

QUARTERLY REPORT ON THE SPANISH ECONOMY

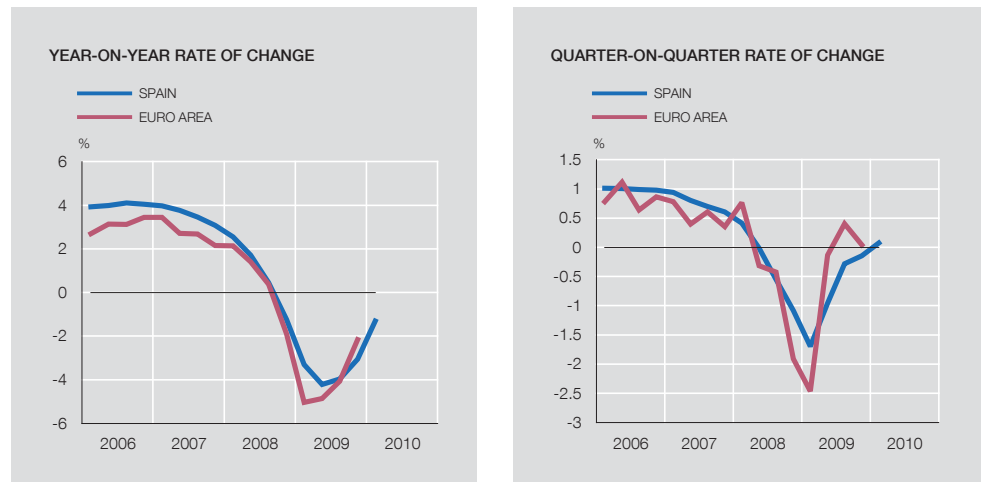
## Overview

The Spanish economy underwent a marked contraction in 2009. This was at its worst in Q1 and eased thereafter, posting a quarter-on-quarter rate of decline in GDP of 0.1% at the close of the year. For the year as a whole, output fell by 3.6%, in response to the annual decline of more than 6% in national demand, whereas net external demand, with a positive contribution of 2.8 pp, helped soften the adverse impact of demand on GDP.

The gradual improvement in the Spanish economy continued in the opening months of 2010, in an environment marked by the progressive recovery of the world economy, the continuation of the effects of the public measures supporting demand and the increase in agents' confidence. Estimates based on the conjunctural information available suggest that, in Q1, GDP grew at a quarter-on-quarter rate of 0.1%, following six consecutive quarters of declines. Nonetheless, in terms of the year-on-year rate, which measures the conjunctural situation with some lag, output is estimated to have declined by 1.3%. On the expenditure side, the rate of decline of national demand slackened to -2.6% (-5% in 2009 Q4) and the positive contribution of net external demand lessened to 1.4 pp (2.2 pp in the three previous months), with a pick-up both in exports and in imports. The plans to support the private sector were influential in rekindling certain spending components, in particular household consumption, although their impact has progressively diminished, while the outcome of the completion of projects linked to the State Local Investment Fund was reflected in something of a fall-off in investment in non-residential construction. In step with this all the productive branches were somewhat less depressed than in previous quarters, and the pace of decline in employment slackened, with this variable posting a year-on-year fall of 3.6% on EPA figures. However, the unemployment rate rose again in Q1, up to 20%, owing to the slowdown in the rate of decline of the labour force. Against this backdrop of low growth and sluggish recovery, inflation continued to moderate. The rate of change of the CPI rose in the opening months of 2010 (1.4% in March) as a result of dearer energy, while the CPI excluding unprocessed food and energy held at a rate of virtually zero. The leading indicator of the HICP showed an increase in its year-on-year rate to 1.6% in April.

Turning to the international economic outlook, the recovery in train - as has been the case since it began - showed different rates across countries and regions. The recovery in the emerging Asian and Latin American economies was prominent, although the United States also contributed decisively to the growth of world GDP. Nonetheless, certain factors persist in the developed economies that weigh on and pose risks to the recovery, including most notably the weakness of the labour market and the generalised deterioration in fiscal positions. Global inflation rose in the opening months as a result of the increase in oil and commodities prices, although expectations about its future course remain moderate. Finally, the ongoing stabilisation of international financial markets, though taking root in numerous segments, was interrupted from February as a result of the fiscal crisis in Greece. This gave rise to various episodes of instability, which were particularly severe in the second half of April, especially in the euro area. Initially, the focal point of these episodes was the sovereign debt markets, but they subsequently spread to stock and foreign exchange markets. Against this background, the exchange rate of the euro depreciated from the start of the year against the dollar by around 7.6%.

In the absence of inflationary pressures, monetary policies retained an expansionary stance, while the central banks of the main developed countries began to implement the plans an-



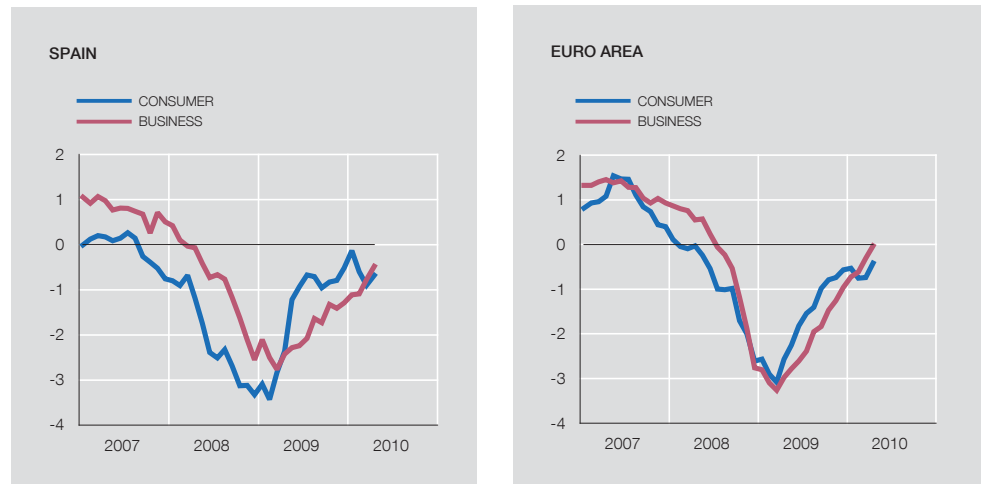
SOURCES: ECB, INE and Banco de España.

a. Seasonally adjusted series.

nounced for the withdrawal of the non-conventional liquidity-support measures. In the United States, the Federal Reserve held its official interest rate in a range of 0% to 0.25% and ended its asset purchase programme in March. The Bank of England left Bank Rate unchanged at 0.5% and, from February, interrupted its asset purchase programme. Finally, the Bank of Japan held its official interest rates at 0.1%, although it extended the fixed-term open market operations running since December.

