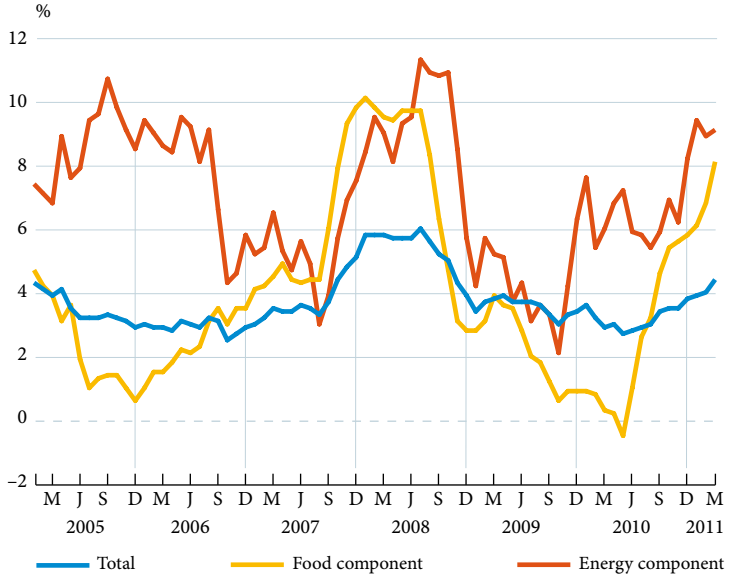
The expansion in activity holds firm in emerging Europe.

Emerging Europe: inflation and public deficit, risks on the horizon

Overall macroeconomic performance continues to be positive in emerging Europe. After nearly two years of evident

INFLATION CONTINUES TO CLIMB

Year-on-year change in the harmonized consumer price index, weighted average for Poland, the Czech Republic, Slovakia, Hungary and Romania



SOURCES: Eurostat, Thomson Reuters Datastream and own calculations.

recovery, activity indicators such as economic sentiment continue at clearly expansionary levels. This reactivation is widespread, as it includes all economies in the region and, in particular, the five countries we regularly single out in this report: Poland, Hungary, Romania, the Czech Republic and Slovakia. In all cases there is notable industrial and export dynamism, a direct result of expansion in the euro area. Consequently, and providing the scenarios we are using for the euro area come about, the forecasts for activity are positive for the rest of the year. Nonetheless, two aspects are clouding these encouraging prospects. Although they are hardly new, as they have been giving out warning signals for some time now, the trends in inflation and public finances are not entirely encouraging.

With regard to the first of these risks, the levels reached at present take on some importance. As can be seen in the graph below, the shock of energy and food commodity prices has been firmly passed on to the corresponding components of the consumer price index. Although the general index moderates these effects, its rate of year-on-year growth, 4.4% for the weighted average of the aforementioned five economies, is tending towards the higher end of the inflation targets set by the central banks as a reference. And we do not expect prices to take a different path in the near future given that, in spite of the recent correction in commodity prices, prices at origin continue to be notably high.

When we combine the fact that the recovery is progressing with the evidence that inflation is increasing its pressure, it's logical for the central banks to start rethinking the accommodating monetary policy they followed when the 2008-2009 crisis erupted. The four countries that still have monetary sovereignty (not the case of Slovakia, a member of the euro area) are going to change their monetary policy in 2011. Poland, in fact, has been doing so since the start of the year and, in the first five months of 2011, has raised its reference interest rate to 4.25%, compared with 3.75% at the end of 2010. The forecasts suggest that this level will be 4.75% by the end of the year. A similar hike is likely in the Czech Republic. Although it has yet to make a move, its central bank is expected to raise its reference rate by 50 basis points, from 0.75% to 1.25% this year, almost definitely starting to tighten up its policy in the summer.

The remaining two countries, Hungary and Romania, should join the monetary normalization movement towards the end of 2011. This delay can be explained by the fact that these two economies have had to undergo notable fiscal consolidation and that, consequently, their recovery is slower and less solid than their neighbours in the region. By December 2011, Hungary might have placed its reference rate at 6.25% (up 50 basis points compared with the end of 2010) and Romania at 6.50% (up 25 basis points compared with December 2010).

The contained response by these central banks, understandable in the last two cases, is less justified when other imbalances are added to the pressure from prices. In particular, last year Poland and Slovakia seemed unwilling to adjust their economies in fiscal terms. As a result of an expansionary spending policy, and in spite of the good cyclic trend for revenue, in 2010 both countries saw their public deficit rise to around 8% of gross domestic product (GDP).

These are high figures in a region that had tended to present its budgetary orthodoxy as a key means of gaining

Inflationary pressure is increasing, resulting from rising commodity prices.

Throughout 2011, the region's central banks will start to normalize their monetary policy.

Of concern is the level of public deficit of Poland and Slovakia, two economies that will attempt to adjust their spending in 2011.

credibility in terms of macroeconomic stability. Although, to date, the trend in country-risk indicators has revealed a relative benign perception on the part of the financial markets regarding this issue, as shown by these countries being completely unaffected by the different episodes of financial uncertainty due to the sovereign debt crisis of the euro area's peripheral countries, the plans of the respective governments clearly point towards the start of the necessary fiscal consolidation in 2011.

In the case of Poland, in the government's update of its convergence programme it announced, in a document that contains the budget scenario up to 2014, that the public deficit would fall to 5.6% of GDP in 2011, compared with 7.9% in 2010. The consolidation should not stop here as the government hopes that, in 2012, the budget imbalance will be 2.9%. In our opinion, while the fiscal adjustment for 2011 seems to be a considerable but feasible target, reaching the target set for 2012 requires too much willpower and the difference between public expenditure and revenue is more likely to be around 4% of GDP. The budget projections for Slovakia are along similar lines. In its last stability programme, the Slovak government proposed going from a deficit of 7.9% of GDP in 2010 to 4.9% in 2011 and 3.8% in 2012. These are feasible scenarios, albeit notably demanding in terms of the current budgetary exercise. The budget challenge in both countries is therefore as ambitious as it is peremptory.

FINANCIAL MARKETS

Monetary and capital markets

Slowly overcoming the crisis

Now coming to the middle of the year, the financial markets are performing within a general situation marked by moderately satisfactory prospects of world growth, expansion in the corporate earnings cycle, the gradual withdrawal of policies to stimulate the economy and the laborious healing of the wounds inflicted by the 2008-2009 crisis. However, the stability of the financial scene is being thoroughly tested by the appearance of some adverse shocks (the Middle East conflicts and the earthquake in Japan), as well as the repercussions and side effects of that crisis (particularly Europe's sovereign debt tensions and the distortions created by abundant liquidity).

The repercussions and side effects of the crisis are still being felt in the markets.

The ECB pauses interest rate hikes while the Fed maintains its line

Reviewing the different elements of the current economic situation, we can conclude that the growth cycle at a global level is in a phase of consolidation: the pace is slowing up but the foundations are being laid. The extent to which this is happening varies according to the geographical area and country, in first place being the emerging countries, followed by the United States and Europe. As economic activity has risen, so have inflationary pressures and, as a consequence of the events occurring in the Middle East and Japan, these have been felt via rising commodity prices. Given this situation, most monetary authorities have started to normalize their monetary policies, with the notable exception of the Federal Reserve.

In the United States, the leading monetary authority continues to remain relatively optimistic. After its last regular monetary policy meeting, the Chairman of the Federal Reserve (Fed), Ben Bernanke, commented that, according to the economic data available, it could be said that the US economic recovery is still «proceeding at a moderate pace». In reference to inflationary risks, he stated that, although the Fed had identified a slight increase in long-term inflation expectations, most members believed this was temporary in nature and did not threaten price stability.

Growth is consolidating unevenly and at a gentle pace, but with good foundations.

However, the reason for maintaining official interest rates at their current levels (0%-0.25%), and which augurs a long period of lax monetary policy, is the predominant weakness of the labour market and job creation. He also confirmed the Fed's intention to finalize quantitative easing at the end of June. By continuously repeating this message, the Fed hopes that its effect on debt markets will be moderate when the time comes. Also, and as anticipated by the public statements made by some of the Fed's members, the last meeting revealed the preference for an «exit strategy» in which hikes in the official interest rates would take place before the Fed starts to sell off its assets.

The Fed continues to prioritize the recovery in the labour market but without ignoring inflation.

For its part, in the euro area the European Central Bank (ECB) kept the reference

The ECB is monitoring inflation developments «very closely».

interest rate at 1.25%, after the hike in April. Given the words used by J. C. Trichet, the message transmitted by the institution, which is totally committed to safeguarding price stabilization by containing inflation expectations and wages, hinted at a slight slowdown in the normalization process. Although there's no doubt that inflation trends will continue to be carefully monitored, the words used to describe this were different from previous months: «very closely» instead of «strong vigilance». This was reason enough for economists and investors to rule out that the toughening up of monetary policy would be slower than initially expected.

The consensus of analysts estimates that the next official interest rate hikes, very likely in tranches of 25 basis points, might be in July and in the last quarter of the year. However, the president of the European Central Bank insisted that there are still inflationary risks in the current economic scenario, and all the monetary policy is needed to combat them. With regard to non-conventional monetary policy measures, the ECB will keep the terms unchanged for its liquidity facilities in the second quarter, although analysts expect that, as from this date, and coinciding with the normalization of official interest rates, the conditions for granting three-month

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									
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	1.25	1.35	2.12	0.25	0.27	0.20	0.50	0.82	0.24
May (1)	1.25	1.43	2.15	0.25	0.26	0.20	0.50	0.82	0.27

NOTES: (1) May 23.

(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.

loans may be modified, returning to the system of competitive auctions and variable interest rates.

In the case of the emerging countries, their monetary scenario is determined by their advanced position in the economic cycle. These economies, which successfully evaded the world economic recession two years ago, have been the first to suffer the effects of growing inflationary pressures. That's why their central banks are focusing their efforts on developing monetary policy strategies to control the expansion of credit and avoid the dangerous signs of economic overheating, as is happening in China, for example.

In order to carry out this control, authorities are resorting to the usual hikes in official interest rates and also to a wide range of measures whose aim is to limit the volume of money and credit. The most representative case is China, whose central bank has once again raised the mandatory reserve ratio for banks (up to 21%) and has applied administrative regulations to contain credit. Whether monetary policy in these countries can successfully get back to normal will largely depend on how stable commodity prices remain over the next few months.

Given this scenario of monetary normalization at differing speeds in different countries, the interbank markets have evolved in line with the expectations of investors regarding the actions of the different central banks: stability in the United States and a slight drop in the euro area. We should note that, over the last few months, these markets have performed very well in terms of risk premia for credit and liquidity. In fact, the premia included in the Libor and Euribor rates for these concepts have risen due to events as serious as the worsening of the sovereign debt crisis in Portugal and Greece. The Libor interest rate in dollars is likely to continue falling over the next few months, following the same pattern of stable behaviour, thanks to the Fed continuing its lax policy. In the euro area, the pause in the official interest rate hikes by the ECB has helped to temporarily relieve pressure on the Euribor twelve-month rate, which will probably start rising again in the second half of the year.

Analysts believe the ECB might raise the official rate again in July.

New episodes of volatility in public debt

In May, the domestic yields for the investment grade public debt continued to fall, specifically that of the United States and Germany.

Like other emerging economies, China continues to restrict its monetary policy to contain domestic credit.

In the case of the United States, the yields for two and ten-year public debt fell to 0.58% and 3.22%, respectively at the end of the month (at the beginning of April these were at 0.85% and 3.60%). There are two key factors behind this drop (which entails a rise in the bond price). On the one hand, the nasty shock provided by some figures on activity, leading to greater uncertainty regarding how sustainable the growth rate will be in the long term. On the other, the sharp correction in commodity prices given the slowdown in expectations for global demand and the withdrawal of speculative positions in precious metals. In addition, within today's US financial context there are some particularly important atypical issues whose development over the coming months, in addition to increasing market volatility, will also affect the interest rate curve.

The yields for Germany and the United States continue to fall in May.

A resolution of the Greek crisis could reverse part of the «flight to quality».

The first is the end of the Fed's QE2 (quantitative easing programme), which has substantially supported the markets since it started last November. The second, related to the first, is the «exit strategy» the Fed will announce once the QE2 has ended. And thirdly, but no less importantly, the pressing budgetary adjustment. On 16 May the US Treasury reached its debt ceiling (14.3 trillion dollars), making financing difficult for the government until Congress agrees a new fiscal plan that includes either an increase in the tax burden or an increase in the debt limit.

Growth and inflation in Germany point towards higher yields in the future.

In the euro area, the public debt of central countries performed similarly to the United States. In the case of Germany, at the end of May the yield for 10-year bonds reached 3.0%, compared with 3.50% at the beginning of April. An important factor in this development is the «flight to quality» caused by the worsening of the crisis in Greece and the fear that this might infect other economies in the region. Given that we expect this factor to be temporary in nature, and taking into account the underlying upward trend in economic growth and inflation, the bulk of the evidence available suggests that the two and ten-year yields for German debt might start rising again over the coming months.

