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西班牙和意大利：已走出危机，但复苏尚待时日

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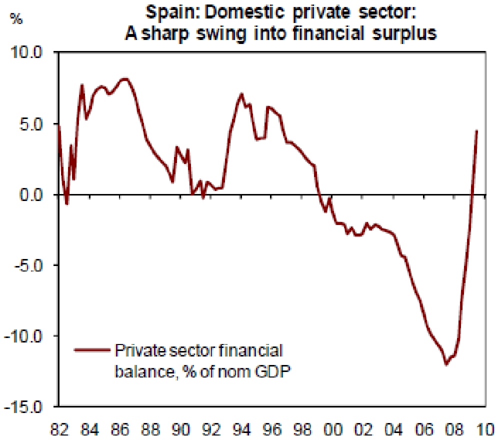
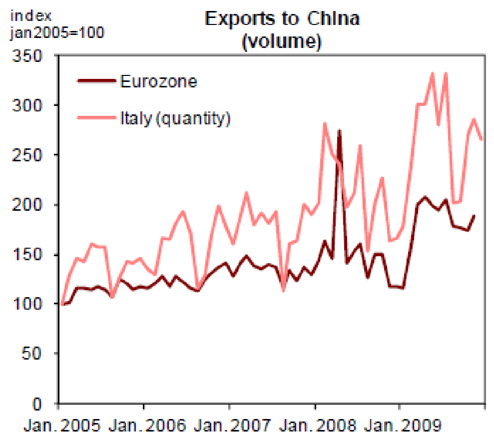
希腊仍是本周全球市场的焦点：如果希腊要求获得财政援助，经济货币联盟（EMU）各成员国将对其采用不同的利率；而希腊银行业要求获得政府支持计划剩余资金的举动也令投资者担忧，推动10年期希腊国债收益率与德国10年期国债收益率之间的利差创历史新高。此外，欧洲央行宣布，将在2010年底以后继续维持担保品最低评级门槛BBB-/Baa3级。自2011年1月1日起，评级在BBB+至BBB-之间的资产都将适用一个分级折扣计划中，但这一计划不会影响到主权债券。

我们本周所要关注的是欧元区南部两个较大的国家——意大利和西班牙。从西班牙的情况看，它的国内部门处于资产负债状况修复过程中，内需大幅下降。净出口需要快速上升才能抵消内需的下滑并带动产出缺口开始缩小。即便是温和地将合同工资下调1-2个百分点，要重新实现平衡仍有很长的一段路要走（即便西班牙出现温和的通货紧缩）。但这些情况在今年都不太可能出现。

与此同时，意大利经济的复苏尚需时日，其出口增长仍落后于其它欧元区国家。尽管较低的生产率和停滞的人口增长仍然是影响其竞争力和可持续性的关键因素，但我们认为，意大利的国际收支失衡尚在可控范围内，而且它将充分受益于金砖四国的需求、整体较为强劲的全球需求和欧元的走软。我们预计，意大利的出口增幅可能会高于欧元区平均水平。



Source: INE, Goldman Sachs



Source: Eurostat, GS Global ECS Research

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Spain and Italy: out of the crisis, in for a long haul

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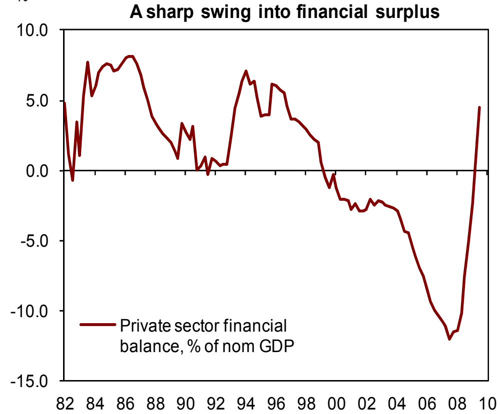
Greece remained the focal point of world markets' attention this week: differences among EMU countries on the interest rate that should be charged to Greece, were it to ask for financial assistance; and Greek banks' request for the remaining funds of a government-sponsored scheme rattled investors, sending the spread of 10-year Greek bond yields over Bunds' to record highs. In addition, the ECB announced that it will keep the minimum credit threshold of collateral at BBB-/Baa3 beyond the end of 2010. Assets rated in the BBB+ to BBB- range will bear a graduated haircut schedule as of 1 January 2011, although this will not affect sovereign bonds.

Our two focuses this week look at the two larger countries in the south of the Euro-zone, Italy and Spain. In the case of Spain, its domestic sector is in balance-sheet repair mode, with domestic demand down sharply. Net exports will have to rise fast to offset that decline and start to reduce the output gap. Even modest 1-2pp cuts to contractual wages would go a long way to facilitate this rebalancing (even if they tipped the country into a moderate deflation). Alas, they are unlikely this year.

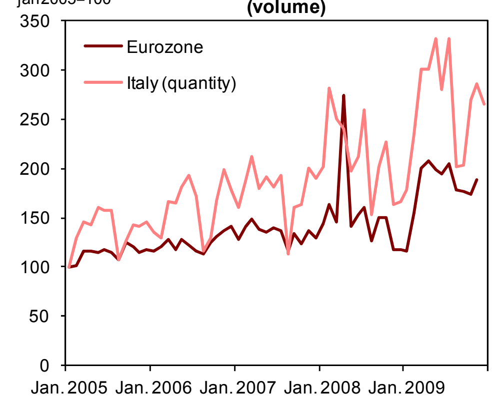
The Italian economy, meanwhile, is taking its time to recover, with export growth lagging that of its peers. While low productivity and stagnant demographics remain the key drags to competitiveness and sustainability, we believe that Italy's external imbalances remain in check and that the country is well positioned to benefit fully from BRICs demand, overall strong world demand and a weaker euro. We anticipate that Italian exports might grow more strongly than the Euro-zone average.