The general trend of recovery was also discernible in the euro area, albeit at a somewhat more muted rate, as was already the case in late 2009. The impulse of the external sector has not yet translated into greater strength in internal demand, in a setting in which some of the temporary factors that boosted the recovery, such as the fiscal stimulus and the change in the inventory cycle, are beginning to lose momentum, and in which bad weather may have adversely affected activity in certain productive branches. Inflation rose somewhat in the opening months of the year, although this was due mainly to temporary factors as a result of transitory increases in the more volatile components (energy and unprocessed food). The foreseeable scenario of mild recovery, wage moderation and slack capacity means risks to price stability are not envisaged in the medium term. Against this backdrop, the ECB Governing Council decided at its meetings in the year to date (to May) to keep its official rate unchanged at 1% for the main refinancing operations, at which level they have held for a year, while the rates for its marginal lending and deposit facilities stand at 1.75% and 0.25%, respectively.

The ECB took further steps in defining the strategy of gradual withdrawal from the extraordinary measures introduced during the financial crisis, although it retained its policy of abundant liquidity provision. In March, the ECB Council confirmed that the conditions under which its weekly and special one-month tenders are made will remain in place at least until 12 October. It also agreed that its regular three-month refinancing operations would resume their habitual variable-rate tender procedure, as from 28 April, although allotment would take into account market conditions. Finally, the ECB decided to keep its collateral requirements relatively unchanged, beyond the end of 2010. However, on 3 May, after issuing a favourable opinion on the ambitious fiscal adjustment programme sanctioned by the Greek government under the aid plan approved by the Eurogroup and the IMF, the ECB Governing Council decided to suspend application of the minimum credit rating threshold to Greek government debt.

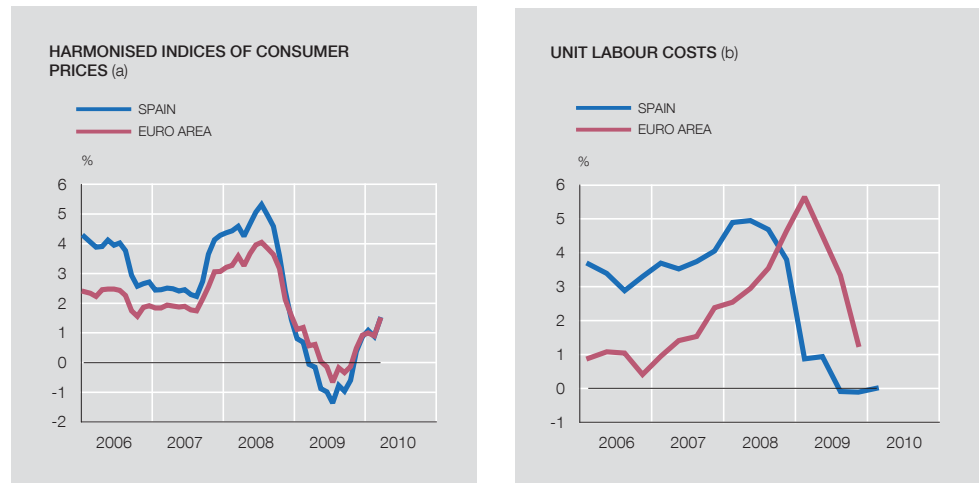


SOURCE: European Commission.

a. Normalised confidence indicators (difference between the indicator and its mean value, divided by the standard deviation).

Following the fiscal disaster in 2009, a slight deterioration is expected in the public finances for the euro area as a whole in 2010 further to the various fiscal consolidation strategies adopted nationally. In the countries with the biggest deficits, these strategies envisage the application in 2010 of adjustment programmes, while in the remaining countries they will be put back to 2011. Nonetheless, the doubts raised by the budgetary adjustment initially presented by Greece ultimately gave rise to an acute fiscal crisis which has required the adoption of a series of unprecedented measures, both by the Greek government and by the European authorities, as detailed in Box 2. The Greek government formally requested on 23 April that the exceptional financial support mechanism defined by the Eurogroup at its meeting on 11 April be activated. This request was dealt with by the euro area ministers of finance on 2 May. They unanimously approved an unprecedented programme envisaging bilateral loans of up to €110 billion over three years, €80 billion (€30 billion the first year) of which would correspond to the euro area Member States, and the remaining €30 billion to the IMF. The first payments will take place prior to 19 May, when a sizeable amount of instruments issued by the Greek Treasury mature. It should be stressed that this aid package which has now been approved entails strict conditionality terms. Indeed, on 2 May the Greek government approved, as a prior step to the activation of the aid, an ambitious and stringent program of fiscal consolidation and far-reaching structural reforms, negotiated beforehand with the European Commission, the IMF and the ECB. The progress made by the Greek authorities in complying with these demanding commitments will be evaluated each quarter. What is involved, therefore, is a not only a great effort by Greece but also an innovative institutional drive to restore confidence, curtailing the serious risks that the potential insolvency of one of its Member States would entail for the stability of the area.

The Greek crisis has in fact highlighted the need to strengthen governance of the euro area and to set in place multilateral mechanisms that ensure greater coordination of domestic economic policies. Heeding these demands, the Commission has announced its intention in May to unveil initiatives in three areas considered essential: first, the reinforcement of multilateral procedures for monitoring competitiveness and for the early detection of external imbalances; second, the reform of the Stability and Growth Pact, and third, the formalisation of a crisis resolution mechanism and a permanent framework that ensures financial support to member countries in difficulties, under the appropriate terms of conditionality. In parallel, progress was



SOURCES: Eurostat, ECB and INE.

a. Year-on-year rate of change.