For its part, the latest news concerning the sovereign debt crisis of peripheral Europe has significantly widened the differential between the debt of those countries involved and German debt. After Portugal's bail-out was agreed (with a package of 78 billion euros), the worsening of the Greek crisis presents

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								
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	3.35	3.71	5.30	4.82	3.47	1.26	3.69	1.96
April	3.31	3.64	5.47	4.74	3.41	1.24	3.58	2.06
May (*)	3.01	3.40	5.51	4.81	3.13	1.14	3.30	1.82

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

itself as the main obstacle, given the current lack of an agreement to sort it out. While the Eurogroup prefers reprofiling (extending the maturities for the public debt), the ECB rejects this proposal and has suggested granting new loans, with the condition that Greece redouble its adjustment efforts. In the case of Spain this circumstance, as well as the downgrade by rating agencies for Italy's and Belgium's economic outlook, has led to its risk premium going back up to March's level (close to 270 basis points). However, and in spite of these temporary upsurges in tension, the spread between Spanish and German debt has remained relatively stable over the last few months, a trait that differentiates Spain's economy from the rest of those countries that have been bailed out.

The dollar gains against the euro

Portugal's bail-out has been approved but the ECB does not believe Greece's debt should be reprofiled.

Events occurring in May on the global economic scene have led to a sudden change in direction for the dollar-euro exchange rate. At the beginning of the month, the dollar was at a minimum (reaching 1.48 dollars per euro) given the start of the ECB's normalization of its monetary policy (remember the official interest rate hike in April), thereby pushing investor flows towards assets held in euros. But, subsequently, various factors have resulted in the dollar making a rapid recovery. Firstly, the greater financing difficulties for Greek debt. At the peak of speculation regarding the possible solution for the Greek crisis, when talk even turned to this country leaving the single currency, the euro sank

Sudden appreciation in the dollar.

EXCHANGE RATES OF MAIN CURRENCIES

May 25, 2011

	Exchange rate	% change (*)		
		Monthly	Over December 2010	Annual
Against US dollar				
Japanese yen	82.2	0.4	1.3	–9.9
Pound sterling	0.618	–1.9	3.6	10.9
Swiss franc	0.879	–0.3	–6.5	–32.0
Canadian dollar	0.977	2.3	–2.1	–8.7
Mexican peso	11.694	0.8	–5.5	–11.4
Against euro				
US dollar	1.413	3.1	–5.6	–14.2
Japanese yen	116.1	–2.8	6.5	3.7
Swiss franc	1.241	–3.5	–0.8	–15.5
Pound sterling	0.872	–1.3	1.7	1.7
Swedish krona	8.936	0.4	–0.6	–9.1
Danish krone	7.457	0.0	0.0	0.2
Polish zloty	3.951	0.1	–0.3	–3.9
Czech crown	24.56	1.9	–1.9	–3.9
Hungarian forint	269.4	1.6	–3.4	–3.3

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

The dollar has been boosted by Greece's financial fragility and the correction in commodities.

by almost 4% against the dollar. In addition to this factor, which made the US currency into a safe haven, the dollar's appreciation has also been boosted by the fall in commodity prices. Over the coming months, volatility will probably continue to increase in this market, related to the developments in the European sovereign debt crisis and to the fiscal adjustment in the United States; but in any case, and as the interest rate spread narrows between the Fed and the ECB (this is likely to begin once the QE2 ends), the most probable trend will be a gradual appreciation of the dollar.

Corporate bonds stand firm against financial turbulence

The corporate bond market has not been affected by the financial turbulence.

As already happened after the dramatic events of February and March (the Middle East and Japan), the corporate bond market has once again stood out for its strength and stability in the face of turbulence in the financial scenario over the last few weeks. This market's good performance is in particular contrast to the volatility and vulnerability shown by global stock markets, which partly explains the (at least temporary) flight of many investors to securities with a less risky profile.

The current recovery in the world economy provides corporate bonds with two pillars to support the upward trend in its indices, in evidence since last year. The first pillar is made up of the good solvency and profitability ratios enjoyed by large western companies on the whole. The second concerns the better credit ratings given by rating agencies within a scenario with a falling risk of bankruptcy. Neither should we forget the benefits provided by the lax monetary policy in the United States: excessive liquidity makes corporate bonds more attractive

HIGH YIELD BONDS CONTINUE TO TAKE PRIDE OF PLACE

5-year CDS Markit itraxx indices

SOURCE: Bloomberg.

compared with the low returns offered by US Treasury bonds. The result is that, month after month, the total return indices for corporate bonds continue to hit new highs, both in investment grade and high yield bonds, whose improved volumes are consolidating the attractiveness of their returns.

In the euro area, where the corporate bond market is not as developed as in the US, the upsurge in the Greek crisis has not prevented risk premia from falling slightly, even those related to the financial sector (which has continued to issue a large number of bonds).

Over the coming months, however, there are several aspects that might make these markets more volatile. For example, the end of the Fed's monetary stimuli and the publication of the stress test results on Europe's banks.

Stock market prices are also affected by adversity

The recent performance of the main stock markets has been determined by a series of opposing forces, leading to erratic movements in most of them. In contrast to the good corporate cycle (as shown in the latest corporate earnings season in the United States and Europe), several worrying aspects have also arisen related to rising commodity prices, monetary tightening in emerging economies, the absence of a fiscal agreement in the United States and the worsening of the Greek sovereign crisis.

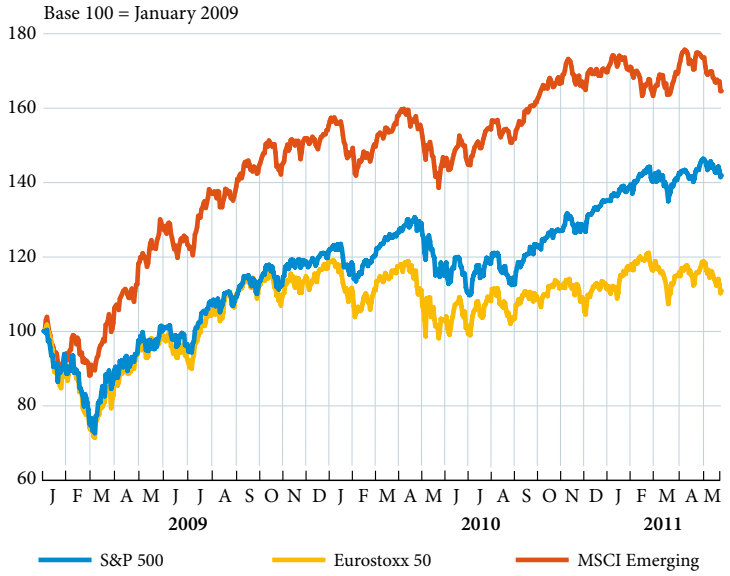
Confident that, in the medium and long term, the global consolidation of economic and business growth, as well as the reduction in credit risk, will boost equity, in the short term the scenario seems to suggest, however, a continued

Economic recovery and lax monetary policy underpin the good performance by corporate debt.

Good business results are not enough to boost stock markets.

STOCK MARKETS SHOW WEAK, IRREGULAR PERFORMANCE

Stock market indices



SOURCE: Bloomberg.

The end of the QE2 might increase volatility and reduce the appetite for equity.

weakness and irregularity in the stock markets that might lead to corrections in the main indices.

The most evident case can be seen in the US stock markets where, in addition to the high degree of overbuying observed in technical indicators, there are also the adverse signs provided by indicators of sentiment, flows and seasonality. Moreover, current issues such as the imminent completion of the QE2 and the absence of a budgetary adjustment plan might push up volatility again and decrease the appetite for risk. In the euro area, although future expectations regarding the sovereign debt crisis are favourable, the recent worsening of the Greek crisis has led to a feeling of exhaustion in the markets, given the reform measures applied and a greater fear of infection, dampening investors' mood. This is particularly affecting the financial sector, hindering those stock market indices in which they predominate, such as the Ibex 35. Lastly, observing the stock market developments of emerging economies, we can state that the risk of correction has started to gradually appear with the tightening up of monetary and fiscal measures in these different countries. This circumstance, together with a possible controlled slowdown in their economic growth rates, suggests these indices are unlikely to rise much this year.

The financial sector is key to Europe's stock markets.

INDICES OF MAIN WORLD STOCK EXCHANGES

May 25, 2011

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*12,411.2*	*–0.8*	*7.2*	*23.3*
Standard & Poor's	*1,322.0*	*–1.1*	*5.1*	*23.1*
Nasdaq	*2,764.6*	*–2.0*	*4.2*	*24.9*
Tokyo	9,477.2	–2.1	–7.3	–2.9
London	5,873.7	–2.4	–0.4	15.9
Euro area	2,810.0	–4.3	0.6	9.8
Frankfurt	*7,186.3*	*–1.5*	*3.9*	*23.8*
Paris	*3,924.5*	*–2.4*	*3.1*	*14.4*
Amsterdam	*344.4*	*–4.1*	*–2.9*	*9.8*
Milan	*20,586.5*	*–5.6*	*2.0*	*8.2*
Madrid	*10,126.3*	*–4.3*	*2.7*	*9.0*
Zurich	6,456.5	0.0	0.3	4.0
Hong Kong	22,730.8	–5.8	–1.3	15.6
Buenos Aires	3,323.1	–2.7	–5.7	56.5
São Paulo	62,929.4	–6.2	–9.2	5.0

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

Sovereign wealth funds: can they be used to generate stability?

The debate regarding global imbalances has given rise to the proliferation of a large number of articles, both academic and from the financial press, dedicated to analyzing the origin of these imbalances and their repercussions in economic and financial terms. One characteristic element in «surplus» countries is the relentless rise in foreign net assets, held by both the private and the public sector. According to the factors that, over the last few years, have led some countries to accumulate an abnormally high amount of foreign reserves, we can identify two large groups. The first is made up of states that are rich in natural resources, which have benefitted from the high prices for oil and other commodities. The second contains some emerging countries, mainly Asian, that have maintained undervalued currencies, leading to high current account surpluses and accumulating net assets with the rest of the world.

Traditionally, foreign reserves have been accumulated for reasons of security; i.e. to be able to defend or reduce the volatility of the national currency against any upsets of an external or internal nature. Consequently, usual practice has been to maintain reserves in the form of assets with maximum security and liquidity (typically the short-term public debt of highly solvent countries). During the recent experience, and as the economic authorities of these two groups of countries mentioned above started to feel comfortable with the threshold reached by their reserves, the appropriateness of this strategy has been questioned.

ASSETS OF THE MOST IMPORTANT SOVEREIGN WEALTH FUNDS VS. FOREIGN RESERVES

Data at December 2010 and given in trillions of dollars

	Country	Total assets	Foreign reserves	Year created
Abu Dhabi Investment Authority (*)	UAE	627	42	1976
Government Pension Fund – Global (*)	Norway	512	50	1990
SAMA Foreign Holdings (*)	Saudi Arabia	439	432	n/a
SAFE Investment Company	China	347		1997
China Investment Corporation	China	332		2007
National Social Security Fund	China	147	2,847	2000
Hong Kong Monetary Authority Investment Portfolio	Hong Kong	259	269	1993
Government of Singapore Investment Corporation	Singapore	248		1981
Temasek Holdings	Singapore	133	226	1974
Kuwait Investment Authority (*)	Kuwait	203	19	1953
National Welfare Fund (*)	Russia	143	444	2008
Qatar Investment Authority (*)	Qatar	85	30	2005
Libyan Investment Authority (*)	Libya	70	97	2006
Australian Future Fund	Australia	67	28	2004
Revenue Regulation Fund (*)	Algeria	57	161	2000
Other		481	–	
Total		**4,150**	**4,645**	

NOTE: (*) Funds associated with the trend in commodity prices.
SOURCE: SWF Institute.

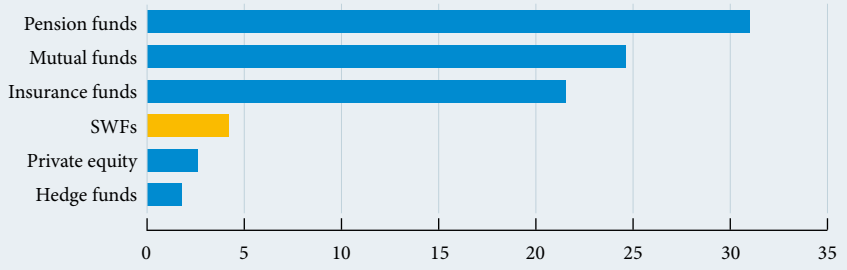
Specifically, it has been wondered whether it is suitable to continue managing such a large stock of reserves so conservatively (obtaining a low yield) or whether it would be better to manage part of this stock with a different approach, so that greater risks could be taken in exchange for higher returns. Within a context characterized by the economic boom in these countries, many have opted to change their management parameters, assuming a market view aimed at increasing their traditional returns. This decision explains the significant rise observed in the creation and expansion of *sovereign wealth funds (SWFs).*

Contrary to appearances, SWFs are not new but date back to 1953, the year when the «*Kuwait Investment Board*» was set up with the aim of investing the surplus generated by oil sales and of thereby reducing dependence on crude. Formally, SWFs are state-owned «vehicles», companies that make it possible to maintain, manage and administer assets in order to achieve financial targets by implementing different investment strategies.

Over the last few years, the appearance of a large number of organizations of this kind has been accompanied by huge growth in the volume of assets under management, which is why their actions have not gone unnoticed in the global markets. At present, SWFs rival hedge funds and private equity firms both in terms of their influence on financial markets and their media impact. The figures speak for themselves. In 2000, SWFs held assets valued at more than 1.1 trillion dollars. At the end of 2010, the total financial assets of the most important SWFs reached 4.2 trillion dollars (2.3 times the amount managed by hedge funds and 1.6 times that managed by the private equity industry).

GLOBAL INVESTMENT: TOTAL ASSETS UNDER MANAGEMENT

Data at December 2010 and given in trillions of dollars



SOURCE: SWF Institute.