Spain: Domestic private sector: A sharp swing into financial surplus



Source: INE, Goldman Sachs

Exports to China (volume)



Source: Eurostat, GS Global ECS Research

Week in review

The ECB meeting today was the highlight of this week's European news, but at the end of day, the ECB's new collateral policy offered little in the way of fundamental reform, with the only major (and already pre-announced change) being the extension of the "relaxed" collateral eligibility threshold. Euro-zone sovereign bonds can still lose eligibility at the ECB, and these assets are not subject to the new haircut graded schedule. We think both of these parameters will have to be reassessed in the near future.

On the data front, final PMI prints came in slightly higher than flash estimates, and despite showing continued divergence at both the regional and sectoral level, continue to signal upside risks to our Q1 growth forecasts. The hard data, however, is not as definitive in this positive signals, as the first round of February IP showed some slowing of momentum following the stronger-than-expected readings in January. Statistical effects related to the cold weather earlier this year likely continue to distort some of the underlying trends, and will probably take a few more months to work their way through the data.

ECB meeting: rates unchanged, collateral policy changes far from sufficient

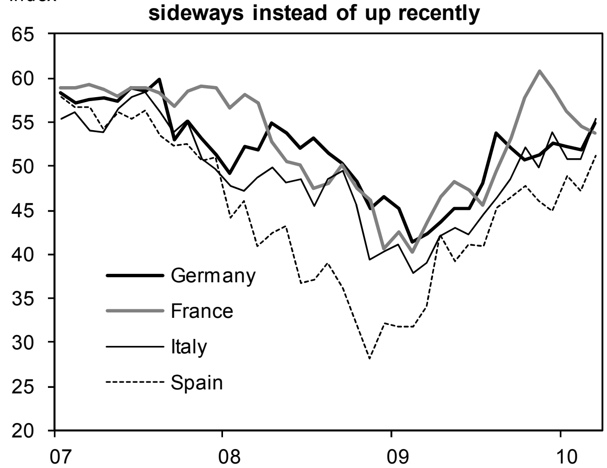
On interest rate policy, today's ECB meeting was uneventful, with the Governing Council keeping rates and unchanged, and, as expected, offering no further details on their exit strategy.

The much awaited new information related to the details of changes in the collateral requirements, but actually turned out to offer little new insight. As was pre-announced two weeks ago, the threshold at which a Euro-zone sovereign member can lose collateral eligibility at the ECB will be kept indefinitely at its present "temporary" level of BBB-, three notches below the old "permanent" level of A-.

Meanwhile, the new sliding scale for haircuts does not seem to apply for sovereigns (they will still face a uniform haircut), and all decisions on their future eligibility will still remain with the three ratings agencies (i.e. until the ECB changes the rules again). In our view, this framework is far from optimal, because it fails to address the fundamental issue with the ECB's collateral rules — mainly that a sovereign member can still completely lose eligibility. However, given the risk that what looked like a half-hearted approach could have been very bad news for Greece and its banks, this de facto "no-change" is, in a peculiar way, good for Greece.

On the assessment of the economic situation, the ECB maintained its view of the prospects for growth (recovery, but uneven) and inflation (no worries), so interest rates remain "appropriate". They also explicitly state that it is normal for lending to the corporate sector to lag the recovery. The ECB's Monthly Bulletin had a box some months ago documenting this phenomenon, so its not exactly news for the ECB, but thus far they had seemed to play down this finding by the staff. Perhaps the newfound emphasis is an early sign of the ECB gaining a little more confidence on the banking system as a whole.

Chart 1: Services PMIs have been moving sideways instead of up recently



Source: Markit

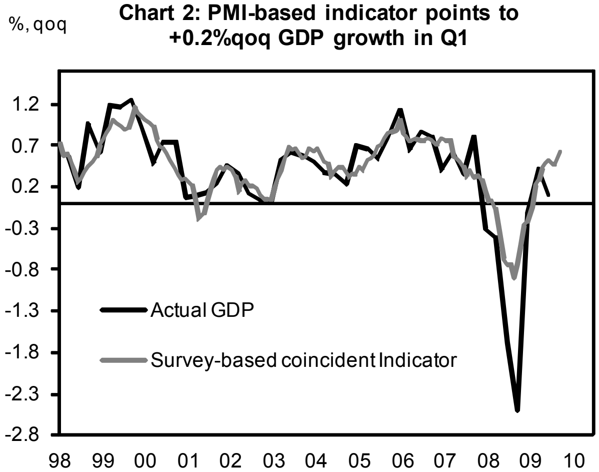
Final PMIs: strong momentum with lingering divergence

The final PMI prints for March came in stronger than the flash estimates, but the overall message of these latest sentiment indicators remains the same—improving momentum but with divergence at both the regional and sectoral level.

In the manufacturing sector, Germany consolidated its status as the EMU frontrunner, with its index rising from 57.2 to 60.2 in March (flash 59.6). After a small hiccup in February, the French index also powered ahead in March (54.9 to 56.3), complementing the gains in both Italy (51.6 to 53.7) and the Netherlands (55.2 to 57.8). Spain finally entered expansionary territory for the first time since late 2007, although it still remains at the bottom of the EMU-5. The major outlier continues to be Greece, where the reported pace of manufacturing contraction worsened in March from 44.2 to 42.9.

While the upward momentum in manufacturing is by now well-established, the signals from the services sector are considerably less unequivocal. Although both Germany and Italy registered large jumps in March, their indices have been quite volatile in recent months, and, if anything, have been more on a sideways path than on a upward trend (Chart 1). The same goes for the Spanish

Chart 2: PMI-based indicator points to +0.2%qoq GDP growth in Q1



Source: Eurostat, GS Global ECS Research

index, which, until surging past 50 in March, had been showing little positive momentum. Even now, some give-back in coming months in not unlikely.