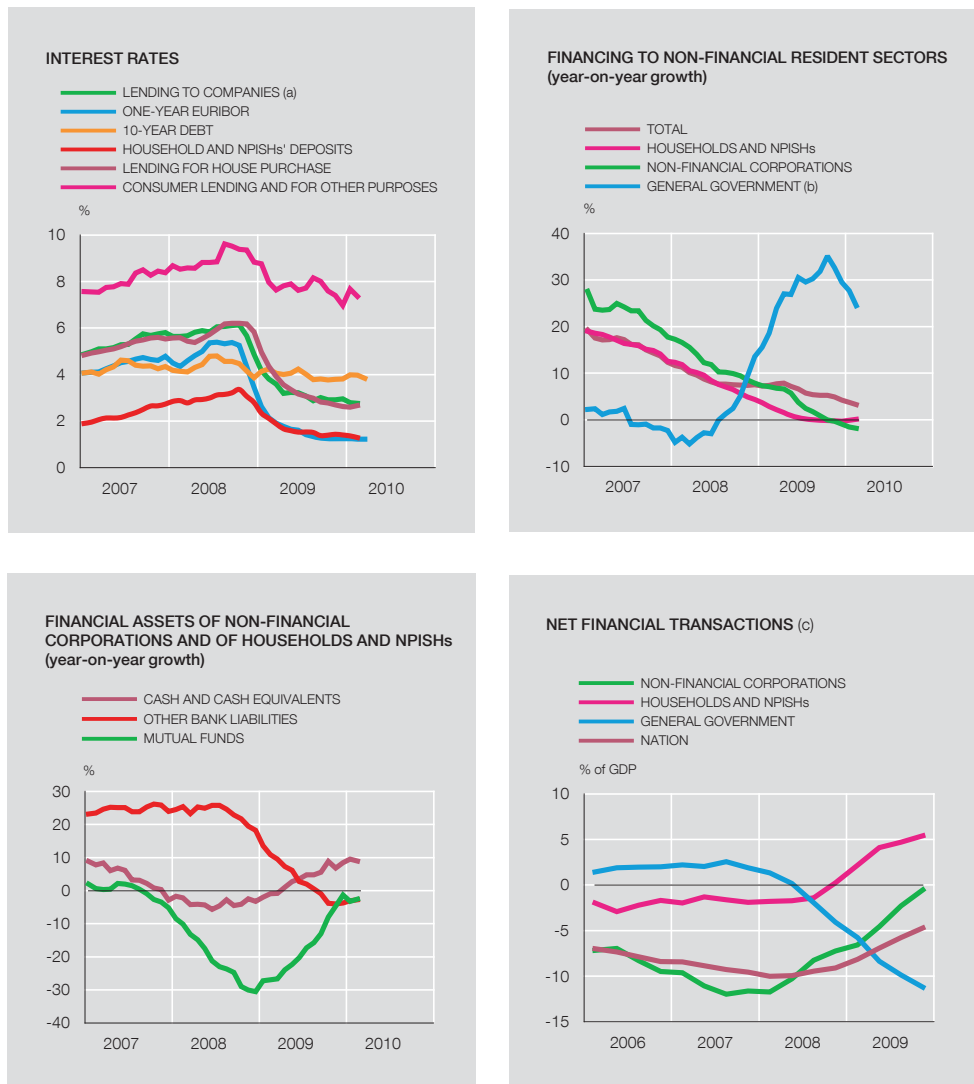
b. Per unit of output. Year-on-year rate of change calculated on the basis of seasonally adjusted series.

made during the quarter in defining the most suitable strategies for withdrawing the economic policy impulses exceptionally applied during the economic crisis.

Despite the bouts of instability on the government debt markets from February, interbank market interest rates held stable at low levels, both globally and in the euro area, and risk premia on private fixed-income markets remained relatively stable. However, the main stock market indices posted losses in Europe and sovereign risk premia held at very high levels in Greece and Portugal. The Spanish economy was affected by this episode of instability; in the four months to end-April, the IBEX registered a loss of 12.1%, a more unfavourable performance than that of the Eurostoxx 50 index of the euro area stock markets (which had fallen by 5% as at the same date). In Spain, the 10-year government debt yield spread over the German *Bund* widened by almost 40 bp to around 100 bp. Lastly, on 28 April a credit rating agency downgraded Spain's long-term rating from AA+ to AA, to a much lesser extent than was the case for sovereign debt issued by Greece and Portugal.

Household and business financing costs held at similar levels to those of the previous quarter, as did the degree of tightness of lending standards, which are in any event stricter than those applied at the start of the financial crisis. In the real estate market, and on Spanish Ministry of Housing figures, the pace of the fall in open-market housing prices slowed, posting a year-on-year rate of decline of 4.7% in Q1 (-6.3% in December 2009).

There was confirmation of the incipient signs of improvement in household spending seen in the past two quarters, while business investment remained relatively depressed. Specifically, the quarter-on-quarter growth rate of household consumption is expected to have risen for the second quarter running, slowing the year-on-year rate of decline in this demand component to -0.7% (-3.4% in the previous quarter). Unlike in the second half of 2009, the consumption of services and, to a lesser extent, of durable goods other than cars is estimated to have played a pivotal role in this recovery, while the effects of the government plan providing direct aid for car purchases are expected to have lost steam. Yet the presence of exceptional factors, also of a temporary nature, cannot be fully ruled out in the rise in specific spending items, which might slacken later (the digital switchover and the bringing forward of purchases before the



SOURCE: Banco de España.

- a. Weighted average of interest rates on various transactions grouped according to their volume. For loans exceeding €1 million, the interest rate is obtained by adding to the NDER (Narrowly Defined Effective Rate), which does not include commission and other expenses, a moving average of such expenses.
- b. Consolidated financing: net of securities and loans that are general government assets.
- c. Four-quarter cumulated data.

VAT rise in July). Over the rest of the year, a continuation of the modest pick-up in consumption may be expected. It will, however, be conditioned by the unfavourable behaviour of disposable income (as a result, above all, of the lower growth in wage income and of the lower contribution of other sources of income, in particular those arising from general government measures), the reduction in household wealth, the need for households to reduce their level of debt and uncertainty over labour market developments. However, the saving rate would begin to turn downwards during 2010 from its peak in 2009 Q4 (18.8% in four-quarter terms).

Residential investment remained firmly set on its path of adjustment, although its rate of decline slowed once more, and a year-on-year rate of around -20% (-25% in 2009 Q4) is estimated for this demand component. This figure was compatible with some stabilising of certain indicators of the demand for housing (such as the number of transactions or of mortgage approvals). In the opening months of the year, levels of affordability continued to improve. These

developments might take the form of some recovery in the demand for housing in the coming months and, alongside this, a somewhat more rapid absorption of the overhang of unsold houses, after this variable peaked in the opening months of this year, although the estimated excess capacity in the sector is subject to great uncertainty. Over the rest of the year the fall in residential investment is expected to slacken, although the behaviour of this variable will continue to weigh on output growth during 2010. In this setting of lesser slackness of household spending, the outstanding balance of household credit stabilised (its year-on-year rate edged up slightly to 0.1% in February) as a result of a slight increase in credit for house purchases (0.5%) and a small fall-off in credit for consumption and other purposes.

Business investment plans showed no signs of picking up. Compounding the factors that have held back non-financial corporations' investment decisions in the past two years (weak prospects of demand recovering, especially domestic demand, a contraction in business profits, high debt levels and a build-up of excess capacity) has been the lesser effect of the stimulus plans on this demand component (the plans mainly affect transport equipment purchases and participation in civil engineering projects). Indeed, investment in equipment might have resumed a negative quarter-on-quarter growth rate after having risen in the second half of 2009, precisely in those investment components. Nonetheless, a most significant correction is foreseen in the year-on-year rate of decline of investment in equipment, which is estimated to be around -3.5%, compared with -15.3% the previous quarter.