The purpose for which SWFs are set up, as well as how they operate and are financed, can vary depending on each country's circumstances. Stabilization funds are created by countries rich in natural resources in order to «immunize» the national economy from the high volatility typical of commodity prices. In other words, these funds are countercyclical fiscal instruments that attempt to create a more stable cash flow in the future to be able to handle any prolonged fall in the price of, for example, copper (Chile) or oil (Algeria, Kuwait, Qatar, etc.). In general, these funds are set up when the resource's price is high.

However, governments set up savings funds in order to create long-term wealth and distribute it among different generations. At first, savings from non-renewable resources are transferred to these vehicles to form a diversified portfolio that helps to achieve the goals for which they were designed.

Another very important type are reserve sovereign funds for state pensions. These companies are set up in order to manage asset portfolios used to offset possible government deficits that would prevent it from meeting the pension payments of retired workers.

Lastly, there are also mutual funds (used to manage the reserves and therefore counted as reserves) and development funds (dedicated to financing high priority socio-economic projects).

Although SWFs may differ in their nature, they all have one thing in common: a marginal level of leveraging. This is because their financing comes from various official sources. For example, current account surpluses (resulting from the export of commodities or manufactured goods), fiscal surpluses or income from privatization. Those institutions whose main source of financing comes from income from the export of oil, gas or other minerals are known as «Commodities SWFs» (CSWFs), while those financed through direct transfers from official foreign reserves and, in some cases, via allocations from surplus government budgets or privatization are called «Non-Commodities SWFs» (NCSWFs).

However, the investment strategies and risk management carried out by SWFs usually vary, irrespective of the origin of their financing, and they will be designed to accomplish the mandate for which they were created. The point of reference is provided by the central banks, which invest their foreign reserves conservatively in low risk, highly liquid assets, for example government bonds with a high credit rating (AAA) or precious metals such as gold, whereas SWFs look to diversify their portfolios in terms of asset type and region to secure higher yields. Among the instruments they invest in are long-term sovereign debt, municipal bonds, mortgage-backed securities (MBS), corporate bonds and equity. Moreover, they frequently make use of professionals from the private financial sector to take up relevant positions (with a long-term perspective) in companies operating in a range of sectors.

Although the data published by most SWFs do not provide exhaustive details, they do give a general idea of the strategies implemented. This indicates that CSWFs adopt a long-term approach and have a clear preference for equity and alternative investments. On the other hand, NCSWFs make shorter term investments, given that the assets selected must be liquid enough to be able to handle any liquidity problem the government may have. For this reason, NCSWFs prefer to invest in US Treasuries or similar assets.

The investment made by SWFs over the last few years, particularly in 2008-09 when the financial crisis was at its worst, have led to some doubts being raised. Firstly, some are concerned about the size of these funds and therefore

ASSETS IN WHICH SOVEREIGN WEALTH FUNDS INVEST

Percentage of funds invested in each asset

	2010	2011
Listed shares	79	85
Debt instruments	79	76
Unlisted shares	55	59
Real estate sector	51	56
Infrastructures	47	61
Hedge funds	37	36

SOURCE: Prequin.

their ability to influence the price of certain financial assets. Secondly, some critics point towards the possible use of their financial power in favour of nationalist interests (national champions). Lastly, some argue that these funds could take control of strategically important firms and, instead of pursuing financial or commercial gain, might pursue national political interests.

In general, the studies carried out by different authors and organizations reach more encouraging conclusions and, in some cases, minimize the arguments of the most critical analysts. The first general conclusion that can be reached is that the authorities of receiving countries must pay close attention to the different actions taken and ensure that acquisitions are carried out with the utmost transparency. Secondly, when the performance of SWFs is analyzed, no evidence is found to suggest the existence of significant impact resulting from a conduct due to reasons other than economic . Thirdly, these studies suggest that the main motivation behind SWFs' investment is fundamentally financial . Lastly, the very characteristics of these agents (investors with very little leveraging and a long-term focus) suggest that their involvement in a company's capital is a factor that can promote stability rather than destabilizing the firm. In general, when they invest in companies they usually sit on the Board of Directors, maintain fluid communication with the company directors and, if necessary, undertake to reorganize these firms.

Consequently, perhaps rather than being excessively concerned, governments should act with diplomacy so as not to frighten off a potentially good investor.

(1) Beck, R. and M. Fidora (2008). «The impact of sovereign wealth funds on global financial markets», Occasional Paper Series, no 91, European Central Bank.
(2) OECD Development Centre (2009). «Are sovereign wealth funds' investments politically biased? A comparison with mutual funds».

This box was prepared by Eduardo Pedreira
Financial Markets Unit, Research Department, "la Caixa"

SPAIN: OVERALL ANALYSIS

Economic activity

Spain's GDP advances more than expected, although partly boosted by public expenditure

The data from the National Accounts system for the first quarter of 2011 show that economic activity continued its gentle recovery. Gross domestic product (GDP) grew by 0.3% in the first quarter of 2011, placing year-on-year growth at 0.8%, two tenths of a percentage point above the figure recorded for the previous quarter.

This rise in GDP was better than expected thanks partly to the increase in public expenditure, up 1.4% in the quarter, vastly exceeding our expectations. However, the data for household consumption and investment in capital goods showed complete stagnation. The weak consumption of households was already partly to be expected given the trend in retail sales, which fell again in the month of March, placing the year-on-year rate of change at –8.7%. With regard to investment in construction, this continued to fall, albeit at a slower rate. As a whole, therefore, domestic demand's contribution to year-on-year growth ended up as negative, deducting six tenths of a percentage point. This means that, as expected, the foreign sector was the engine of GDP growth in the first quarter of the year.

Of note, however, is the disparate role played by exports between goods and services. While exports of goods rose very significantly, services fell in spite of the good performance by tourism, pointing towards a substantial fall in exports of non-tourism services. The significant growth in goods exports coincides with the improvement in the industrial production of intermediate and equipment goods, which tend more towards foreign markets, observed during the first three months of 2011. On the other hand, the data show a significant fall in the industrial production of consumer goods, particularly durables.

GDP grows by 0.3% quarter-on-quarter from January to March 2011.

Given the trends in the different elements of GDP from January to March and available indicators, the reactivation of the economy looks likely to slow up a little in the second quarter. Firstly, pressure on household consumption is still great, as reflected in the erratic recovery in the consumer confidence index, whose trend has remained very flat over the last few quarters. In this respect, if inflationary pressures persist, they will continue to hinder the recovery in disposable income. Interest rates are also likely to rise gradually. The poor trend in employment isn't helping either. In the first quarter, this fell by 1.4% year-on-year in terms of full-time equivalent jobs. However, the situation in the labour market is expected to ease a little in the second and third quarter. Given all these variables, consumption is likely to progress over the coming quarter, albeit very slowly.

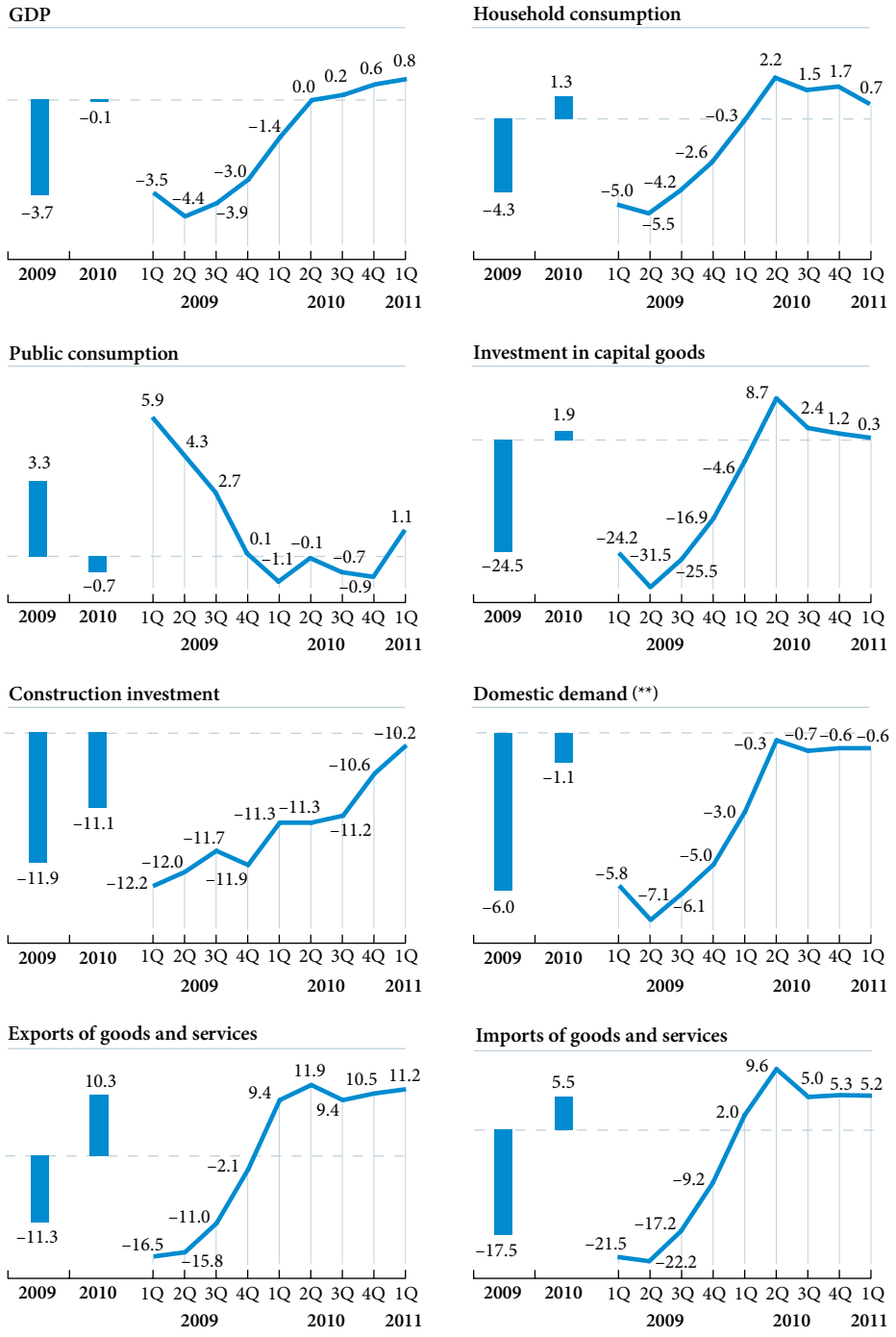
Public consumption increases while private remains stagnated.

Secondly, the increase in public expenditure of the first quarter is unlikely

The recovery is expected to run out of steam in the second quarter.

TREND IN SPAIN'S GDP BY COMPONENT

Percentage year-on-year change (*)



NOTES: (*) Data adjusted for seasonal and calendar effects.
(**) Contribution to GDP growth.
SOURCE: National Institute of Statistics.

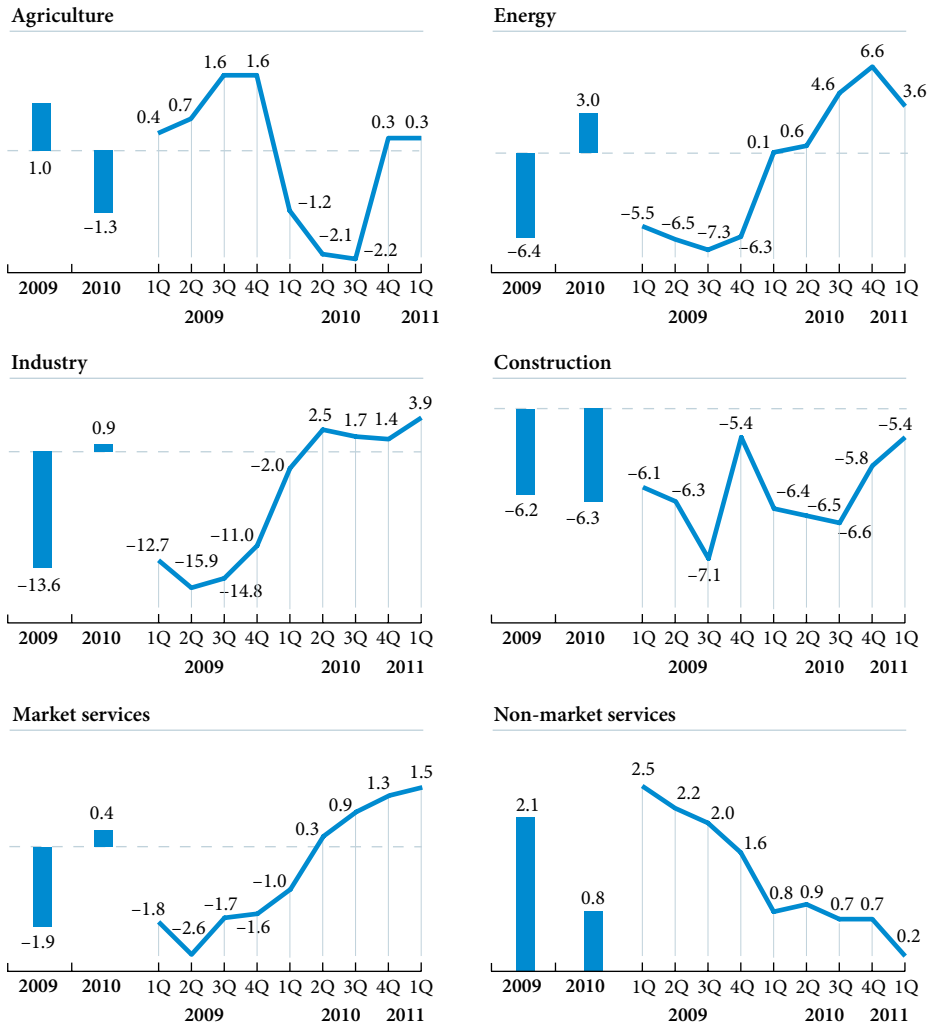
to be repeated in the rest of the year, given the government's firm commitment to reduce the deficit, reflected in the Update at the end of April of the Stability Programme for the period 2011-2014. Certainly, the reduction in the deficit throughout 2010 led to a decline in public consumption of 0.7% year-on-year. So if the target deficit cuts are achieved this year, this will mean that public expenditure will probably fall sharply over the coming quarters.