We have noted the underperformance of the services sector relative to manufacturing for some time now, and as long as external demand continues to outpace domestic sectors, this pattern should persist. Despite the underlying divergences, business sentiment in aggregate is still pointing to a robust economic recovery across the Euro-zone, with the implied GDP growth rate of +0.6% to 0.7%qoq now signalling upside risks to our forecast of +0.4% (Chart 2).

German IP stumbles, weather effects still to be played out

While the business surveys are pointing to stronger-than-expected growth, corroborative evidence from the hard data remains difficult to interpret. Industrial production numbers largely surprised to the upside across the Euro-zone in January, but it is hard to say how much the cold weather influenced these numbers, and to what extent it will factor into future prints.

In principle, cold weather should depress construction activity and elevate energy production, and this is indeed what happened in January. We have been expecting that as the weather normalizes, these offsetting effects should unwind and that other sectors (such as manufacturing) should drive the underlying trend of IP. However, the first round of February IP readings have not necessarily followed this choreography.

German industrial output was flat on the month, and the January figure was revised down to +0.1%mom after an initial estimate of +0.6%. Construction retraced only 1% of its 14%mom plunge in January, and manufacturing, which we had expected to strengthen given the buoyant business surveys, actually edged down 0.1% on a monthly basis.

In Spain, we don't have the full sectoral breakdown yet but overall IP fell 0.6%mom in February on the back of a 1.0% decline the previous month. If the remaning major countries (France, Italy and Netherlands) come in line with our expectations, this means that IP would be flat in February.

In this sense, the hard data thus far as not as definitive as the surveys in terms of upside risks to growth, and it will likely take another month or two for weather effects to play themselves out and for a clear underlying growth trend to emerge.

Q4 GDP revised down a touch

The final bit of major data this week was Eurostat's second estimate of Q4 Euro-zone GDP, which, while backward-looking, still has some technical implications for our growth path.

GDP growth in Q4 was revised down from 0.1%qoq to flat, as updated estimates showed marginally slower growth in Italy, Netherlands and Portugal. Some additional drag came from the dismal Irish Q4 print of –2.3%qoq, which was incorporated into the Euro-zone aggregate for the first time.

Despite these updated figures, we think that more Q4 revisions are in order, especially in light of the fact German industrial production for December was again revised up — IP in Q4 now grew +1.1%qoq as opposed to the +0.4% initially thought. When all is said and done therefore, Q4 GDP growth for the Euro-zone as a whole will therefore likely stand at around 0.1% to 0.2%qoq, meaning the jump-off point for subsequent quarters will not be drastically different from the one on which we are currently basing our forecasts.

Erik F. Nielsen and Nick Kojucharov

Spain: The crash behind, the task ahead

The Spanish private sector is in balance-sheet repair mode. The public sector has contributed to that repair process for the last couple of years but its financial balance has swung sharply into deficit as a result, prompting the government to embark on sizeable fiscal consolidation. As the share of domestic demand in overall spending continues to fall in the next few years, net exports will have to rise quickly to offset that decline, to narrow the output gap and to prevent further declines in the economy's productive capacity.

The good news is that, over the past ten years, Spanish exports have held up relatively well despite large increases in relative labour costs, suggesting competiveness gains not captured in the official price data; that the country has undergone an intense process of capital stock expansion that bodes well for the future; that the repair of balance sheets is proceeding fast; and that the low level of public debt allows for a gradual fiscal adjustment. The bad news, however, is that the country was not prepared in 1999, and is not prepared now, to accept wage cuts, which are the quickest way to raise competitiveness in export and domestic markets and to facilitate rebalancing.

Wage cuts of about 1-2pp per year for the next few years would likely tip the country into a moderate deflation. This would add to the burden of highly-leveraged agents in the economy. It would also raise real interest rates. But this deflationary scenario would be the lesser evil: without the wage cuts there is a clear risk that the re-balancing will still proceed but settle at a level of GDP far from its potential, with the unemployment rate hovering in the high teens for most of the next decade.

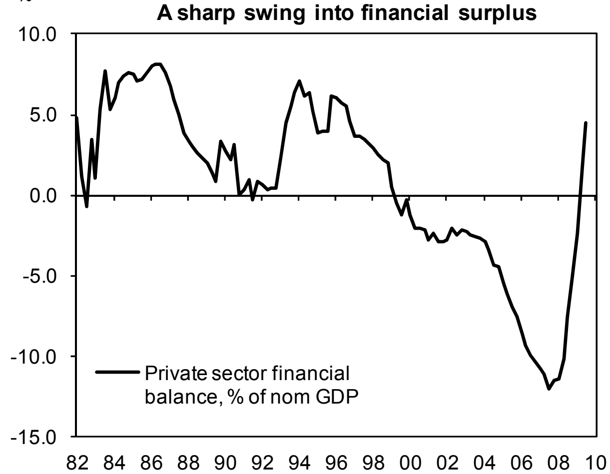
We wrote recently that Spain's fiscal plans are credible and implementable[1]. There were three reasons for this positive assessment:

- The government had implemented or announced unpopular tax hikes (income tax and VAT), the critical test of the authorities' resolve to deal with fiscal imbalances[2].
- The plans map out clear performance signposts against which the markets can assess the consolidation, in particular the spending cuts worth 4.3pp of GDP tabled for 2011-2013 (although these cuts will require the co-operation of regional and local governments). This is a credibility-enhancing strategy as the authorities will find it difficult to deviate from those plans without unnerving investors.
- The low level of debt, 55.2% of GDP in 2009, allows the adjustment to be gradual, reducing the risk of a fiscally-driven relapse into recession.