The component of investment in other construction, which also includes public investment in this item, showed signs of sluggishness as a result of the completion of infrastructure projects linked to the State Local Investment Fund and of the potential lag that the start of the projects to be financed by the State Fund for Employment and Local Sustainability (which will, in any event, be for a lesser amount) will most probably entail. As to the financing of non-financial corporations, credit continued to contract (its year-on-year rate turned even more negative, to -4.3% in February), which had a relatively generalised effect on all the productive branches.

The expansionary nature of general government conduct is expected to have begun to moderate as a result of the implementation of the 2010-2013 fiscal consolidation plan, bearing on both government consumption and public investment. Subsequent to the publication of the January quarterly report on the Spanish economy, details were released on this consolidation plan, which the government approved in late January. Specifically, it proposes cutting the deficit by 1.6 pp of GDP in 2010 and by 2.3 pp of GDP annually between 2011 and 2013. It would essentially target the structural deficit, as it is based above all on public spending cuts to 2013 - distributed among employee compensation, inputs, transfers, public investment and subsidies - although also on the tax increases approved under the 2010 budget. Given the scale of the budgetary imbalance resort will inevitably have to be made to increasing resources by means of the taxes offering the greatest revenue-raising capacity and those which generate least distortions. The aims of the programme are ambitious, but based on an optimistic macroeconomic scenario. Accordingly, strict compliance with the programme may require the adoption of complementary measures that prevent deviations from the established targets.

As regards trade with the rest of the world, the as yet incomplete information available indicates that the contribution of net external demand to annual GDP growth was positive (1.4 pp) in 2010 Q1, with substantial increases in both exports and imports. The take-off of exports is connected to the recovery in economic activity globally - although the reactivation of our export markets was more moderate - in a setting in which the favourable performance of price-competitiveness in recent months continued. However, the contribution of the external sector was smaller than in the previous quarters, as goods imports began to rise in response to the

slight recovery in certain domestic spending components. To date, however, this rise is weak, and its trajectory is not free from oscillations. Trade in services, of which tourism is a part, also picked up in Q1. The outcome of these developments was a further improvement in the nation's net borrowing, which continued to decline in January and February.

On the supply side, the year-on-year rate of decline in value added in the market economy eased, as was the case with employment, since there was a significant slowdown in job destruction (-3.6% on EPA figures, against -6.1% in 2009 Q4). Nonetheless, compared with the previous quarter, only value added and employment in market services showed positive rates of growth. The remaining non-farm productive branches posted declines, which were more acute in the construction industry, in light of the completion of some of the projects linked to the State Local Investment Fund and, perhaps, relatively bad weather.

The latest information on collective bargaining indicates that the start of the year is being marked by greater wage moderation. Wage agreements reached in the period to March show average settlements of 1.4%, 1 pp down on 2009. The influence of the agreement on employment and collective bargaining entered into by the social partners last February, which sets 1% as the ceiling for wage increases in 2010, is proving limited so far owing to the majority presence of revised agreements in collective bargaining. However, in the immediate future the agreement should allow wage growth to be adjusted to a greater extent to the economic situation and to provide for a downturn in compensation per employee and a slowdown in unit labour costs.

The government has put a labour reform proposal to the social partners which, though specific details have yet to be ironed out, suggests setting limits on temporary hiring, promoting permanent contracts and boosting part-time contracts and the youth employment plan. All these aspects, depending on how they finally materialise, may prove very relevant for the functioning of the Spanish labour market. Nonetheless, the proposal diverts the amendment of collective bargaining arrangements to the agreement between the social partners, which may unfortunately delay the necessary reform of this key labour market aspect.

Finally, the growth rate of the CPI has risen at the start of this year to 1.4% in March, as a result of the increase in oil prices. But core inflation held on the declining trend of recent quarters, and the year-on-year rate of change of the CPI excluding unprocessed food and energy (the two most volatile variables) stood at 0.1% in Q1. That meant the core inflation differential vis-à-vis the euro area remained favourable to Spain, by 0.6 pp. With a view to the future this inflation performance should desirably become entrenched, as it may make a decisive contribution to improving competitiveness and the recovery in growth.

## 2 The external environment of the euro area

During the opening months of 2010 the recovery on international financial markets and in global economic activity has continued. These processes have been mutually reinforcing, despite the fact that there have been bouts of growing instability related chiefly to the situation of public finances in certain European countries. During the quarter a gradual and bigger-than-expected improvement in world economic activity was perceptible, albeit at different rates across countries and regions, with a prominent firming of the recovery in the emerging Asian and Latin American economies. China and the other emerging Asian countries, on one hand, and the United States, on the other, were the main contributors to world GDP growth. In any event, in the developed economies output remains below its pre-crisis levels, and there are still factors weighing on and posing risks to the recovery, such as the weakness of the labour market (despite the first signs of improvement being observed), the fragility of the recovery in the housing market (especially in the United States and the United Kingdom), the slackness of bank credit and, above all, the public finances position (see Box 1).

On the international financial markets the recovery has been taking root in many segments. Following a correction in February and, also, in late April, the main stock market indices showed gains of between 2% and 7% in the first four months of the year, and both volatility and credit spreads on corporate bonds and emerging market sovereign spreads have diminished. Nonetheless, market developments have been very closely linked to news relating to the fragility of the Greek fiscal position, and the possible contagion to other European countries, which has given rise to various bouts of instability during the period. The improved economic outlook prompted an increase in private-sector bond issues in 2010 Q1, which were up 25% on 2009 Q4. At the same time, a very high volume of government bond issues - especially medium and long-term issues - is forecast for 2010, which has contributed to the slope of the US yield curve reaching a high. On the foreign exchange markets, the dollar has since the start of the year strengthened against the euro (although it has only partly corrected the depreciation recorded in 2009), sterling and the yen, while it has depreciated against most of the main emerging economies' currencies, which have been boosted by the return of capital flows to these countries. On the commodities markets, the pick-up in demand in many emerging and in some developed economies has led to a notable increase in prices, which have reached highs not seen since autumn 2008. The price of Brent oil is currently at around \$85 per barrel, and oil futures do not anticipate significant increases in this price.