The limited progress made by household spending and weak trend in public expenditure will not revive investment. In particular, the better performance of investment aimed at the production of goods will not be enough to offset the fall in investment in construction. Nonetheless, indicators as a whole point towards the construction sector slowing up its rate of decline, as noted by the slight improvement in confidence in construction in the month of April.

Public consumption will probably slow up over the coming months.

TREND IN SPAIN'S GDP BY SUPPLY SECTOR

Percentage year-to-year change (*)



NOTE: (*) Data adjusted for seasonal and calendar effects.
SOURCE: National Institute of Statistics.

The net external balance will contribute positively to GDP growth in 2011.

In short, given the poor trends expected in the main components of domestic demand, the capacity to recover will be at the mercy of the foreign sector. In this respect, the fact that Europe's non-peripheral countries have enjoyed high growth rates in the first quarter improves the prospects for exports and the volume of tourists in the coming months. Exports should therefore continue their positive trend. For their part, imports should also increase but more moderately, so that the net external balance should make a notable contribution to GDP growth.

To determine the economy's potential growth in the medium term, it's important to observe how productivity indicators are performing. The data from the National Accounts system provide a mixed view of this area. Although apparent productivity per equivalent job rose by two tenths of a percentage point to 2.2%, this variable per effective hour worked fell by more than one and a half points to 0.5%, so that there was no clear improvement. For their part, unit labour costs continued to fall, albeit at a slower rate.

But the main risk is the slowdown in exports, the great push behind the recovery.

To sum up, although the recovery seems to be on the right track, with the prospect of positive growth for the year as a whole, uncertainty is still high. On the one hand, one of the notable risks is the possibility of inflationary pressures continuing due to rising commodity prices, something that would result in a loss of competitiveness for firms and a loss of purchasing power for consumers. The former would jeopardize the boost provided by exports while the latter might slow up the recovery in purchases on the part of households. Another unfavourable factor is the fiscal adjustment being carried out by the government, which means that public consumption will fall considerably in the rest of the year, especially in the second half.

The sustainability of an external deficit

When a country spends more than it produces and its external current account is therefore in deficit, this excess expenditure must be financed by net inflows of foreign capital. These inflows generate liabilities with the rest of the world, for example in the form of foreign debt, and obligations associated with these liabilities, such as interest and principal payments. One way of judging whether an external deficit is sustainable is to evaluate whether the country can meet its future payment commitments.

As an economy's ability to pay is determined by its income level, this condition means that the level of external debt (strictly speaking, the net liability position) must not be too high in relation to GDP. The maximum level that can be sustained safely has risen with the greater financial integration resulting from globalization, but this still varies from country to country, depending on factors such as the composition of its liabilities, how open it is to foreign trade and the quality of its institutions. For example, a country that is not very attractive for direct foreign investment, incapable of issuing debt in its own currency, that does not export very much and has a relatively unsophisticated tax agency, can only sustain a relatively modest level of external debt. This explains

why more than 50% of the episodes of non-payment among middle-income countries between 1970 and 2001 occurred at levels of external debt that did not exceed 60% of GDP.

The level at which a country's net debt position stabilizes depends basically on three variables: the external deficit, understood as the current and capital deficit not including investment income, the interest rate applicable

LONG-TERM LEVEL OF DEBT IN AN ECONOMY WITH 4.5% NOMINAL GDP GROWTH

(% of GDP)

External deficit excl. investment income (% of GDP) →	0.50	0.75	1.00	1.25	1.50
Nominal interest rate (%) ↓					
2.75	30	45	60	75	90
3.00	35	52	70	87	105
3.25	42	63	84	105	125
3.50	52	78	105	131	157
3.75	70	105	139	174	209

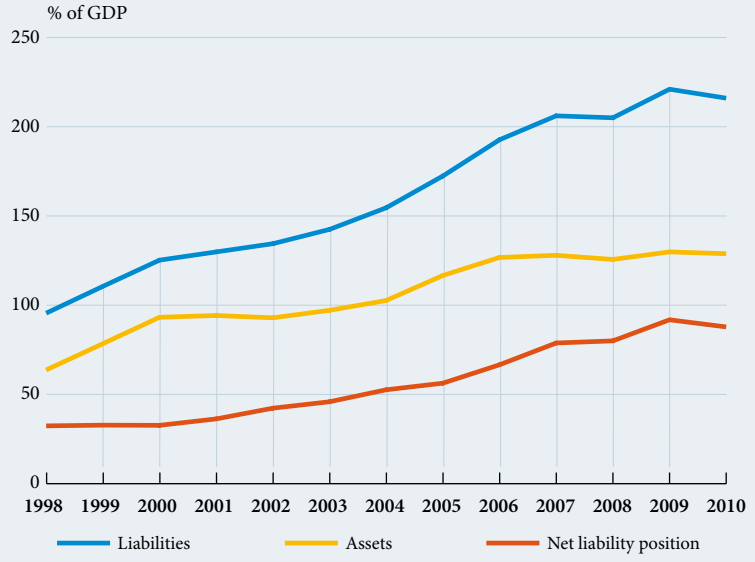
NOTE: The formula that relates the external deficit excluding investment income *(x)* with the equilibrium debt level *(d)* depending on the rate of growth in nominal GDP *(g)* and the interest rate *(i)* is:

$$d = \frac{(1+g)}{(g-i)} \cdot x$$

SOURCE: Own calculations.

SPAIN'S NET LIABILITY POSITION HAS MORE THAN DOUBLED SINCE THE START OF THE EURO

Spain's liabilities and assets with the rest of the world



SOURCES: Bank of Spain and own calculations.

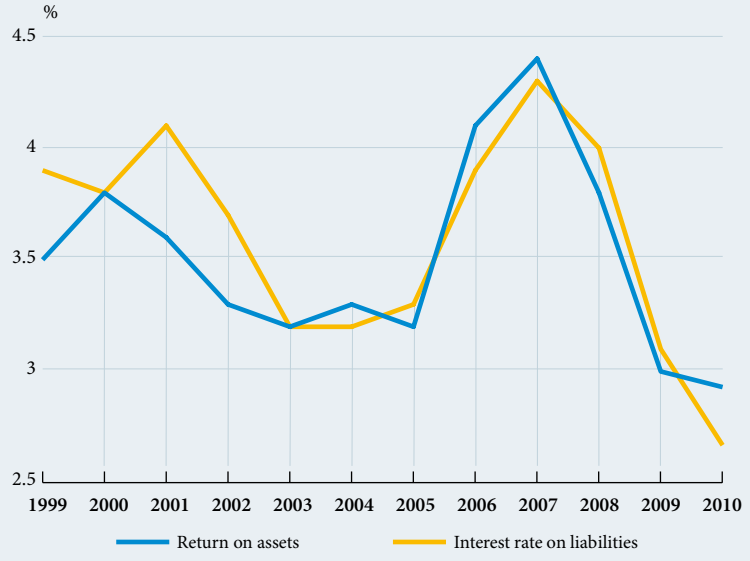
to the debt and the rate of growth in nominal GDP. Should the interest rate be higher than the nominal GDP growth rate, any external deficit will lead to an unlimited increase in the external debt and it is therefore not sustainable. However, if the growth rate is higher than the interest rate, the debt will tend to stabilize, although a deficit may be repeatedly recorded. The greater the difference between growth and interest rates, the lower the level at which the debt position will stabilize for a certain level of external deficit. For example, a country with a deficit of 1% of GDP, a nominal GDP growth rate of 4.5% and an interest rate on its debt of 3.25% would stabilize its external debt at a level equal to 84% of GDP (see the table above). Its current account and capital deficit would tend towards a level of 3.7% of GDP (1% + 3.25%*84).

In the case of Spain, its net liability position with the rest of the world stood at 87% of GDP at the end of 2010. This position results from combining external assets equivalent to 128% of GDP and liabilities of 215% of GDP (see the graph above). Around three quarters of these liabilities are in the form of debt and the rest are divided equally among foreign direct investment (in non-debt instruments) and portfolio investment in the Spanish stock market. Although Spain's net external borrowing reached 3.9% of GDP in 2010, resulting from an external deficit excluding investment income of 1.9% and a deficit in the income account of 2.0% of GDP, its net liability position improved by 4 points of GDP compared with 2009 thanks to the net effect of valuation changes on assets and liabilities. In 2010, Spain also benefitted from a historically low interest rate on its liabilities (2.7%) and which was, moreover, somewhat lower than the average rate of return on its assets (2.9%, see the graph below).

The above table suggests that Spain's external deficit is not far from the level that would stabilize its net liability position at the level recorded in 2010. If we use the average interest rate on its liabilities since the euro was

THE RETURN ON SPAIN'S EXTERNAL ASSETS IS SIMILAR TO THE COST OF ITS LIABILITIES

Average return/interest rate on Spain's external assets and liabilities



SOURCES: Bank of Spain and own calculations.

implemented, namely 3.5%, and we assume a potential growth rate for the Spanish economy of around 4.5% (combination of 2.5% real growth and a 2% inflation rate), the external deficit (excluding investment income) that would stabilize its net liability position below 90% of GDP would be around 0.8% of GDP. As we have mentioned before, the deficit stood at 1.9% in 2010 but we predict that, in 2011, this will fall to around 1.6% of GDP. It will therefore be very close (eight tenths of a percentage point) to reaching the level of external deficit that would maintain a stable external position in the medium term. However, if the Spanish economy's risk premium remained abnormally high and therefore the cost of the debt was greater than in the past, the external deficit would have to fall even further to stop the net liability position from increasing too much.

A low risk premium, good growth rate and a large dose of competitiveness are the key ingredients to stabilizing external debt at a sustainable level. However, the answer to the question «what is the sustainable level?» is not the same for all countries at all times. In any case, it's worth keeping a cautious distance from those levels that could make a country vulnerable to changes in investor sentiment, interest rate fluctuations and ups and downs in economic growth. Episodes that, as we have seen, do happen.

This box was prepared by Enric Fernández
International Unit, Research Department, "la Caixa"

Labour market

The labour market worsens in the first quarter of 2011...

...although it's expected to improve over the next three months, boosted by favourable seasonal factors.

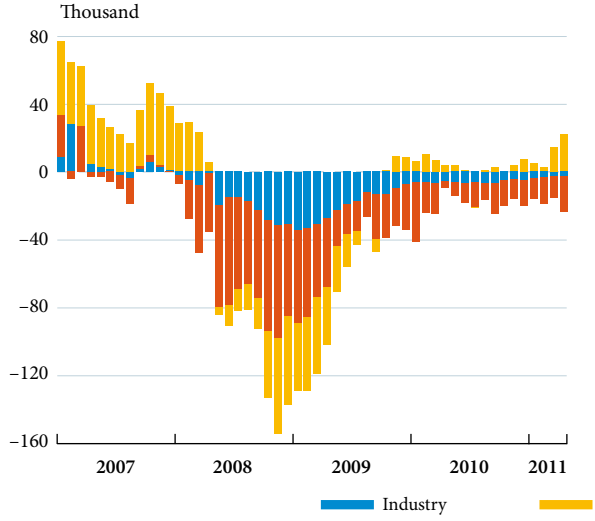
The labour market takes a breather in April thanks to favourable seasonal factors

The progress made by economic activity in the first quarter of 2011 was not enough to create jobs. Figures from the labour force survey (LFS) confirm the halt in the recovery of the labour market during the first three months of the year. According to LFS estimates, employment in the first quarter fell quarter-on-quarter by 256,500 people, placing the year-on-year drop at 1.3%, the same as in the previous quarter. This interruption in the improvement in employment was expected after the trends observed in the number of people registered with Social Security as employed and unemployed, published from January to March.

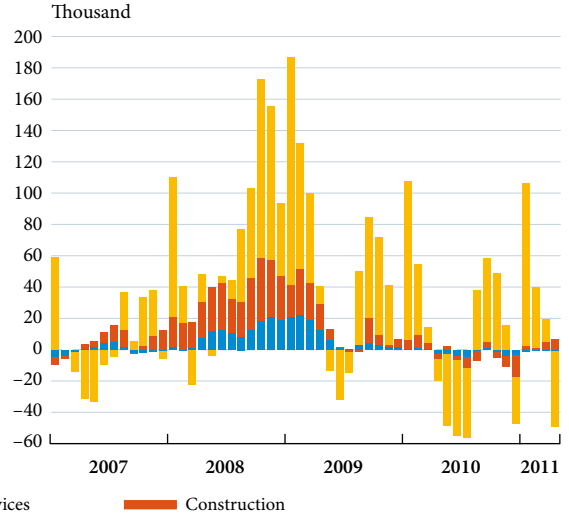
But the outlook is for employment to improve in the second quarter, as reflected by the number of people registered as employed and unemployed in April, posting a rise and fall, respectively. The total number of employed rose by 81,447 people that month, moderating by one tenth of a percentage point the rate of fall in registered employed to 1.0%. However, this better performance was partly due to the favourable seasonal factors for the period as the positive result disappears once the figures have been corrected for this effect. Similarly, the number of registered unemployed fell by 64,309 people in April, once again seasonal factors being a decisive factor in this drop. We can therefore see the important role played by the Easter holiday period in the labour market's recovery in April.