But nothing will help as much as confidence in the outlook for economic growth. Despite the positive take on the fiscal prospects, we also stressed that much of the fiscal improvement will hinge on the growth performance of an economy that is undergoing a gruelling, difficult re-allocation of resources towards external demand. A healthy, dynamic re-balancing (as opposed to a re-balancing achieved through a protracted contraction of domestic demand and overall GDP) would:

- facilitate the consolidation of fiscal accounts and the repair of domestic balance sheets (including those of the banking sector); and

Chart 1: Domestic private sector: A sharp swing into financial surplus



Source: INE, Goldman Sachs

- minimise long-term unemployment and withdrawal from the labour market, thus supporting the long-term economy's productive potential.

What follows assesses the key parameters of this re-balancing, its nature and magnitude. It considers some scenarios for the "internal devaluation" (i.e. a reduction of domestic costs that would replicate the competitiveness-boosting impact of a traditional currency devaluation and facilitate the re-balancing). It also considers the desirability (we think it is "desirable" if only because the alternative is worse) and its likelihood (we think it is unlikely wages and consumer prices will actually fall, at least in this year: blame the downward nominal rigidity of wages and the 1-2% hike in the VAT rates slated for July).[2] The Box on page 9 examines the latest activity indicators: it concludes that while the

1. See "The Euro-zone challenge: Greece and contagion", European Weekly Analyst 10/04, February 4, 2010. If negative, other sectors (usually banks) are financing the shortage (via loans).
2. The government raised income tax by €400 per taxpayer in January, and the VAT rates (from 7% to 8%, and from 16% to 18%) from July.

economy is showing signs of life, the underlying momentum remains quite fragile.

A highly-leveraged private sector

Starting in 1999, and following almost 20 years of financial surpluses, the Spanish private domestic sector entered a phase of intense spending which resulted in increasing financial deficits year after year (Chart 1).[3] Table 1 shows the balances of the key domestic sectors.

The factors that, coming together, generated this episode can be classified in two groups:

- **Financial factors:** a sharp decline in real interest rates in the run-up to, and after, EMU accession, a strengthening of the real exchange rate and high real house price inflation all supported buoyant private spending in Spain, see Charts 2 and 3.

- **Structural factors:** the phenomenon of strong immigration inflows together with a fast incorporation of women into the labour market produced an unprecedented demographic shock (see Chart 3) which depressed the stock of capital per person. Companies and house developers moved in to restore those ratios, resulting in a long and intense period of rapid fixed capital formation which, not unlike an emerging economy, required external financing (the current account deficit peaked at 10% in 2007).

Sustainable debt: the case of Spain. Neither financial deficits, nor current account deficits, nor the leverage of households, companies or governments, individually or in the aggregate, have to be by themselves problematic — on the contrary, in most cases they reflect welfare-enhancing exchanges that benefit both lenders and borrowers. Deficits or debts become excessive when they exceed the debtors' ability and willingness to repay their obligations. This often gives way to a sharp retrenchment in spending (as debtors seek to repair their balance sheets) or to financial "sudden stops" (as creditors and investors withdraw new financing). As these episodes tend to occur much faster than the economy can adjust, recession usually follows suit.

Table 1: Domestic leverage in Spain and Emu

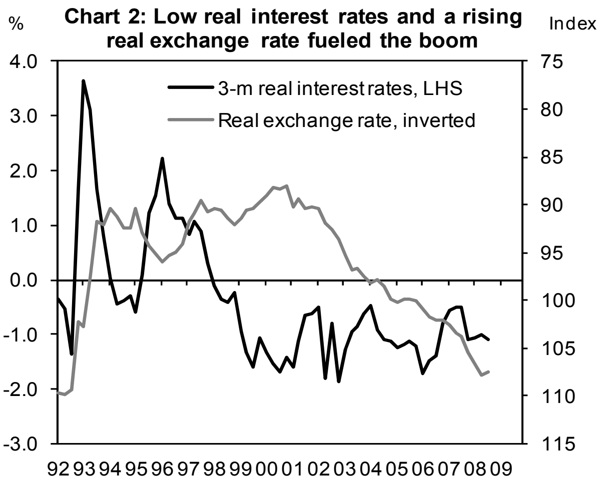
% of GDP		Spain	Emu
Household debt	1999	42.8	48.6
	latest	85.4	63.9
Non-financial corporations	1999	54.4	72.3
	latest	137.2	105.1
General government	1999	62.3	71.7
	2009	56.2	80.3

Source: Eurostat, INE

These general consideration s apply to the Spanish case. There are also a few, more specific features:

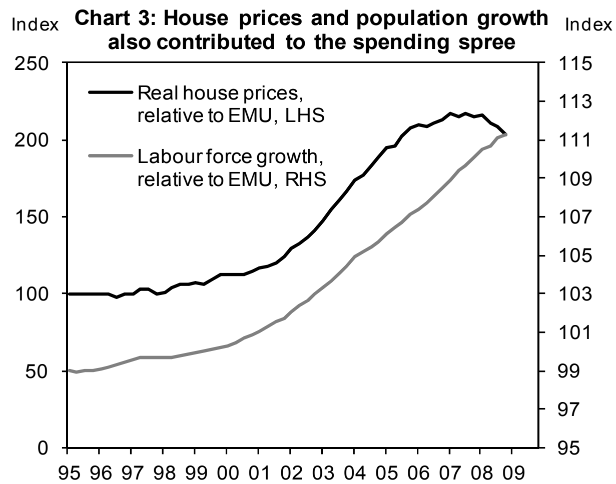
- **Into balance-sheet repair mode for the foreseeable future.** The sharp swing of the private sector financial balance into surplus has been driven both by the credit supply crisis (manifested in a tightening of credit standards) and by a retrenchment of domestic agents, worried about their own levels of leverage. The latter is likely to be more lasting than the former: households and companies in the aggregate can be seen as worrying about their falling income and sales, about the withdrawal of credit lines, and about the decline in value of the assets in their balance sheet (with real estate developers particularly burdened by their holdings of expensive, rising inventories). This retrenchment is evident not only in the investment and consumption data but also in the surge of the household saving ratio, up to 18.8% of disposable income in 2009 from a trough of 11% two years earlier.