In the United States, the GDP estimate for Q1 was for quarterly growth of 0.8% (3.2% in annualised terms), down on the figure of 1.4% for 2009 Q4. This was due above all to the momentum of private consumption and stockbuilding. This initial estimate confirmed the increases reflected in the supply-side and employment indicators, although doubts persist about the recovery in consumption. Net employment was created in the labour market in Q1 for the first time since end-2007, and the unemployment rate dipped to 9.7%, 0.3 pp down on Q4. Conversely, the housing market continues to show signs of weakness, as reflected in the stabilisation of prices and in the flatness of constructors' confidence, although both housing starts and sales rose in March, moving ahead of the phasing out of government aid. The CPI measure of inflation eased during the quarter to a year-on-year rate of 2.3% in March, while core inflation fell to 1.1%. Against this background, the Federal Reserve held its official interest rate unchanged in a range between 0% and 0.25% at its April meeting, reiterating that the rate would remain at a low level over a prolonged period, in step with developments in the economy. Furthermore, its asset purchase programme ended in March. On the fiscal front, the reform of

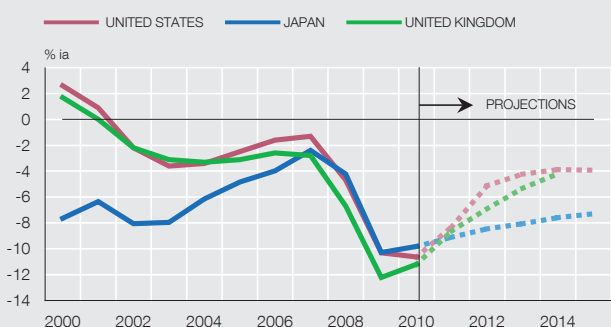
The deep recession experienced by the advanced economies against the background of the global economic and financial crisis, the forceful fiscal activism pursued (essential for averting the collapse of aggregate demand), and, to a lesser extent, the support to the financial system have resulted in a drastic increase in these economies' budget deficits and debt, to levels unprecedented in the post-Second World War period. This poses major policy challenges and risks to the economic and financial outlook.

The three main developed economies outside the euro area (the United States, the United Kingdom and Japan) faced the effects of the crisis from relatively similar starting points as far as general government financial balances were concerned, but markedly different ones in terms of their public debt. The three countries showed deficits of between 1% and 3% of GDP in 2007 (see Panel 1), although their structural deficits - which take into consideration the cyclical position of the economy - were concentrated in a range of 2.5%-3%. Nonetheless, Japan reached these levels following a fiscal consolidation process which enabled it to reduce its budget deficit by more than 5 pp from 8% of GDP in 2002, while in the United Kingdom and the United States the structural deficit remained relatively unchanged over this period, although the expansionary phase of the business cycle

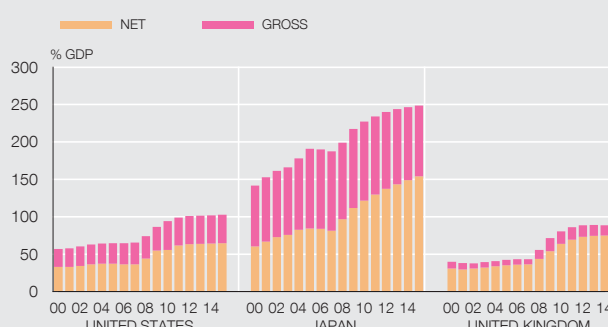
prompted an improvement in their general government balance. As regards debt, the legacy of the banking crisis in the 1990s in Japan and its unfavourable economic performance since then, which has been accompanied by persistent deflation, were reflected in public debt that amounted to 188% of GDP - in gross terms - in 2007, compared with 62% in the United States and 44% in the United Kingdom. However, as Panel 2 shows, the differences in terms of net debt, i.e. taking into account State assets and the debt holdings of other public-sector entities, were substantially less. In the United States and the United Kingdom, the net debt ratio was similar, at around 40% of GDP, while it stood at 82% in Japan.

In the wake of the crisis, treasuries contributed very actively to sustaining aggregate demand and implemented financial sector support plans. The support for aggregate demand was both through discretionary measures and stimulus plans, and through the operation of the automatic stabilisers. Among the discretionary measures adopted from 2008 were the increase in public investment (or the bringing forward of that scheduled for 2010 and 2011), support for employment (including training and placement programmes), direct transfers, tax cuts and, in some cases, aid to specific industries, such as the automobile and real estate sectors.

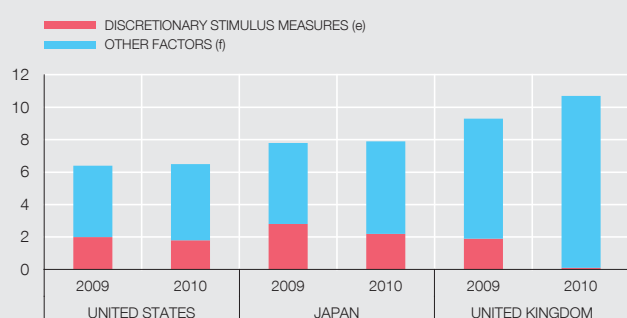
1 BUDGET DEFICIT (a) (b)



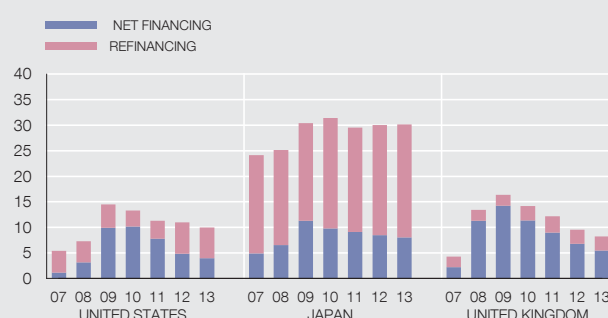
2 GROSS AND NET PUBLIC DEBT (a) (b) (c)



3 FISCAL SUPPORT TO AGGREGATE DEMAND (d)



4 GROSS ISSUE OF PUBLIC DEBT SECURITIES (a) (c) (g)



SOURCES: IMF, US Treasury, Congressional Budget Office, UK Treasury, Cabinet Office and Japanese Ministry of Finance.

- a. The UK and Japanese debt and deficit figures refer to fiscal years.
- b. The US, Japanese and UK projections are from the CBO, the IMF and the UK Treasury, respectively.
- c. UK gross debt refers to the general government sector (central and local government), while net debt refers to the overall public sector (including public corporations).
- d. Excludes financial-sector support measures, in order to analyse the fiscal measures with a direct effect on demand.
- e. Budgetary cost of discretionary measures related to the crisis, compared with 2007.
- f. Includes the impact of the automatic stabilisers and the impact on revenue of factors other than the cyclical change (e.g. the fall in house prices or in financial sector profits).
- g. The US, Japanese and UK projections are from the CBO, Japanese Ministry of Finance and the UK Treasury, respectively.

The scale of the discretionary fiscal stimulus differs across the three countries analysed (see Panel 3). In Japan it exceeded two percentage points of GDP in 2009 (2.8%) and it is projected to be reduced by only half a point this year; in the United States it stood at around this figure in 2009 and is expected to hold at a similar level this year; finally, in the United Kingdom the fiscal impulse was on a similar scale to that of the other two countries in 2009, although it will be practically zero in 2010. This difference is due to the lesser room for manoeuvre offered by the strong deterioration in the UK's fiscal balance and the additional increase in debt arising from support to the financial sector. Regarding the first point, Panel 3 shows that the greater deterioration in the UK fiscal balance - by almost 10 pp in the past two years - came about due both to the greater weight of its automatic stabilisers and to the strong decline in tax receipts from the real estate and the financial sector; the latter has a greater relative weight in the United Kingdom than in the other two economies.