THE SERVICES SECTOR BOOSTS THE LABOUR MARKET

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



Monthly change in the number of registered unemployed (*)



NOTE: (*) Series corrected for seasonal factors.

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

Nonetheless, in the second quarter the prospects for the labour market look brighter than in the first quarter. One example of this is the trend in service sector employment. In April, the change in employment in this sector was positive, helped by the good performance of tourism. The slowdown in the rise in the number of unemployed in this sector was also notable.

For the moment, job losses are expected to continue to come mainly from construction, albeit at a slower rate.

For its part, industry did not lose jobs but neither is it generating employment for the moment. The significant growth in Germany and France at the beginning of the year might boost the sale of Spanish products, encouraging industry in the next quarter. This would boost job creation in this sector.

The services sector looks good in April.

The LFS also provides us with relevant information on how labour conditions are progressing in each socio-economic group. The figures for the first quarter highlight the big differences in the

The unemployment rate among young people rises above 45%.

ESTIMATED EMPLOYMENT

First quarter 2011

	No. of employees (thousands)	Quarterly change		Annual change		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	783.2	–21.3	–2.6	–52.0	–6.2	4.3
Non-farm	17,368.5	–235.1	–1.3	–190.4	–1.1	95.7
Industry	*2,540.8*	*–82.0*	*–3.1*	*–59.0*	*–2.3*	*14.0*
Construction	*1,494.0*	*–78.5*	*–5.0*	*–169.0*	*–10.2*	*8.2*
Services	*13,333.7*	*–74.6*	*–0.6*	*37.6*	*0.3*	*73.5*
By type of employer						
Private sector	14,965.8	–273.9	–1.8	–340.0	–2.2	82.4
Public sector	3,185.9	17.4	0.5	97.5	3.2	17.6
By work situation						
Wage-earners	15,120.8	–193.4	–1.3	–132.5	–0.9	83.3
Permanent contract	*11,374.8*	*–139.1*	*–1.2*	*–157.9*	*–1.4*	*62.7*
Temporary contract	*3,746.0*	*–54.3*	*–1.4*	*25.5*	*0.7*	*20.6*
Non-wage-earners	3,024.8	–59.3	–1.9	–106.0	–3.4	16.7
Entrepreneurs with employees	*974.4*	*–38.8*	*–3.8*	*–73.5*	*–7.0*	*5.4*
Entrepreneurs without employees	*1,896.7*	*–36.6*	*–1.9*	*–15.9*	*–0.8*	*10.4*
Family help	*153.7*	*16.1*	*11.7*	*–16.6*	*–9.7*	*0.8*
Other	6.1	–3.8	–38.4	–4.0	–39.6	0.0
By time worked						
Full-time	15,585.3	–348.4	–2.2	–357.1	–2.2	85.9
Part-time	2,566.4	91.9	3.7	114.7	4.7	14.1
By sex						
Males	10,059.0	–150.7	–1.5	–180.9	–1.8	55.4
Females	8,092.7	–105.8	–1.3	–61.5	–0.8	44.6
TOTAL	**18,151.7**	**–256.5**	**–1.4**	**–242.5**	**–1.3**	**100.0**

SOURCES: National Institute of Statistics and own calculations.

Long-term unemployment continues to rise.

performance of employment and unemployment according to workers' characteristics. For example, the graph below shows that the rise in unemployment continues to hit the most disadvantaged groups the hardest. On the one hand, the total number of unemployed who are under 25 continued to rise, reaching an unemployment rate of 45.4%. According to the Organization for Economic Cooperation and Development (OECD), this was partly due to the dual Spanish market, where temporary contracts predominate among the younger population and older employees enjoy greater protection.

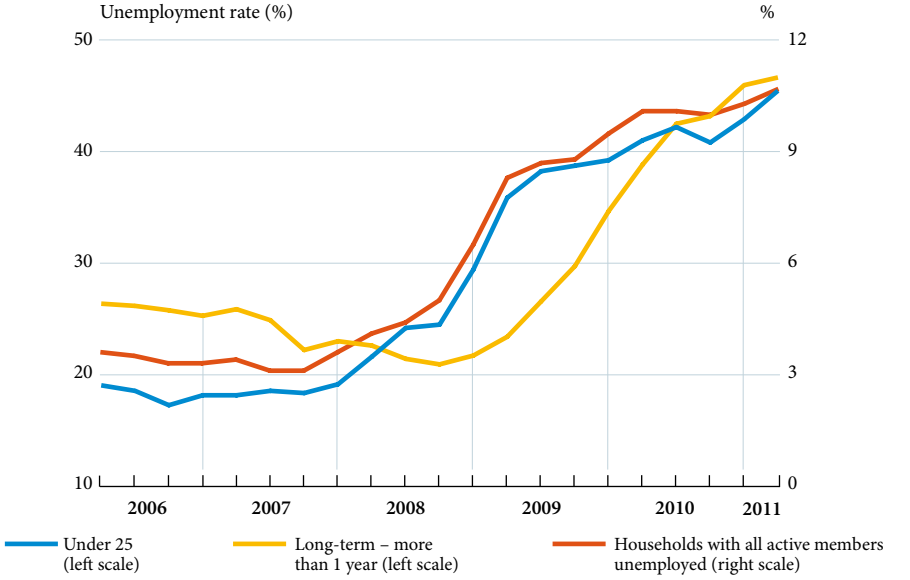
In this respect, the International Monetary Fund (IMF) has warned that, should the high unemployment rate among young people continue, it might damage this group's production capacity. Within this context, another relatively negative variable is the increase in long-term unemployment, which has more than doubled during the economic recession to 46.6% of the total unemployed in the first quarter of the year. In effect, studies show that, under equal conditions, this group is substantially less likely to find employment compared with other unemployed people. Lastly, the percentage of households with all their active members unemployed has also continued to rise in the first quarter of 2011.

Notable differences in job market trends between regions.

On the other hand, the dynamism of the labour market is unequal between autonomous communities, as observed in the table below. The Basque Country has the lowest unemployment rate, at 11.6%, contrasting with Andalusia, at 29.7%.

To some extent, the differences in the progress being made by employment between regions can be explained by the disparate progress being made by employment by sector. Those autonomous communities with the lowest negative or positive rates in the change of the number of private sector employees in the first quarter correspond largely to

UNEMPLOYMENT CONTINUES TO RISE AMONG THE MOST VULNERABLE GROUPS



SOURCES: National Institute of Statistics and own calculations.

those that lost the fewest jobs or even created employment in the economy as a whole. By way of example, while employment in the private sector in Catalonia increased by around 12,000 people in the last year, 340,000 jobs were lost in the economy as a whole. Given that the private sector employs the largest volume of workers and is a better reflection of the strength of economic activity, job generation in this sector in some regions might point to a change in trend in the coming months. For the moment, however, in the economy as a whole only public administration and public corporations created jobs in the first quarter, close to 100,000 jobs compared with the same quarter a year ago.

In short, as a result of the latest figures for the labour market and our own projections for growth in gross domestic product (GDP), which will be quite moderate in 2011, only a very gradual improvement in employment trends is expected. The fact that April's figures have been more favourable for the services sector augurs better performance in the second quarter. This might also be helped by the high growth in non-peripheral Europe, which could boost the foreign sector and thereby employment, both in services and also industry. Nonetheless, for the whole of the year, we estimate a decline in the total number of employed of approximately 0.7%, so that jobs are unlikely to be created until mid-2012.

The public sector generates jobs while the private sector destroys them.

LABOUR FORCE, EMPLOYMENT AND UNEMPLOYMENT BY AUTONOMOUS COMMUNITY

First quarter 2011

	In work force			Employed			Unemployed			Unemployment rate (%)
	Total (thousands)	Annual change	% annual change	Total (thousands)	Annual change	% annual change	Total (thousands)	Annual change	% annual change	
Andalussia	4,001	29	0.7	2,814	–77	–2.7	1,188	107	9.9	29.7
Aragon	644	–12	–1.8	528	–28	–5.0	116	16	16.0	17.9
Asturias	477	–6	–1.3	391	–13	–3.2	87	7	8.5	18.2
Balearic Islands	568	0	–0.1	424	–17	–3.9	144	17	13.1	25.4
Canary Islands	1,095	7	0.7	783	–4	–0.5	312	11	3.7	28.5
Cantabria	274	–4	–1.3	229	–8	–3.4	45	5	11.4	16.4
Castile-Leon	1,177	5	0.4	973	–13	–1.4	205	19	10.0	17.4
Castile-La Mancha	992	8	0.9	776	5	0.6	216	4	1.8	21.8
Catalonia	3,827	52	1.4	3,100	1	0.0	728	51	7.6	19.0
Valencian Community	2,487	–43	–1.7	1,887	–60	–3.1	600	17	2.9	24.1
Extremadura	499	13	2.6	374	2	0.4	125	11	9.6	25.1
Galicia	1,307	10	0.7	1,081	–16	–1.5	227	26	12.9	17.3
Madrid Community	3,384	–32	–0.9	2,862	–2	–0.1	522	–30	–5.5	15.4
Murcia	734	0	0.0	542	–22	–3.9	192	22	12.9	26.2
Navarre	311	5	1.6	270	1	0.4	42	4	10.3	13.4
Basque Country	1,063	21	2.0	940	11	1.2	124	10	8.6	11.6
La Rioja	156	0	0.0	132	0	–0.2	24	0	1.3	15.4
Ceuta and Melilla	65	3	4.3	49	0	0.6	16	2	17.8	24.5
Total	**23,062**	**55**	**0.2**	**18,152**	**–243**	**–1.3**	**4,910**	**298**	**6.5**	**21.3**

SOURCE: National Institute of Statistics and own calculations.

Prices

Inflation continues to rise due to the upswing in oil prices

Energy prices push inflation up to 3.8% in April...

The upward trend in oil prices continued to affect prices in April, with the year-on-year rate of change in the consumer price index (CPI) increasing by two tenths of a percentage point to 3.8%, the highest rate since September 2008. However, we expect inflation to have hit a peak this month and start to ease gradually, with a somewhat more pronounced fall at the beginning of summer, when the base effect of the hike in indirect taxes disappears. This gradual drop might place inflation at 2.4% by December.

...and pull core inflation up by four tenths of a percentage point to 2.1%.

Inflation trends depend largely on how energy prices perform. One example of this is the fact that, within the rate of 3.8%, almost one and a half points are directly attributable to the component of fuel and oils. In this respect, our forecasts are based on a scenario of high but more stable crude prices, with an average for Brent in 2011 of around 107 dollars/barrel.

Indirectly, the upswing in commodities has also had an effect on those elements most sensitive to them. This is the case of processed foods and package holidays, which contributed significantly to the rise in inflation in April. In turn, this also pushed up core inflation, which excludes unprocessed food and energy products, by four tenths of a percentage point to 2.1%. Given these figures, our projections

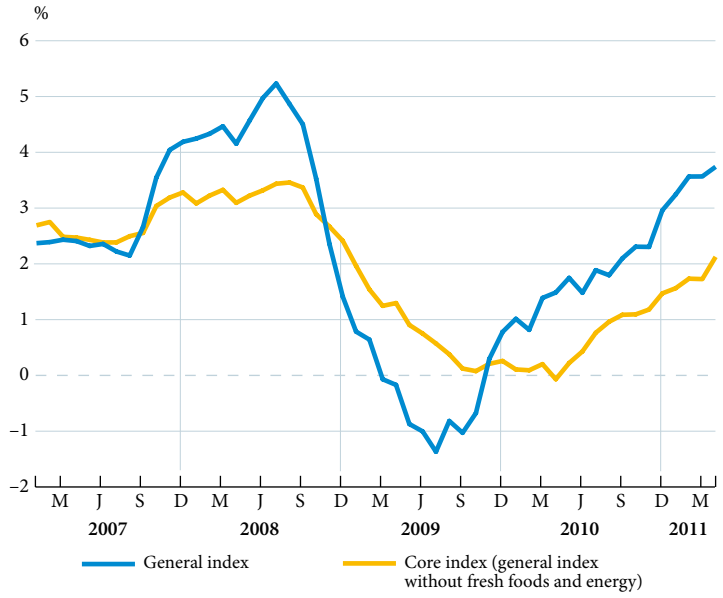
CONSUMER PRICE INDEX

	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	1.2	1.4	3.8
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 UPWARD TREND IN ENERGY PRICES ALSO PUSHES UP CORE INFLATION

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

for core inflation for the whole of 2011 stand at 2.0%.

However, having discounted these most influential items, inflation is still relatively moderate both in services and non-energy industrial goods, so their contribution to the general rate is quite small. This is largely due to the weak domestic demand and high unemployment rate, thereby avoiding second-round effects.

A large part of Spain's inflation is therefore being caused by the sharp price rises in the most volatile elements, as in the rest of the euro area. Given the high inflation rate in most euro area countries, last April the European Central Bank (ECB) raised the reference interest rate by 25 basis points, up to 1.25%. Within this scenario, April's rise in inflation to 2.8% for the euro area as a whole augurs further interest rate hikes over the coming months, particularly if inflationary pressures continue.

The ECB might raise the interest rate again if inflationary pressures continue.