Chart 2: Low real interest rates and a rising real exchange rate fueled the boom



Source: Goldman Sachs, OECD, INE

Chart 3: House prices and population growth also contributed to the spending spree



Source: Eurostat, INE, Housing ministry

3. A sector's financial balance is simply the difference between money inflows and outflows, excluding financial operation (borrowing, lending, investing). For example, in the case of the household sector, its balance is equal to their savings (disposable income minus private consumption) minus the funds spent in real investment (usually housing investment). If this balance is positive, it will flow to other sectors (banks, companies, governments) via financial operations (bank deposits, purchase of shares or bonds, etc). If negative, other sectors (usually banks) will be financing the shortage (via loans).

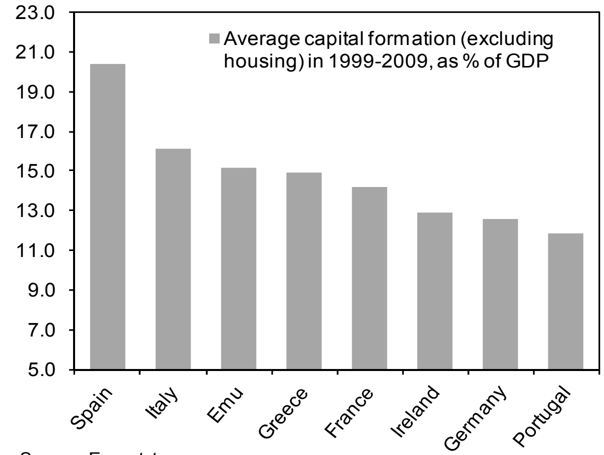
- **Public sector cushioned the crash.** The sharp change in spending behaviour by private domestic agents has triggered a counteracting swing into deficit of the public sector financial balance. While some discretionary fiscal measures (tax cuts in 2008 and public works programs in 2009/10) explain part of the swing, most of it has been prompted automatically, as the collapse in activity depressed tax revenues, raised welfare payments and lowered nominal GDP (the denominator in the deficit ratios). In other words, part of the improvement recorded in the private sector financial balance reflects an income transfer from the public sector: without it, and without the increase in actual public investment, the economy would have declined even faster. Evidently, that transfer can continue only to the extent that the public sector balance sheet can afford it: the low starting level of public debt, at 55.2% of GDP in 2009, means that the transfer can last longer than otherwise, providing some time for the economy to adjust.

- **The private sector's capacity to pay back.** A third consideration, often overlooked, is the intense expansion of the stock of capital of the Spanish economy during the 10 years previous to the crash (even when we exclude housing investment, see Chart 4). This is not a definite measure of capacity to service the debt — investment may have been undertaken with too optimistic projections, or in the wrong sectors, etc. Still, from the point of view of a creditor, it's certainly more preferable that the borrowed funds (or the current account deficits) have been used to finance productive potential rather than to finance consumption.

Rebalancing: the size of the task ahead

All these considerations provide an outline of the challenge that the Spanish economy faces and that will set it apart from conditions in the larger EMU countries for the foreseeable future: the challenge is to offset the dramatic retrenchment of domestic spending with an equally dramatic expansion of net exports. If this is not the case, then aggregate spending will remain depressed

Chart 4: Spain has invested substantially more than other Emu countries



Source: Eurostat

relative to its potential, implying not only a high headline unemployment rate but an upward drift in the structural unemployment rate of the economy. Income formation will suffer and with it the balance sheets of households and companies — especially in the real estate sector — and, indirectly, those of banks and the public sector.

To illustrate the magnitude of the rebalancing required we have modelled the economy on the basis of some basic assumptions about the unemployment rate target (to bring it down to 10% in 2015) and constraints (mainly that the share of domestic spending in total spending has to come down to 95%, from 105% currently). The key results are shown in Table 2 below:

- Exports would have to re-accelerate strongly to about 10-12%yoy from next year onwards, with exports in 2015 some 60% above its expected 2010 level. We assess in the next section the conditions in which this could be achieved. Note also that our current forecast for export growth in 2011 is much more modest 4.6%yoy

- This surge in export growth would support domestic demand — after all the expansion of exporting firms and the ensuing job creation will generate local

Table 2: Illustration of the re-balancing required to bring unemployement down to 10% at the end of 2015

		1999-2007	2008	2009	2010	2011	2012	2013	2014	2015
GDP, yoy		3.7	0.9	-3.6	-0.6	2.7	4.4	4.8	4.7	4.2
Domestic demand	**yoy**	4.5	-0.4	-5.9	-2.2	0.1	2.1	3.1	3.5	3.3
Exports	**yoy**	6.7	-1.0	-11.5	6.1	9.8	12.3	10.1	8.5	7.3
Imports	**yoy**	9.3	-4.9	-17.9	-0.2	1.3	4.7	5.2	5.3	5.1
Employment	**mn**	16.5	20.3	18.9	18.3	18.5	19.0	19.7	20.5	21.3
	yoy	4.1	-0.5	-6.8	-3.0	0.9	2.9	3.7	4.0	3.9
Labour force	**mn**	20.6	22.8	23.0	22.9	22.8	22.9	23.1	23.5	23.9
	yoy	2.6	3.0	0.8	-0.8	-0.4	0.5	1.2	1.5	1.6
Unemployment	**mn**	3.4	2.6	4.1	4.5	4.3	3.9	3.4	3.0	2.6
	%	15.4	11.3	18.0	19.8	18.8	16.9	14.8	12.7	10.7