Turning to support for the financial system, the main developed economies implemented a series of measures which included, inter alia, capital injections, asset purchases and guarantees of assets or liabilities, and whose direct cost accounted for around 3.5% of the GDP of these economies. However, there were substantial differences among the countries, in accordance with the relative size of their financial systems, the degree of exposure to impaired assets and funding needs on wholesale markets. Thus, in the United Kingdom and in the United States, the amount of earmarked resources exceeded 80% of GDP overall as at mid-2009, while in Japan this figure was scarcely over 30% (a similar ratio to that of the euro area). Nonetheless, the differential characteristics of the types of support meant that the impact of these measures on public finances was notably greater in the United Kingdom (8.2% of GDP) than in the United States, while in Japan the impact was relatively insignificant.

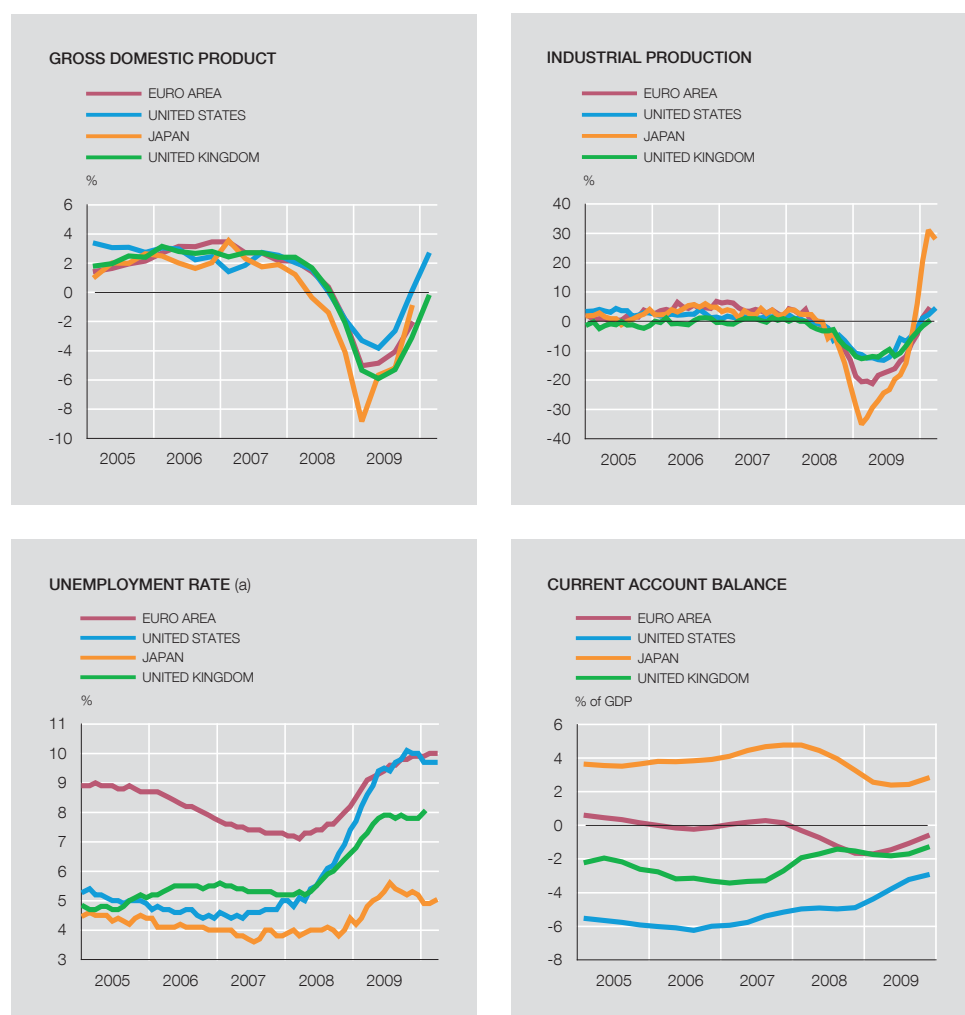
As a result, the crisis has caused a very marked increase in budget deficits and in public debt. Deficits exceeded 10% of GDP in the three aforementioned countries in 2009, while public debt increased between 2007 and 2009 by 20 pp of GDP in the United States, by 28 pp in the United Kingdom and by 30 pp in Japan. These high deficits and public debt levels pose a difficult fiscal policy challenge. On one hand,

the recovery of private-sector demand is still fragile, whereby fiscal stimuli would need to be maintained during 2010. On the other, the swift increase in debt, in a setting in which concerns over its sustainability in other developed economies have increased, points to the need to diligently design and communicate credible fiscal consolidation plans for the medium term. In this respect, both the United States and the United Kingdom have unveiled budgetary projects that provide for a very gradual reduction in their deficits (reaching around 4% of GDP in the United States and 5% in the United Kingdom by 2013), based both on spending restraint and an increase in the tax burden (through higher taxes in the United Kingdom and through the phasing out of prior tax cuts in the United States). In both cases, these fiscal plans are based on revenue-raising forecasts on what are deemed optimistic assumptions. Although Japan has not presented deficit projections for the coming years (a medium-term fiscal plan is expected to be announced in June 2010), the IMF estimates that the Japanese deficit will fall slightly to 8% of GDP in 2013. Despite the envisaged pick-up in activity, the still-high deficits in the next four years mean the gross debt of the three countries will move on a rising path, which in 2013 would amount to 244% of GDP in Japan, to 100% in the United States and to 90% in the United Kingdom. Furthermore, there has been little specific headway in these three countries as regards reducing the fiscal burden stemming from population ageing.

This fragile public finances situation harbours factors of risk for the economic recovery and for financial stability. Firstly, an increase in agents' uncertainty over debt sustainability may force through a faster-than-expected fiscal adjustment. At the same time, the still-high deficits in the coming years in these three economies, combined with the need to refinance growing volumes of debt (see Panel 4), may give rise to upward pressures on long-term interest rates, as the economic and financial situation normalises. And such pressures might compromise the incipient recovery in private-sector demand. Also, it is important to generate further fiscal policy headroom so as to be able to tackle any demand shocks arising in the future. All these factors point to the need to present credible fiscal consolidation strategies, along with a reform programme that promotes an increase in potential growth and which contributes to the sustainability of public finances in the long run.

the US health care system was approved, and in February the executive branch unveiled the draft budget bill for fiscal year 2010-2011, which proposes a gradual reduction in the deficits over the period to 2013.