In addition to reducing households' purchasing power, the upswing in inflationary pressures also hinders gains in competitiveness for the Spanish economy. This becomes evident when we look at the producer price index, which reflects the change in the prices of industrial goods charged by manufacturers. In fact, the table below shows that producer prices continued their upward trend and rose by two tenths of a percentage point in the month of March, up to 7.8% year-on-year. Prices rose for industrial products throughout all components, although particularly among energy goods. The fact that producer prices have increased less in the euro area on average than in Spain over the last few months has meant a loss of competitiveness. In the month of March, the year-on-year growth rate for producer

Production costs increase further than in the euro area.

CONSUMER PRICE INDEX BY COMPONENT GROUP

April

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2010	2011	2010	2011	2010	2011
By type of spending							
Food and non-alcoholic beverages	109.4	–0.1	0.3	–0.9	0.6	–1.9	2.2
Alcoholic beverages and tobacco	148.7	0.0	–0.1	2.9	2.5	12.1	14.7
Clothing and footwear	104.1	9.5	9.6	–4.0	–4.1	–0.9	0.4
Housing	124.1	0.7	0.7	2.0	4.3	3.4	8.0
Furnishings and household equipment	108.5	0.3	0.5	–0.3	0.0	0.2	1.2
Health	96.3	0.0	–0.1	0.1	0.0	–1.7	–1.3
Transport	118.4	1.5	1.0	4.9	4.9	8.3	9.3
Communications	98.7	–0.9	0.2	–0.9	0.1	–1.3	0.3
Recreation and culture	98.1	–0.2	1.5	–1.1	0.6	–2.5	0.6
Education	117.1	0.0	0.0	0.1	0.0	2.6	2.2
Restaurants and hotels	115.0	0.5	0.6	0.9	1.1	0.9	1.9
Other goods and services	115.0	0.2	0.2	1.5	1.8	1.9	3.2
By group							
Processed food, beverages and tobacco	116.3	–0.4	0.4	–0.5	1.4	0.5	4.5
Unprocessed food	109.0	0.5	–0.1	–0.3	–0.5	–1.3	2.4
Non-food products	111.9	1.4	1.5	0.9	1.5	1.9	3.8
Industrial goods	110.0	2.7	2.5	1.2	1.9	3.0	5.4
Energy products	*136.6*	*2.7*	*1.7*	*8.2*	*10.2*	*16.7*	*17.7*
Fuels and oils	*134.3*	*3.7*	*2.3*	*10.7*	*10.9*	*21.3*	*18.7*
Industrial goods excluding energy products	*101.1*	*2.7*	*2.9*	*–1.2*	*–1.2*	*–1.5*	*0.9*
Services	113.8	0.1	0.5	0.6	1.2	0.8	2.2
Underlying inflation (**)	109.7	0.9	1.3	–0.2	0.4	–0.1	2.1
GENERAL INDEX	**112.5**	**1.1**	**1.2**	**0.6**	**1.4**	**1.5**	**3.8**

NOTES: (*) Base 2006 = 100.
(**) General index excluding energy products and unprocessed food.
SOURCE: National Institute of Statistics.

The inflation differential compared with the euro area is around seven tenths of a percentage point.

prices was more than one point less in the euro area than in Spain.

This loss of competitiveness can also be seen in the inflation differential compared with the euro area, the main trading partner for the Spanish economy, which is still quite large. According to Eurostat data, the year-on-year change in the harmonized price index for the euro area stood at 2.8%, while the figure for Spain was 3.5%. Part of this gap is due to the taxation changes introduced in Spain during the second quarter of 2010 and the gap should therefore narrow once this base effect disappears. The price differential will therefore probably decrease again over the coming months, particularly if oil prices slow up their upward trend.

INFLATION INDICATORS

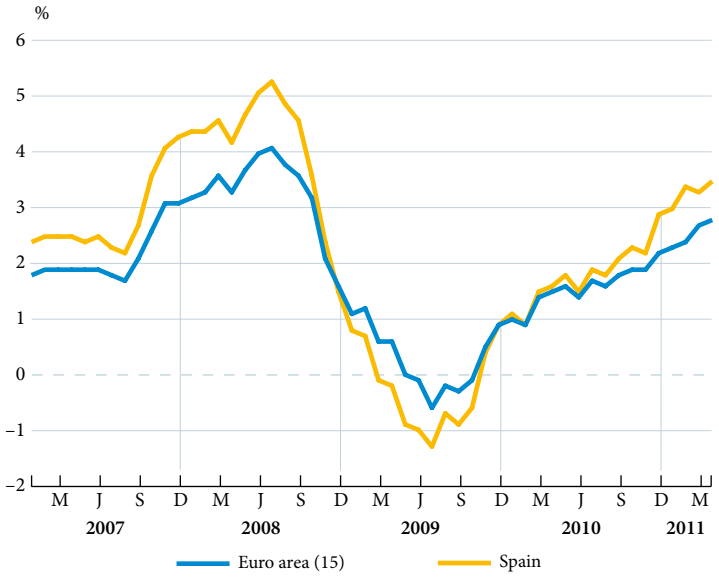
Percentage change over same period year before

	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											
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	1.8
March	...	7.8	2.1	1.2	8.0	18.8	10.7	5.5	1.1	11.9	–

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

THE INFLATION DIFFERENTIAL WITH THE EURO AREA REMAINS

Year-on-year change in HCPI



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

Foreign sector

The foreign sector boosts the economy in the first quarter

Foreign demand contributes 0.3 percentage points to growth in the first quarter.

The upswing in foreign demand was once again the main factor in Spain's economic recovery in the first quarter of 2011. According to the data from the National Accounts system, the foreign sector's contribution to the quarterly growth in gross domestic product (GDP) was 0.3%, offsetting the weak domestic demand. Dynamic international trade, the recovery in Europe's economy and the upswing in tourism boosted exports of goods and services. This favourable context is expected to continue throughout the year, maintaining the foreign sector's positive contribution. Domestic demand won't take over the reins of the Spanish economy until 2012.

This good performance by exports has been widespread among the different economic sectors. Customs data point to exports of intermediate goods as the most dynamic in the first few months of 2011,

FOREIGN TRADE

January-March 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	13,807	38.4	21.1	2,802	85.6	5.3	–11,004	20.3
Consumer goods	14,893	6.5	22.7	18,036	13.9	34.2	3,143	121.1
Food	*3,685*	*10.8*	*5.6*	*6,734*	*12.5*	*12.8*	*3,049*	*182.7*
Non-foods	*11,208*	*5.2*	*17.1*	*11,302*	*14.7*	*21.4*	*94*	*100.8*
Capital goods	4,276	4.6	6.5	4,640	37.8	8.8	364	108.5
Non-energy intermediate goods	32,533	20.3	49.7	27,260	23.8	51.7	–5,273	83.8
By geographical area								
European Union	34,837	13.3	53.2	35,249	19.0	66.8	412	101.2
Euro area	*28,403*	*14.7*	*43.4*	*28,636*	*16.7*	*54.3*	*233*	*100.8*
Other countries	30,670	26.0	46.8	17,488	33.5	33.2	–13,182	57.0
Russia	*2,244*	*90.1*	*3.4*	*567*	*54.3*	*1.1*	*–1,676*	*25.3*
United States	*2,747*	*28.8*	*4.2*	*2,053*	*48.5*	*3.9*	*–694*	*74.7*
Japan	*922*	*1.7*	*1.4*	*439*	*30.0*	*0.8*	*–483*	*47.6*
Latin America	*3,797*	*26.3*	*5.8*	*3,001*	*35.6*	*5.7*	*–796*	*79.0*
OPEC	*6,850*	*30.0*	*10.5*	*1,839*	*23.4*	*3.5*	*–5,011*	*26.8*
Rest	*14,111*	*19.1*	*21.5*	*9,590*	*31.2*	*18.2*	*–4,522*	*68.0*
TOTAL	**65,508**	**18.9**	**100.0**	**52,737**	**23.4**	**100.0**	**–12,770**	**80.5**

SOURCES: Ministry of the Economy and own calculations.

due to the recovery in industrial activity in the heart of the European Union. In the first quarter of the year, capital equipment and semi-manufactured non-chemical goods recorded year-on-year growth of 26.1% and 32.0% respectively. In addition to these products, and without taking into account the sharp rise in exports of commodities and energy products because of their small relative weight, of note is the gradual improvement in the automobile sector. Car and motorbike exports picked up in the first quarter, after the stagnation recorded in the second half of last year due to the end of subsidies for buying vehicles.

As a consequence, goods exports rose by 23.4% year-on-year in the first quarter. If we take the change in the volume of exports into account, net of the price effect, this figure falls to 15.8%. In the case of imports, this difference between the nominal and real variation is much greater, due to the sharp rise in oil prices and the rest of commodities. This explains why, in spite of the foreign sector's positive contribution in the first quarter of the year, the trade deficit worsened in March.

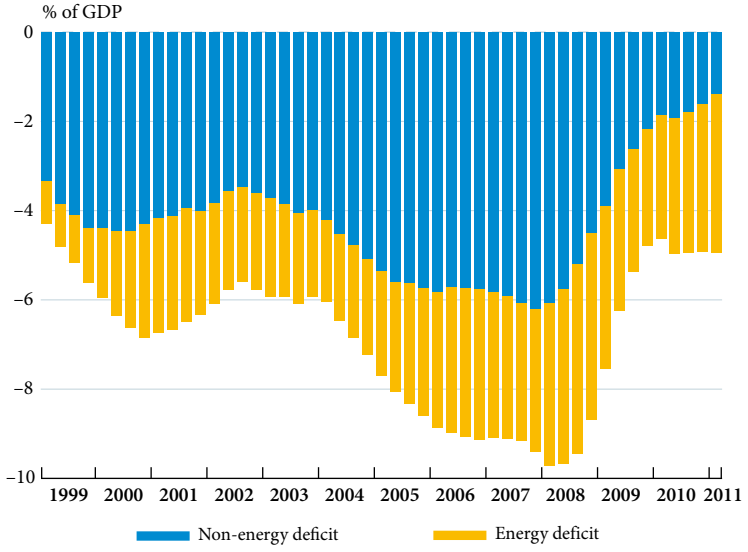
Sharp upswing in exports of intermediate goods.

In fact, an analysis of the data accumulated over the last twelve months, which provide a more reliable reflection of the long-term trend, shows that the trade deficit increased to 52,689 million euros in March, equivalent to 4.9% of GDP. This figure represents an increase of three tenths of a percentage point compared with the minimum reached in March 2010. As shown by the graph below, the widening of the energy imbalance was the reason behind this higher deficit, exceeding the good performance of the non-energy component. For the remainder of the year, a gradual fall in commodity prices and the good performance of the European economy are expected to slightly reduce Spain's trade deficit, albeit remaining at levels similar to that of 2010.

Rising oil prices tarnish the recovery in the non-energy balance.

THE ENERGY BALANCE ACCOUNTS FOR 70% OF THE TRADE DEFICIT

Trade balance broken down by product



SOURCES: Ministry of the Economy and own calculations.

Tourism will be the main way to reduce the current deficit

The current deficit stands at 48,370 million euros in February.

In spite of this worsening of the trade balance, the figures for the balance of payments show a fall in the current deficit in February, standing at 48,370 million euros accumulated over the last twelve months. This level is similar to the one recorded in 2005. The reason for this improvement is the reduction in the income deficit, while the rest of the components remained almost stable.

The upswing in tourism will help to correct the current deficit to 4.3% of GDP in 2011.

However, beyond what monthly comparisons can tell us, influenced as they are by calendar effects, the underlying trends point to tourism as the main force behind the correction in the current deficit over the last few months.

The upswing in tourism, intensified by the outbreak of political conflict in North Africa, has hugely increased revenue from the services balance during the first two months of the year. The good news regarding the entry of tourists in March and April, with overall growth of 11.3% compared with the same months in 2010, is an encouraging sign of what tourism might do throughout the year.

This improvement will help to correct the current deficit by around two tenths of a percentage point in 2011, down to 4.3% of GDP. This small reduction will be due to the stagnation in the goods balance and a more than likely increase in the income deficit, given the rising financing costs required for Spanish debt by the markets.

BALANCE OF PAYMENTS

February 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	–7,410	4.1	–47,390	–6,013	14.5
Services					
Tourism	*3,009*	*9.6*	*27,222*	*1,229*	*4.7*
Other services	*–375*	*5.1*	*969*	*1,862*	*–*
Total	2,634	10.3	28,191	3,091	12.3
Income	–3,784	18.9	–22,297	4,336	–16.3
Transfers	–3,416	–4.7	–6,874	2,288	–25.0
Total	**–11,976**	**4.2**	**–48,370**	**3,702**	**–7.1**
Capital account	**1,439**	**–6.5**	**6,362**	**1,216**	**23.6**
Financial balance					
Direct investment	–1,116	–	–9,449	–20,789	–
Portfolio investment	31,925	–	68,818	35,660	107.5
Other investment	–13,170	–	–22,965	–21,370	–
Total	**17,639**	**97.0**	**36,404**	**–6,498**	**–15.1**
Errors and omissions	463	–	–1,157	4,652	–80.1
Change in assets of Bank of Spain	–7,564	–	6,762	–2,817	–29.4

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.

With regard to financial flows, of note is the high portfolio investment, with a net inflow of 16,211 million euros in February. This figure, together with the also high inflow recorded the previous month, makes portfolio investment the main source of external financing for the last twelve months. On the other hand, Spanish financial institutions had resorted to the European Central Bank for most of their financing needs up to the middle of last year. This reduction is due to the gradual opening up of financing markets during the first quarter of 2011. The recent tensions appearing once again in the risk premium are expected to ease over the coming months, keeping the use of the Eurosystem at a low level.