Source: INE, GS Global ECS Research

Table 3 - Spain's trading partners: Half the trade with EMU, half with the rest of the world

Total	Goods and services		Goods		Services	
	€bn		€bn	% of total	€bn	% of total
Exports	**291.4**		193.9	*66.5*	97.5	*33.5*
Imports	**352.5**		281.5	*79.9*	71.0	*20.1*
to/from EMU						
	€bn	% of total to/from the world	€bn	% of total to/from the world	€bn	% of total to/from the world
Exports	**153.4**	***52.6***	109.7	*71.5*	43.7	*28.5*
Imports	**162.1**	***46.0***	130.4	*80.4*	31.7	*19.6*
to/from the Rest of the World						
	€bn	% of total to/from the world	€bn	% of total to RoW	€bn	% of total to RoW
Exports	**138.0**	***47.4***	84.2	*61.0*	53.8	*39.0*
Imports	**190.4**	***54.0***	151.1	*79.4*	39.3	*20.6*

Source: 2008 Balance of payments

spending. Overall GDP would have to accelerate already in 2011 to about +2.7% (our current forecast is +1.1%) and to about 4-5% in 2012-2015.

- If the reduction of unemployment down to 10% were slated for later in the decade, say, 2018, exports would still have to accelerate markedly (to about 10%). Moreover, having excess unemployment for longer would not only imply a "production loss"; it would also dampen the trajectory of the potential of the economy as discouraged workers exit the labour market in bigger numbers while those remaining lose skills or are shunned by employers (a problem especially acute for older workers in long term unemployment).

Export outlook and internal devaluation

Export growth rates of 10-12% per annum, or 60% over five years are a tall order but they are by no means unheard of. For example, in the 1990s, Spanish exports almost tripled (they were up 260% during that decade) clocking up an average annual growth rate of 10%. A key factor driving that export outperformance in the 1990s was the 20% devaluation of the Peseta in 1992/93 (see Chart 2), a policy instrument which is no longer available.

Generally, the determinants of export growth are domestic demand in Spain's export markets (which we assume grows at 4.5% p.a. until 2015); and the competitiveness of the goods and services sold. Competitiveness is determined by the nominal exchange rate, by productivity growth and by the nominal costs of producing in Spain.

- With the exchange rate fixed with Spain's EMU trading partners (representing about 50% of total exports/imports, see Table 3) and with the exchange rate of the Euro determined by conditions that only marginally reflect Spanish domestic conditions, the cost of domestic production appears as the only variable that can help to raise competitiveness in the next few years.[4]

- Assuming a stable mark-up over costs, export prices could be then reduced commensurately, raising the demand for Spanish goods and services, abroad and domestically.

- However, given the size of the re-balancing required, we calculate that the reduction of Spanish prices (relative to those of the competitors) required to achieve the targeted effect on net exports would have to be very large, on the order of 5% every year for five years. We have made the calculations using the price elasticities shown in Table 4 below, from the Bank of Spain's quarterly model.

There are, however, reasons to expect that the price elasticities shown in the Table are distorted and that the required decline in relative prices could be significantly lower:

Table 4: Elasticities of exports and imports to price competitiveness (relative prices)

	Updated Estimated for 1986Q1-2006Q4		**Original** Estimated for 1980Q1-1998Q4	
	1st quarter	**After 3 years**	**1st quarter**	**After 3 years**
Exports to:				
Euro-zone	0.37	0.43	0.48	0.86
Rest of the world	0.50	0.91	0.50	1.08
Imports to:				
Euro-zone	-0.58	-0.38	-0.74	-0.54
Rest of the world	-0.20	-0.20	-0.18	-0.47

Source: Bank of Spain, Documento de Trabajo 0717

How to read it: a 1pp decline in export prices (relative to the prices of competitors) raises the level of exports to EMU countries by 0.9pp after three years.

4. Faster productivity growth would also certainly help. While, generally, productivity growth is a long-term issue, some changes to labour regulations (regarding functional and working-hours flexibility, for example) could deliver relatively quick productivity gains.

- Note that the Spanish export performance over the last ten years is remarkable, especially when taking into account the continued increases in unit labour costs. Exports have held up well, outperforming France and Italy, see Chart 5 and 6.

- This performance suggests there is more to competitiveness than the official export prices. As Table 3 shows, the Bank of Spain extended the sample period to 2006 and re-estimated the elasticities, finding significantly lower new estimates. The Bank suggested the results could reflect some type of ongoing quality improvement, perhaps shifts into higher value-added segments, that were not correctly captured by the export price series. As it is reasonable to expect that if these improvements were to continue for the foreseeable future, the real (but unobservable) export prices might actually fall (and so boost export growth) even in the absence of large declines in the official export prices.

Mild domestic deflation is desirable

Still, this last point remains a conjecture. Moreover, the magnitude of the re-balancing required is such that the sooner and the larger the boost to price competitiveness, the better the outcome, even if it entails a period of mild deflation.

Deflation has always had bad press: it has been associated historically with periods of low output and large welfare losses such as the Great Depression in the US and the 1990s episode in Japan. Yet this association misses important aspects of the deflation phenomenon:[5]

- Generally, deflation is an outright negative development if it becomes so entrenched (through the expectations channel) that it causes further spending weakness (which produces a new wave of falling prices). It also raises the real value of debt, potentially becoming such a burden that income inflows may be destined to reduce it, at the expense of capital expansion.

- Were Spain to experience some mild deflation, the impact on real debt could be quite debilitating given its highly-leveraged private sector. In addition, real interest rates could rise substantially (by as much as the drop in inflation).

- Yet despite these burdens, deflation may be the right development for countries which, like Spain, require a rebalancing from domestic towards external demand — that's how adjustment happens in a monetary union with segmented labour markets.