In Japan, GDP in 2009 Q4 grew at a quarterly rate of 0.9% (-1% year-on-year), reversing the decline of 0.1% the previous quarter. The expansion was essentially underpinned by the strength of external demand, and by the improvement in domestic demand, boosted by various fiscal support measures. In 2010 Q1, the economy continued to show signs of recovery. Industrial production continued to grow and the Tankan business confidence index regained its highest level since the crisis began, reflecting signs of improvement both in the services

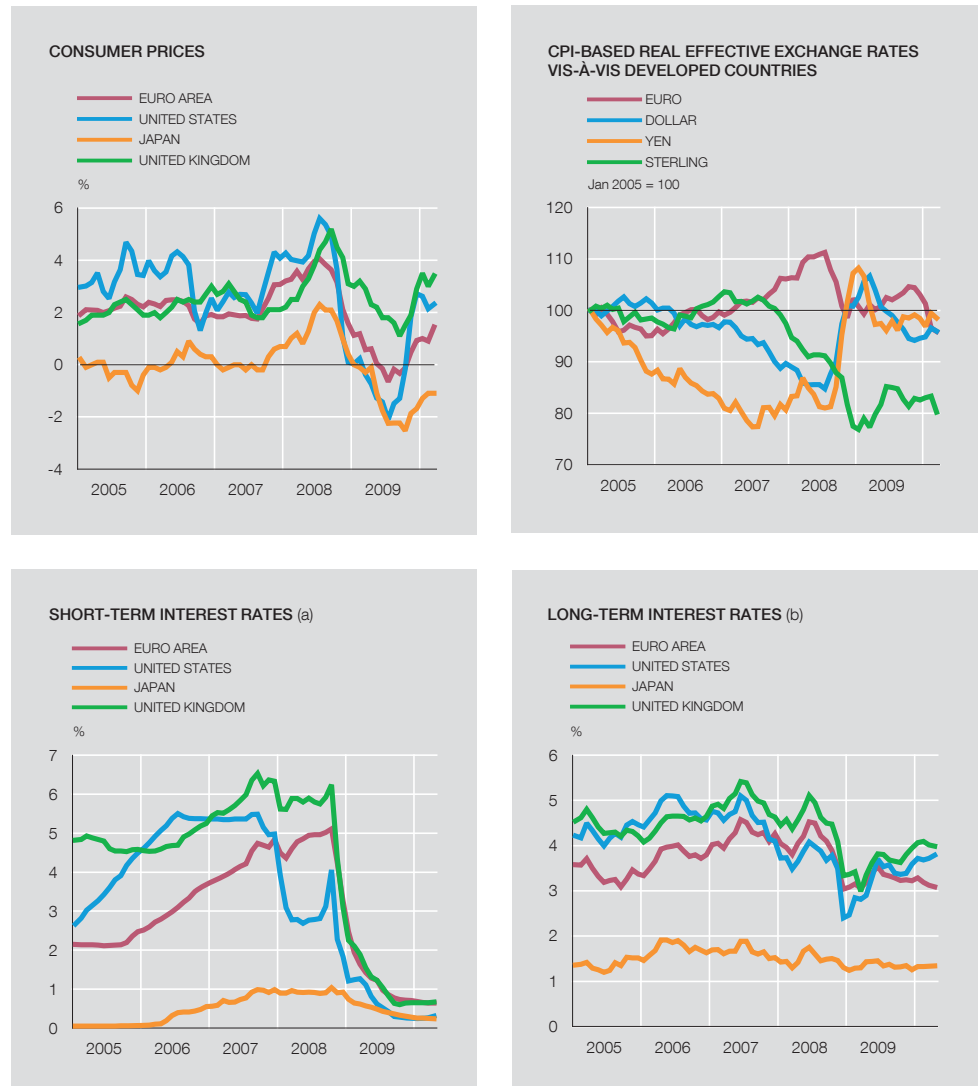


SOURCES: Banco de España, national statistics and Eurostat.

a. Percentage of labour force.

sector and in SMEs. Despite the sluggishness of disposable income, consumption benefited from the government incentives for goods purchases. In the labour market, the unemployment rate stood at 5% in March (0.2 pp down on the December figure), due to the pick-up in employment in Q1. Consumer and wholesale prices continued to fall in year-on-year terms, albeit with less intensity, owing to oil price rises. Against this backdrop, the Bank of Japan kept its official interest rate on hold at 0.1%, but decided to extend the fixed-rate money market operations approved in December, up to an amount equivalent to 4.2% of GDP. Further, in late April it revised its growth forecasts for fiscal year 2010-2011 upwards from 1.3% to 1.8%.

The gradual recovery in the UK economy continued in Q1, with a preliminary estimate for quarterly GDP growth of 0.2% (-0.3% year-on-year), compared with 0.4% in 2009 Q4. The Q1 industrial production and business sentiment indicators had already anticipated this development, offering a positive outlook for external demand and a somewhat gloomier picture for domestic demand (especially for investment spending). Retail sales remained sluggish in March, still under the effects of the January rise in VAT and persistent credit restrictions. The labour market, while fragile, continues to show signs of some stability, although the unemployment rate edged up in February to 8%. Diminished activity was observed in the real estate