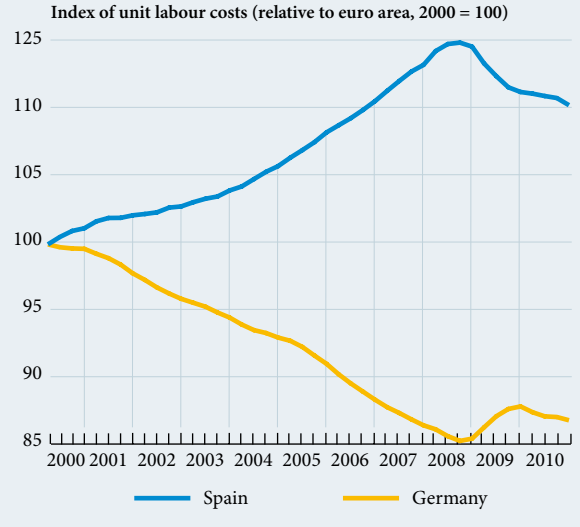
Portfolio investment takes prime position as the main source of financing.

Strong exports, weak competitiveness: an odd couple?

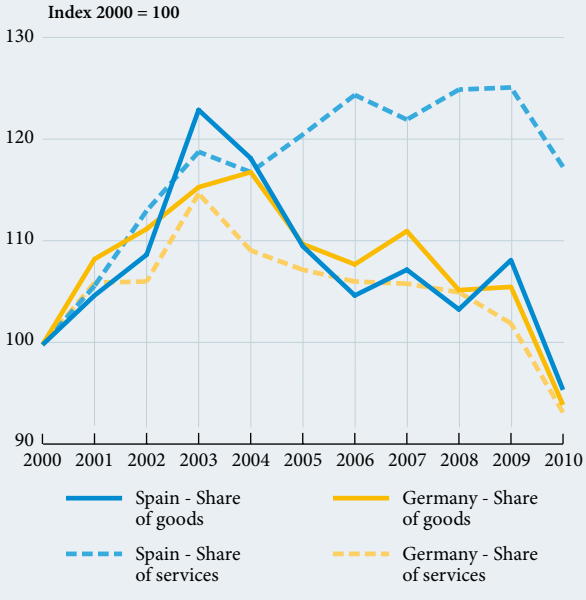
During the economic boom that preceded the crisis, Spain's current account deficit and its price competitiveness progressively deteriorated compared with its partners in the euro area, particularly Germany. This coincidence led many to conclude that this loss of competitive edge was the main reason behind its huge external imbalance. However, there is one figure that upsets this thesis: in the last decade, the export share of Spanish goods has remained practically the same, both in global terms and within the euro area, and the share of services has even improved (see the graphs below). How can this relative strength in Spanish exports be explained, given the continued loss of competitiveness?

COSTS INCREASE BUT EXPORTS RESIST

Cost competitiveness



Global export share



NOTE: Moving four-quarter averages.
SOURCES: IMF DOTS, OECD, WTO and own calculations.

In the period 2000-2010 and in terms of Spanish interests, there was an adverse trend in price and cost differentials relative to the euro area as a whole. In spite of the correction caused by the crisis, the differential between unit labour costs in Spain and those of the euro area increased by 10%. Similarly, the Bank of Spain estimates the loss of competitiveness to be 10.1% when measured in terms of consumer prices and 5.7% in export price terms. This can essentially be put down to inflation being repeatedly higher in Spain without being offset by equally higher growth in productivity. On the other hand, the relative stability of the export share is also a fact: at a global level, this remained at around 1.7% for goods and close to 3.5% for services, while the share of goods and services within the euro area has not moved very far from 3.5%. These two figures could be due to a possible external shock that has shifted demand towards Spanish products, or due to a change in the composition of the export basket, or too simple an interpretation of the customary price competitiveness indicators.

The hypothesis that links the trend in Spanish exports to disproportionate growth in the markets these exports are aimed at, which would have shifted demand in their favour, does not get much support from the data. Spain exports relatively little to the economies that have grown the most this decade, namely China, India and their neighbours in South East Asia, while the euro countries, the destination for almost two thirds of Spanish exports, have recorded relatively modest growth rates.

Neither does it seem plausible that the strength of Spanish exports is due to changes in the composition of the export basket. The evidence points to a structure without any notable variations: in goods, a clear bias has remained towards sectors of a medium-low technology content, given that high-tech goods have not managed to improve on their share of 5%. Services have been more dynamic, however, with a growing share of premium categories (the weight of business services has gone from 15.3% in 2000 to 23.3% in 2010, and IT services from 3.9% to 5.2%) but tourism continues to dominate, albeit reducing its share from 57% to 42%. Another figure that does not fit in with the theory of significant changes in the composition of Spanish exports is the stabilization in market share in practically all manufacturing sectors.

So, one plausible hypothesis remains: that the apparently contradictory relationship between export share and competitiveness can be explained by possible deficiencies associated with the usual competitiveness indicators. Firstly, the loss in price competitiveness might have been overestimated; i.e. the export sector may not have lost (so much) competitive edge in prices as has been suggested by the indicators. Ultimately, the effective real exchange rate is merely an aggregate measure and, as such, cannot specifically reflect the reality of a highly heterogeneous business fabric. In this respect, the evidence confirms that exporters in Spain are clearly a case apart: not only do they tend to be larger and more innovative than the rest of firms but they also reveal higher than average levels of productivity and competitiveness.

Recent studies state that, during the period 2000-08, those firms with more than 200 employees were the ones that increased their exports the most and that saw their unit labour costs (ULC) rise less quickly.[1] It can also be seen that the ULC of the largest Spanish firms (>500 employees) grew at a slower rate than that of their German, French or Italian peers while, according to a study by Fedea-McKinsey in 2010, their productivity is deemed to be comparable. If, moreover, we take into account the fact that it is precisely the competitiveness of these firms that export the most that ends up determining the behaviour of Spanish exports, the aggregate price competitiveness indicators would be too biased, underestimating the external competitiveness of the Spanish economy. This would explain part of the disconnection between satisfactory export trends and the loss of aggregate competitiveness.

(1) See Antrás, Segura and Rodríguez (2010). «Firms in international trade with an application to Spain». http://www.economics.harvard.edu/faculty/antras/files/Ponencia_SAE.pdf

The rest should be attributed to another deficiency of price competitiveness indicators: their inability to capture changes in the quality of exports. If we only take into account the trend in these indicators to reach conclusions regarding competitiveness, the influence of price on export performance is being overestimated. If this is the case (and it is, to judge by the disconnection between appreciation in the real exchange rate and the stability of the export share), we would be seeing a replica of the famous Kaldor paradox, a Hungarian-British economist who, back in 1978, claimed that the export success of a country was not necessarily related to a drop in prices.

Fortunately, his famous paradox stopped being paradoxical when the new models of international trade included trade in differentiated products, proving, at a formal level, that companies do not just compete via price (as had been established by the classic models of trade in homogeneous goods) but also via the degree of differentiation, level of quality or power of the brand. In this respect, a recent study by Goldman Sachs confirms that, in the Spanish case, the factor of quality has been crucial. Their findings show that Spain is the country in the euro area with the lowest price elasticity regarding demand for its exports, a consequence of its specialization in sectors under little price pressure (medium and medium-low technology content) but in which competition in terms of quality is decisive.[(2),(3)] This would explain the relative immunity of the export share to the loss in price competitiveness.

In short, there are reasons to believe that the strength of Spanish exports is due to the fact that the loss in competitiveness during the boom years was not as damaging as had been feared for Spanish exporting firms, as these were different from the average firm and, in any case, the competition faced by Spanish exporters is no longer governed solely by price but, above all, by differentiation strategies. Nonetheless, medium and long-term competitiveness continues to require continued improvements in productivity, improvements which, for the present, have fallen short. A situation that has yet to be resolved.

(2) Goldman Sachs Global Economics (January, 2011), «Euro-zone competitiveness: Price is not all, quality also matters».
(3) The data also indicate that Spanish exports to emerging countries are more sensitive to price trends. See Vollmer, Martínez-Zardoso and Nowak-Lehmann (2009), «Unit Values, Productivity, and Trade Determinants of Spanish Export Strength», *Global Economy Journal*.

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

Public sector

Accomplishments and challenges after one year of fiscal adjustment

The public accounts continue to consolidate one year since the start of the fiscal adjustment.

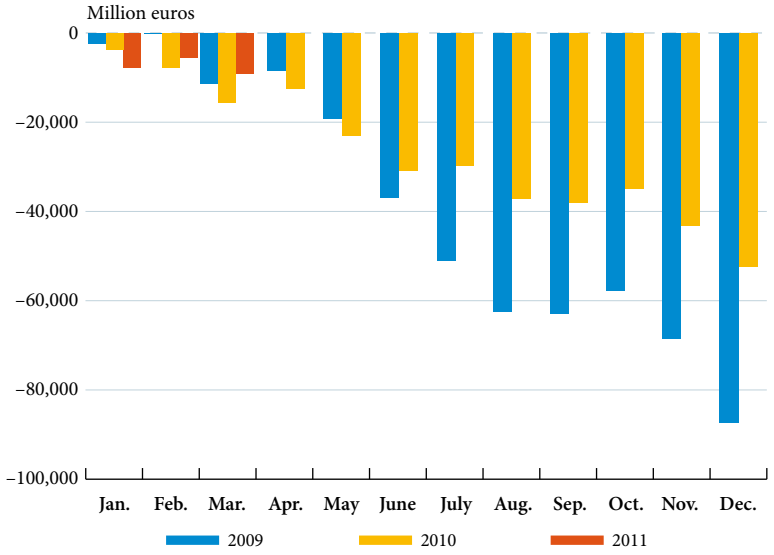
Last May marked one year since the decision was taken by the Spanish government to adopt a new and significant package of adjustments to correct the imbalance in the public accounts. Significant advances have been made since then in the area of fiscal consolidation. In effect, these adjustment measures managed to reverse the trend in the public deficit in 2010, even placing it one tenth of a percentage point below the target set by the fiscal adjustment plan. The outlook for this year once again points towards a sharp reduction in the deficit that, according to our forecasts, will be slightly above the 6,0% expected by the government. As a consequence, the interest rate on Spanish debt has moved away from the rest of the peripheral countries. However, there are still some obstacles, both at a state and European level, that must be overcome to regain the confidence and credibility of the markets. The next few months will be key to achieving this proposal.

The cash deficit falls by six tenths of a percentage point to 0.85% of GDP.

According to the data published by the Ministry of the Treasury, the fiscal adjustment is going well. The central government's accumulated cash deficit in the first quarter fell to 0.85% of gross domestic product (GDP), six tenths of a percentage point below the figure

THE CASH DEFICIT CONTINUES TO ADJUST IN 2011

Accumulated cash deficit of the central government for the year to date



SOURCE: Ministry of the Treasury.

recorded in the same period a year ago. This improvement can also be seen on a national accounts basis, with a reduction in the central government's net borrowing of two tenths of a percentage point, standing at 0.64% of GDP. In line with the government's adjustment plan, the improvement in the public accounts is largely due to huge spending cuts. These lie behind three quarters of the fall in the total deficit in 2011 and this contribution will continue in the adjustments over the next few years.

In fact, the central government's cash accounts data show a fall in non-financial payments in the first quarter of 24.2% year-on-year, compared with a fall in income of 16.2%. However, it's difficult to reach any firm conclusion based on these variations, as the income and expenditure statistics for this year cannot be compared with those of last year. This is because a new common regime financing system has been implemented for the autonomous communities. Under this new system, the communities have a greater share of the taxes, especially value added tax (VAT), personal income tax and special taxes. Transfers from the central government have also been reduced.

In spite of the difficulty in comparing data, it is possible to recognize the main forces underlying the improvement in the central government's deficit. In the case of income, an analysis of the total tax revenue, which takes into account both the share of the central government and of regional governments, shows the highest revenue to come from VAT. This grew by 8.0% year-on-year in the first quarter of the year, a result of the tax hike in July 2010 and, to a lesser extent, of the gradual recovery in the Spanish economy. On the other hand, revenue from special taxes fell by 2.8% over the same period, with tobacco taxation recording the largest reduction.

With regard to central government payments, all the evidence seems to suggest that public expenditure is mostly being adjusted by real estate investment and current expenditure on goods and services. At the same time, wages and social security contributions of public employees fell by more than 5% compared with the first quarter of last year. A fall that was neutralized by the rise in benefit payments. Also of note was the sharp fall in financial costs, 23.2% year-on-year in this period. However, this was due to the maturity calendar for Spain's public debt, so that payments for this item are expected to accelerate over the coming months.

In this respect, the interest rate for ten-year sovereign bonds rose again in May, reaching a yield of 5.45%. This figure is 240 basis points above the financing cost for German debt. A risk premium that, although it has moved away from the premia required for the rest of the peripheral countries (Ireland, Portugal and Greece), is still far above that of other countries in the euro area with a heavily indebted public sector, such as Belgium or Italy.

This high risk premium is due to the uncertainty regarding how Spain's public debt will perform in the future. These doubts are being fed, firstly, by the recent tensions caused by Portugal's bail-out and the delicate situation of the Greek public accounts. At a state level, of note are the difficulties encountered by the autonomous communities to meet the deficit targets set by the government. This, and the lack of specificity in the measures required to meet the targets

Rise in the non-financial income of both the central and regional governments due to higher VAT revenue.

Market uncertainty keeps the risk premium high.

The risk premium is expected to adjust over the next few months.

of the fiscal adjustment plan beyond 2011, mean that the markets are still wary.