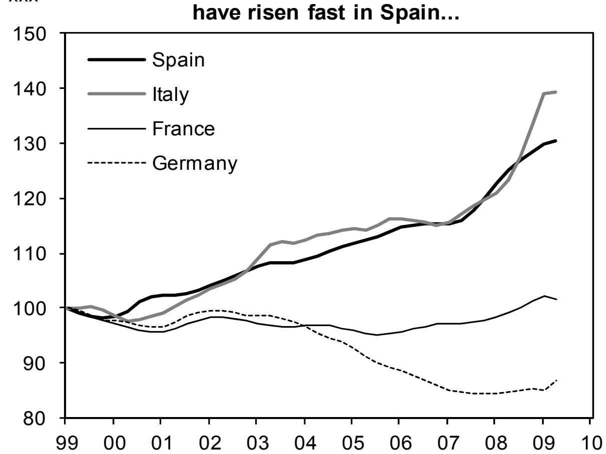
Note, however, that for deflation to be beneficial (if painful) it must affect both domestic consumer prices and production costs, so that the rise of profitability in the exporting sector attracts investment and jobs, helping to offset the nominal effects of deflation. Were consumer price deflation to take hold without production costs following suit, the rise in real wages would hurt profitability and impair the prospects of a successful re-balancing.

Spanish consumer prices are already flirting with deflation: for example, seasonally-adjusted core prices fell in January and February, although they have probably risen in March. However, wage inflation has not fallen as much:

- The latest data (for February) show contractual wages rising at about 1.5%yoy. Wages per employee on a national account basis were still rising by about 3%yoy in Q4 (although we expect them to decelerate gradually in the next few quarters, ending this year at 1%yoy).

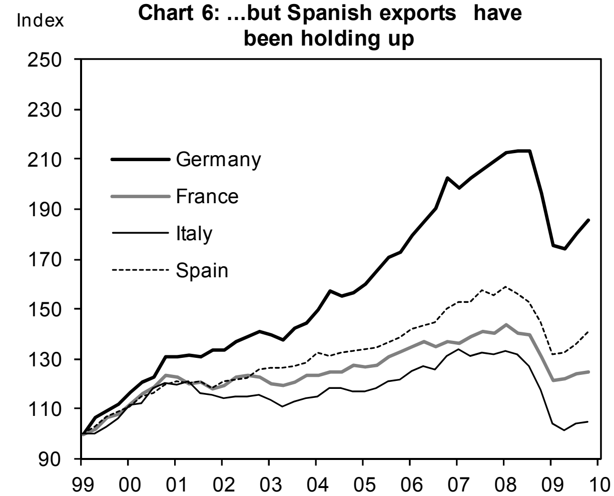
- Trade unions and employers have agreed on wage increases the next three years: "up to 1%" for 2010, 1-2% for 2011, and 1.5-2.5% in 2012. As usual, these wage increase recommendations are binding floors for the agreements to be signed at a sectoral/company level. While the agreement seems to open up the possibility of individual companies opting out from the wage recommendation — something we had been

Chart 5: Unit labour costs* have risen fast in Spain...



Source: OECD; * Manufacturing

Chart 6: ...but Spanish exports have been holding up



Source: Eurostat

5. We repeat here some of the ideas in "Euro-zone disinflation: resumption and divergence", European Weekly Analyst 10/08, March 4, 2010.

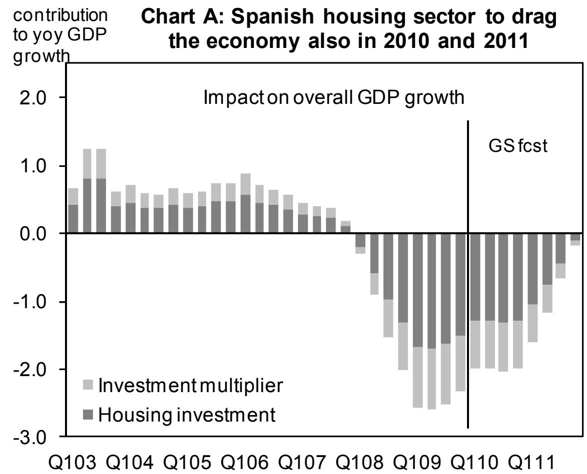
The economy stabilises but remains fragile

The economy is showing signs of life but the underlying momentum remains quite fragile.

Spanish GDP contracted 0.1%qoq (non-annualised) in Q4, after –0.3%qoq in Q3, bringing average GDP growth in 2009 to –3.6% (after printing +0.9% in 2008). The data available for Q1 shows some further progress:

- Industrial production has been moving along the bottom, with output easing in both January and February. However, Spain's manufacturing PMI rose to 51.8 in March, from an average 45.6 in Q4, signalling growth in the manufacturing sector for the first time since November 2007. Probably reflecting this mild improvement, electricity consumption, once adjusted for working days and weather effects, was up 2.3%qoq in Q1, after +0.9%qoq in Q4.
- The services PMI also rose above 50 (to 51.3, after 47.1 in February) although this may have reflected the timing of Easter.
- Indicators of private consumption remained mixed. On the positive side, car sales registrations stabilised in Q1 at about 1.2m (annualised), after the large increases posted in Q3 and Q4—they were up 45%yoy. Retail sales were up in February for a third consecutive month, driven by strong gains in clothing.
- On the negative side, the number of registered jobless continued to rise, up 2.4%qoq in Q1, after +2.7%qoq in Q4. The decline in the number of people registered with Social Security, a good proxy for employment, re-accelerated in Q1, down 0.7%qoq, after a drop of only 0.2%qoq in Q4. Consumer confidence fell in February and March (to –19 and –22 respectively) after having risen from a trough of –48 last February. Unsurprisingly, households' saving rate had ended 2009 at a record-high of 18.8% of disposable income.