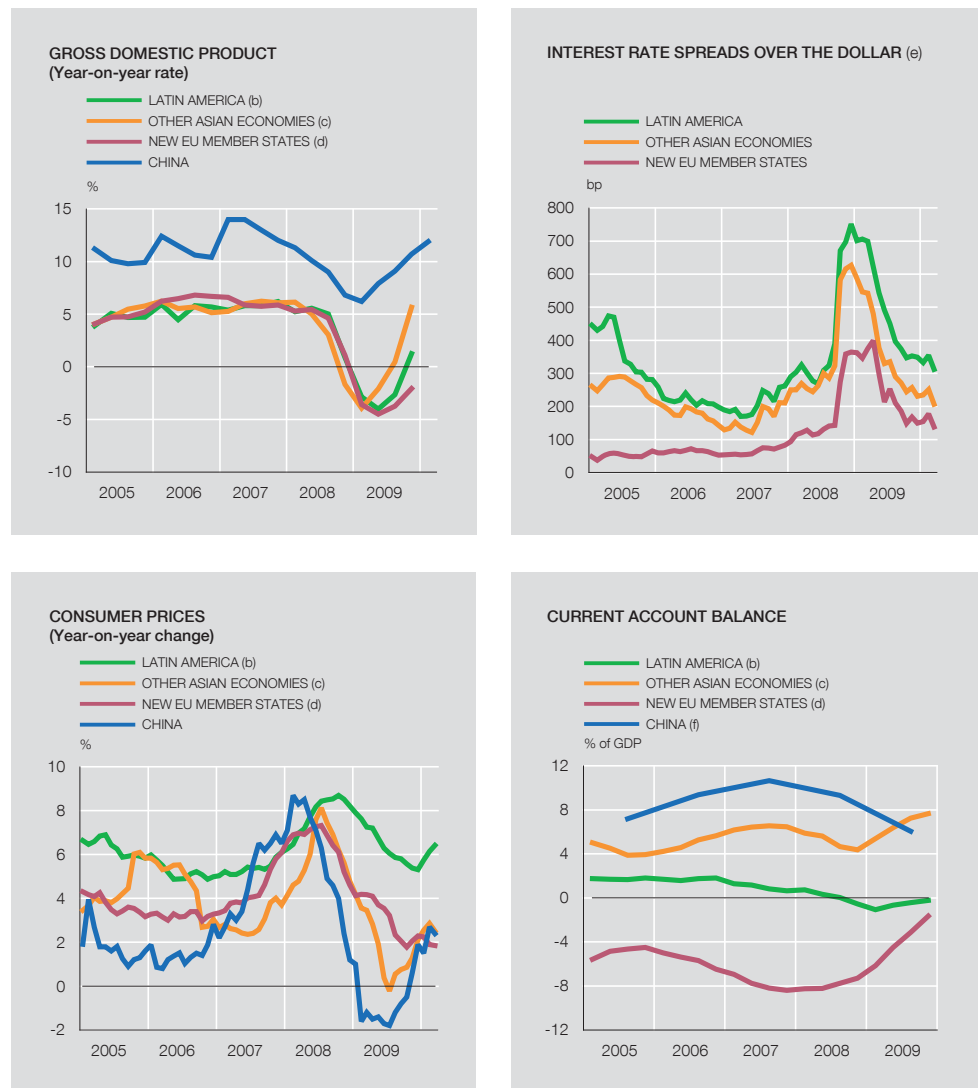


SOURCE: Banco de España.

- a. Three-month interbank market interest rates.
- b. Ten-year government debt yields.

market, a development partly attributable to the fact that the tax exemption for house purchases ended in December. Inflation increased notably in Q1, rising to 3.4% year-on-year in March, owing to the temporary effects derived from the increase in oil prices and the rise in VAT at the start of the year. Against this background, the Bank of England held its official interest rate unchanged at 0.5% and, from February, it halted its asset purchase programme. Finally, the government presented the budget for 2010, which includes measures to continue supporting the recovery, while drawing up medium-term fiscal consolidation plans.

In the new EU Member States outside the euro area, the decline in GDP in Q4 eased to -2.2% year-on-year on average, compared with -3.6% in Q3. There were, however, marked differences across countries; while there was a decline of around 18% in Latvia, Poland posted growth of 3.1%, the only country with a positive year-on-year rate. In 2009 as a whole, aggregate GDP fell by 3.6% on 2008. The gradual economic recovery continued to be underpinned by the pick-up in exports, while domestic demand – both consumer and investment demand – remains flat. Nonetheless, industrial production continued to improve in Q1, thanks



SOURCES: National statistics and JP Morgan.

- a. The aggregate of the different areas has been calculated using the weight of the countries that make up these areas in the world economy, drawing on IMF information.
- b. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
- c. Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore, Philippines and Taiwan.
- d. Poland, Hungary, Czech Republic, Slovak Republic, Estonia, Latvia, Lithuania, Bulgaria and Romania.
- e. JP Morgan EMBI spreads. The data on the new EU Member States relate to Hungary and Poland. The aggregate for Asia does not include China.
- f. Annual data.

to the expansion in the export sector, while there are still no signs of recovery in private consumption. During the quarter, inflation remained moderate and declined by 0.1 pp in March to 2.7% year-on-year. In this situation, Latvia, Romania and Hungary lowered their official interest rates. On the fiscal front, there was a notable deterioration across the board in budget balances and in gross debt in 2009 (with the exception of Estonia). On average, the budget deficit amounted to 6.6% of GDP and gross debt rose to 43%. At the second plenary meeting under the so-called “Vienna initiative” (with the participation, inter alia, of national authorities, of the main international organisations and of the banking groups with interests in the region) it was proposed to boost the development of local-currency-denominated capital markets and to lay down an appropriate prudential policy regulating the extension of foreign-currency-de-

nominated loans. Indeed, some countries, such as Hungary and Poland, had already moved in this connection and set limits on granting loans.

In China, GDP quickened in Q1 to a year-on-year growth rate of 11.9%, up on 10.7% in Q4. This strong expansion confirmed the momentum indicated by industrial production, investment in fixed assets and retail sales. Conversely, regarding the external sector, the trade surplus fell significantly in Q1 (posting in March its first deficit since 2004), owing to the strong growth of imports (65% year-on-year), while exports rose by around 24%. However, reserves continued to build up, amounting at the end of March to \$2.4 trillion. Set against the gradual slowdown in the money supply and in bank loans (owing to the effect of the restrictive measures), inflation dipped by 0.3 pp in March to a year-on-year rate of 2.4%. In the rest of Asia, economic activity and the external sector continued to show notable dynamism in Q1, and in some countries there were signs of overheating. Inflation tended to fall in most countries, with the notable exception of India, where it rose to a year-on-year rate of 9.9% in March. These price developments led India (on two occasions) and Malaysia to raise their official interest rates during the quarter. The strong acceleration in activity in Singapore prompted it, along with inflationary pressures, to revalue its exchange rate in mid-April and to announce the gradual widening of its intervention bands in the future.

In Latin America, GDP grew at a year-on-year rate of 1.3% in Q4, following three consecutive quarters of declines. This meant that in 2009 as a whole activity contracted by 2.1%, having grown by 4.2% in 2008. Underpinning the recovery was the positive contribution of external demand and the reactivation of domestic demand, particularly private consumption. The indicators for Q1 would suggest an acceleration in the recovery, more markedly so in Brazil and less vigorously so in Mexico. During the quarter, inflation moved on a rising path, owing to the increases in food and fuel prices, and it stood in March at a year-on-year rate of 6.5% for the region as a whole, while the core inflation rate held at 6.6%. In Brazil, price developments, combined with the buoyancy of activity, prompted the central bank to raise its official interest rate by 75 bp. Conversely, Colombia surprisingly cut its rate by 50 bp, while in the other countries rates remained unchanged. The aggregate current account deficit declined in 2009 (from 0.7% to 0.1% of GDP), thanks to the improvement in trade balances. Portfolio investment flows increased most notably, as both governments and companies raised their bond issues on international markets, especially in Q4, whereas direct investment inflows fell to their minimum 2006 levels. On the fiscal front, primary balances improved across the board late in the year, owing to the pick-up in receipts. Argentina offered a further debt swap for holders who did not avail themselves of it in 2005.