Significant advances are expected to be made over the coming months to help correct this situation. At a European level, June will see the approval of the economic governance reforms in the European Union. Along the same line is the possible approval, in Spain, of the reform of collective bargaining in the next few weeks. This, together with the new rule passed by the government that does not allow growth in public expenditure to exceed medium-term growth, would help dissipate doubts regarding whether the country can achieve a deficit of 2.1% by 2014, as predicted by Spain's fiscal stability programme.

Savings and financing

The fall in credit confirms private deleveraging

Debt in the private sector multiplied by 7.2 between 1995 and 2008, representing 225% of the gross domestic product (GDP). Up to December 2010, this imbalance looked practically stagnant. However, there are now some signs that debt is starting to adjust in the first few months of 2011. The weak recovery of the Spanish economy and rising interest rates look like the main reasons for private deleveraging. This trend is expected to continue over the coming quarters.

In fact, private financing fell by 20,068 million euros in the first three months of 2011. A fall that equally affected non-financial organizations and households in Spain. Public sector debt, on the other hand, continued its upward trend started two years ago with a rise in its liabilities of 39,735 million euros in 2011 so far.

However, the fall in the outstanding balance of bank credit to non-financial corporations and households is due to different reasons. In the case of the former, the reallocation of production factors among different sectors of the economy suggests that this reduction in credit has not been homogeneous. Greater adjustment can be expected in those sectors related to real estate while others, such as industry and services,

The fall in credit in the first quarter confirms the deleveraging in the private sector.

FINANCING OF NON-FINANCIAL SECTORS (1)

March 2011

	Balance	Change this year	Change over 12 months	% share
	Million euros	Million euros	% (2)	
Private sector	2,192,032	–20,068	0.2	76.4
Non-financial corporations	1,303,999	–9,565	0.7	45.4
Resident credit institution loans (3)	*882,708*	*–14,766*	*–1.5*	*30.8*
Securities other than shares	*66,247*	*1,695*	*10.1*	*2.3*
External loans	*355,045*	*3,505*	*5.0*	*12.4*
Households (4)	888,032	–10,503	–0.5	30.9
Housing loans (3)	*674,320*	*–5,547*	*–0.1*	*23.5*
Other (3)	*210,367*	*–4,981*	*–1.9*	*7.3*
External loans	*3,345*	*25*	*5.4*	*0.1*
General government (5)	678,503	39,736	13.7	23.6
TOTAL	**2,870,534**	**19,668**	**3.7**	**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.

The real estate sector is the one that will undergo the most deleveraging.

might have even increased their financing.

With regard to households, the high unemployment rate is reducing solvent credit demand for consumption and housing. Moreover, part of the reduction in mortgage loans was due to demand being brought forward in 2010, caused by the withdrawal of tax discounts. This resulted in a significant drop in the number of mortgages granted in the first few months of 2011, with a 20.2% year-on-year decrease in March. The number of mortgages accumulated over the last twelve months was 586,000, a figure that is far from the maximums recorded in 2006. This trend is expected to continue throughout the year.

April's bank loan survey predicts further falls in credit.

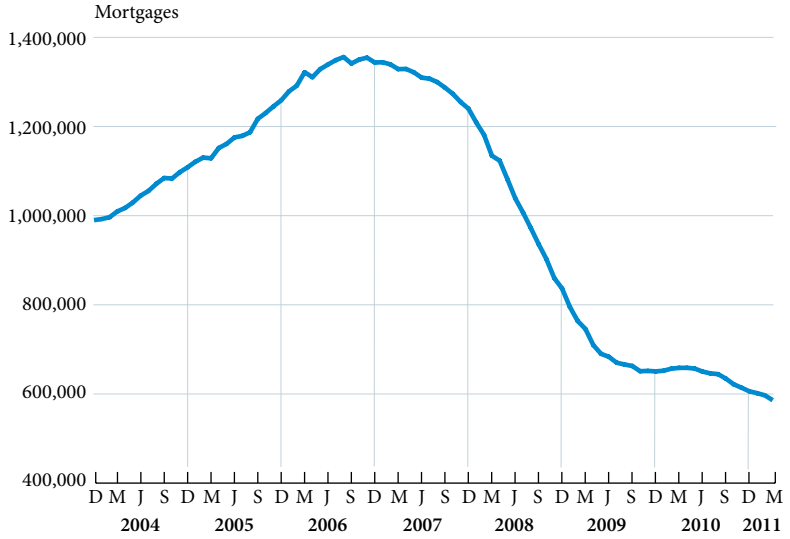
The findings of the bank loan survey in April 2011 point in the same direction. According to the banks taking part, in the second quarter of the year the decline in consumer confidence will reduce the demand for financing. Moreover, the expected rise in funding costs means that they don't see any substantial improvement in the criteria applied by banks to approve financing for households.

Similarly, the rise in funding costs for Spanish financial institutions led to further growth in the interest rate for granting credit in March, standing at 3.89%. This figure was five tenths of a percentage point above the previous month's. With a view to the future, further rises are expected in interest rates, although how these perform will depend on the pressures in financial markets, the competition to attract deposits and the capacity of banks to pass on these higher costs to their credit.

Without doubt, any reduction in bank funding costs depends on the sector regaining credibility among international investors. One example is the containment of the doubtful debt rate at levels that, although high, do not jeopardize the system's solvency per se. In fact, March's data provided a pleasant

THE NUMBER OF MORTGAGES FALLS ONCE TAX DISCOUNTS END

Number of mortgages granted in the last twelve months



SOURCE: National Institute of Statistics.

surprise, down one tenth of a percentage point, placing this rate at 6.1%. However, the months of June and July will be key to regaining the confidence of the funding markets. The publication in June of the results of the stress tests on 91 European financial institutions (among these, almost all Spanish institutions) should dissipate doubts regarding the solvency of Spain's banking system. All this within a context of the restructuring of a large proportion of the sector. A process that will see, in July, the two largest savings banks in the country becoming listed through their instrumental banks.

The doubtful debt rate falls by nine basis points to 6.1%.

Bank debt continues to decrease

Within this context of private sector deleveraging in the first quarter of 2011, the figures for bank debt held by households and firms were down 0.6% compared with December 2010. This fall was mostly due to the larger decrease in term deposits. A breakdown of bank debt between banks and savings banks shows a sharp rise in the former. This, however, is a result of the current reorganization of the banks, in which some savings banks have changed their legal status to banks.

Bank debt among firms and households falls by 0.6% in the first quarter of 2011.

The interest rate for new deposits rose in March, standing at 1.6%, the same level as in December 2010 and putting an end to three consecutive months of decreases. The recent tensions in sovereign bond markets might increase the cost of funding for Spanish banks.

A new government proposal has recently been approved that studies limiting the interest rate on sight deposits and accounts at financial institutions. This would prevent interest rates from being raised to attract retail banking customers. To achieve this end, those institutions with too high interest rates have to increase their contributions to the corresponding bank guarantee funds. The main effect of this regulation has been to transfer this competition for deposits via higher interest rates to other kinds of remuneration, one clear example being the rewards offered to attract salary payments.

With regard to mutual funds, these recorded net withdrawals in April totalling 466 million euros, putting an end to two consecutive months of net subscriptions.

The battle for deposits shifts to new fields.

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

March 2011

	Balance	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	263,352	1,586	0.6	4,692	1.8	18.4
Savings deposits	210,480	–807	–0.4	6,115	3.0	14.7
Term deposits	739,504	–4,063	–0.5	30,295	4.3	51.7
Deposits in foreign currency	19,686	303	1.6	–2,475	–11.2	1.4
Total deposits	**1,233,021**	**–2,982**	**–0.2**	**38,627**	**3.2**	**86.2**
Other liabilities (*)	**196,746**	**–6,265**	**–3.1**	**–8,503**	**–4.1**	**13.8**
TOTAL	**1,429,767**	**–9,248**	**–0.6**	**30,124**	**2.2**	**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.

"la Caixa" Research Department

Publications

All publications are available on Internet:
www.laCaixa.es/research
E-mail: publicacionesestudios@lacaixa.es

THE SPANISH ECONOMY MONTHLY REPORT
Report on the economic situation (available also in Spanish version)

ANUARIO ECONÓMICO DE ESPAÑA 2010
Selección de indicadores
Complete edition available on Internet

COLECCIÓN COMUNIDADES AUTÓNOMAS
1. La economía de Galicia: diagnóstico estratégico
2. La economía de Illes Balears: diagnóstico estratégico
3. La economía de Andalucía: diagnóstico estratégico
4. La economía de la Región de Murcia: diagnóstico estratégico
5. La economía del País Vasco: diagnóstico estratégico
6. La economía de la Comunidad de Madrid: diagnóstico estratégico

CÁTEDRA "la Caixa" ECONOMÍA Y SOCIEDAD
1. El tiempo que llega. Once miradas desde España José Luis García Delgado (editor)

DOCUMENTOS DE ECONOMÍA "la Caixa"
15. Factores determinantes del rendimiento educativo: el caso de Cataluña Maria Gutiérrez-Domènech
16. ¿El retorno del *decoupling*? Mito y realidad en el desacoplamiento de las economías emergentes Àlex Ruiz
17. El crecimiento de China: ¿de qué fuentes bebe el gigante asiático? Claudia Canals
18. Hacia una nueva arquitectura financiera Oriol Aspachs-Bracons, Matthias Bulach, Jordi Gual y Sandra Jódar-Rosell
19. Globalización y *decoupling*. ¿Hacia un mundo emergente desacoplado de las economías avanzadas? Àlex Ruiz
20. Inmigración y mercado laboral: antes y después de la recesión Joan Elias
21. La recuperación del comercio mundial. Lo que la crisis se llevó Marta Noguer
22. Diferencial de inflación con la eurozona: ¿mejora sostenible? Pere Miret

"la Caixa" ECONOMIC PAPERS
1. Vertical industrial policy in the EU: An empirical analysis of the effectiveness of state aid Jordi Gual and Sandra Jódar-Rosell
2. Explaining Inflation Differentials between Spain and the Euro Area Pau Rabanal
3. A Value Chain Analysis of Foreign Direct Investment Claudia Canals and Marta Noguer
4. Time to Rethink Merger Policy? Jordi Gual
5. Integrating regulated network markets in Europe Jordi Gual
6. Should the ECB target employment? Pau Rabanal

WORKING PAPER SERIES
Only available in electronic format at: www.laCaixa.es/research
01/2010. The impact for Spain of the new banking regulations proposed by the Basel Committee "la Caixa" Research Department
01/2011. Crecimiento versus progreso Jordi Gual
02/2011. Sobrecalentamiento emergente: Causas, consecuencias y riesgos Claudia Canals and Marta Noguer
03/2011. School Dropout in Europe: Trends and Drivers Maria Gutiérrez-Domènech
04/2011. The new capital requirements in banking: a critical review Jordi Gual
05/2011. Offshoring and Intellectual Property Rights Reform Claudia Canals and Fuat Sener

ECONOMIC STUDIES
35. La generación de la transición: entre el trabajo y la jubilación Víctor Pérez-Díaz y Juan Carlos Rodríguez
36. El cambio climático: análisis y política económica. Una introducción Josep M. Vegara (director), Isabel Busom, Montserrat Colldeforns, Ana Isabel Guerra y Ferran Sancho
37. Europe, Like America: The challenges of building a continental federation Josep M. Colomer

Academic Advisory Council

The Academic Advisory Council guides the Research Department in its work analyzing the economic and social policies that might be effective in ensuring the progress of Spanish and European society. The members of the Council are:

- Manuel Castells
  Universitat Oberta de Catalunya and University of Southern California
- Antonio Ciccone
  ICREA-Universitat Pompeu Fabra
- Luis Garicano
  London School of Economics
- Josefina Gómez Mendoza
  Universidad Autónoma de Madrid
- Mauro F. Guillén
  Wharton School, University of Pennsylvania
- Inés Macho-Stadler
  Universitat Autònoma de Barcelona
- Massimo Motta
  Barcelona GSE - Universitat Pompeu Fabra
- Ginés de Rus
  Universidad de Las Palmas de Gran Canaria
- Robert Tornabell
  ESADE Business School
- Jaume Ventura
  CREI-Universitat Pompeu Fabra

Research Department

- Jordi Gual
  Chief Economist of "la Caixa"
- Joan Elias
  Deputy Management
- Matthias Bulach
  Director, Economic Analysis
- Enric Fernández
  Director, International Unit
- Oriol Aspachs
  Director, European Unit
- Avelino Hernández
  Director, Financial Markets Unit

THE SPANISH ECONOMY
MONTHLY REPORT
June 2011

CAJA DE AHORROS
Y PENSIONES
DE BARCELONA

Research Department

Av. Diagonal, 629,
torre I, planta 6
08028 BARCELONA
Tel. 34 93 404 76 82
Telefax 34 93 404 68 92
www.laCaixa.es/research

e-mail:
For enquiries regarding
The Spanish Economy
informemensual@lacaixa.es

For subscriptions
(new, cancellations, etc.):
publicacionesestudios@lacaixa.es

"la Caixa" GROUP: KEY FIGURES

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**

Monthly Report
iPad edition

The economy from your sofa

The iPad edition of the Monthly Report has been produced in a format that can be read on an Apple iPad and on most eBook readers. The file is also available in the Amazon Kindle format.

For more information: www.laCaixa.es/research

Design, page make-up and printing: www.cege.es - Ciutat d'Asunción, 42 - 08030 Barcelona

D. L.: B. 21063-1980 ISSN: 1134-1920

"la Caixa"

ELEMENTAL CHLORINE FREE GUARANTEED

FSC
www.fsc.org
MIX
Paper from responsible sources
FSC® C015618