Chart A: Spanish housing sector to drag the economy also in 2010 and 2011



Source: INE, GS Global ECS Research

Beyond the very short term, the growth prospects remain clouded by three developments:

- The still-ongoing correction of the housing sector — at least another four quarters to go, see Chart A.
- A sluggish re-allocation of economic resources towards those sectors with better demand prospects — see main text.
- The impact of the fiscal consolidation, down to a deficit of 3% of GDP from 11.4% in 2009, planned by the government for the next four years.

We expect a GDP contraction of –0.6% in 2010 and a +1.1% increase in 2011. We see consumer price inflation averaging 1.5% in 2010 and 1.9% in 2011, lifted in part by the hike to VAT rates slated for July.

looking forward to — the actual wording remains too vague for comfort. Moreover, the agreement continues to incorporate inflation safeguards, so that, in practice, wages remain indexed to inflation.

Readiness to accept wage cuts: the missing element of Spain's EMU membership. This downward rigidity of nominal wages will inevitably slow down the re-balancing of the Spanish economy.[6] In fact, the possibility of wage cuts should have been made explicit, to workers and their trade unions, to households and firms in the run-up to EMU as an intrinsic part of the deal. The sooner it's accepted that that rigidity is at odds with adjustment within a monetary union like EMU, the sooner the recovery will start in earnest, the smaller the output losses, and the more transient the damage to the economy's potential — even a small initial reduction of contractual wages, say 1-2%, could send a powerful message that adjustment and re-balancing can be achieved over the next five years.

Javier Pérez de Azpillaga

6. Wages are not the only domestic production costs: cuts in contributions to Social Security and other welfare programs could also be effective if only the public coffers could finance them. Lowering dismissal costs for permanent employees would also count as a reduction of production costs. However, we doubt that measure would be that effective in the short term: after all, employers can already avoid many of those higher costs if they choose to. As for profits, a strong recovery requires rising profits: it is precisely that prospect that attracts investment and leads to job creation.

Italy's exposure to the BRICs

Structurally weak, the Italian economy got strongly hit by the crisis and is taking time to recover. Despite the country's "usual drags" to competitiveness and sustainability – low productivity, demographics – we believe that, ignoring the country's heavy foreign energy dependency, Italy's external imbalances do not look that bad, and suggest that the country is well positioned to benefit fully from BRICs demand. Sweeping generalizations about Southern European economies should therefore be avoided. Extrapolating the dynamics of Italy's exports to the BRICs, combining it with the strength of world demand and a weaker euro, we anticipate that Italian exports might grow more strongly than the Euro-zone average.

A painful crisis on a structurally weak economy

Undoubtedly, it is taking time for Italy to find its way to the recovery. After a rebound in the third quarter of 2009, when Italy's GDP posted a +0.5%qoq gain on account of a long-awaited rebound in exports, activity stalled again in Q4 with a deceiving -0.3%qoq that dragged the Euro-zone growth average to a flat reading on the quarter. In Italy so far, the "usual "export-led recovery has not materialized in a decisive way – at least not according to aggregate trade numbers. Price competitiveness remains a drag: relative producer prices worsened, and on various measures, labour productivity sharply declined in 2009, showing up in concomitantly surging unit labour costs (we investigated this theme at length in our *European Weekly Analyst 09/41*)

From a more structural perspective, as we had argued a while ago (see our *Global Paper 184, "Italy: the reality is better than you think"),* Italy's macroeconomic performance has long underperformed that of its neighbours. Real GDP growth averaged a meager 1.5% over 1996-2006, at a time when the Euro-zone was growing at 2.2%. Total factor productivity has displayed endemic weakness, demographic developments are unfolding unfavorably as the country is ageing fast, and competitiveness has been eroded. Italy has experienced an unprecedented fall in productivity over the past decade, both in the manufacturing and services sectors. As a result, prior to the crisis, the economy has performed poorly relative to its large EMU neighbours.

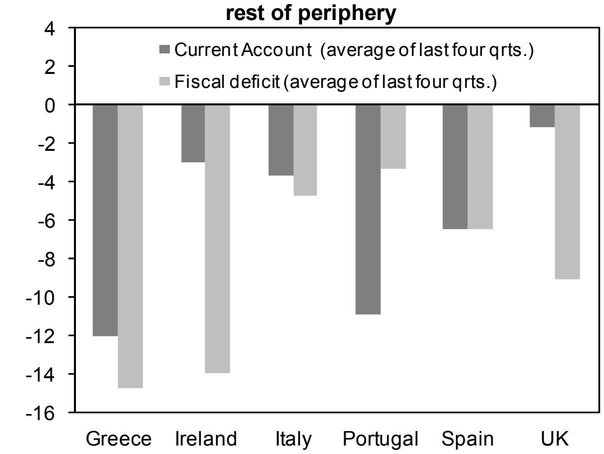
Twin deficits, really?

In this context of weak structural, or trend, nominal GDP growth, a lot has been written about the unsustainability of the country's imbalances – mostly on the fiscal, but also on the external side – flagging Italy as one potential target for future market woes, once developments in Greece, Spain and Portugal have been digested. We dealt with the former – fiscal imbalances — at length in a previous piece (see *European Weekly Analyst 10/06*), arguing that public finances have been kept on a definitely sustainable track for about half a decade under Ministers Padoa-Schioppa and Tremonti – a view that seems to be shared by rating agencies (especially if hints that the country could even be upgraded are confirmed).

On the latter — the external side, as measured by the current account – Chart 1 reveals that of all Southern Euro-zone countries, Italy does not look bad at all, with "twin" deficits on the order of 3 to 4% of GDP, generally lower than those of Spain, Portugal, not to mention Greece. To set things in perspective, Italy's current account deficit at the worst of the crisis stood only at 3.3% of GDP, way below Greece's 12% and Spain's 6%.

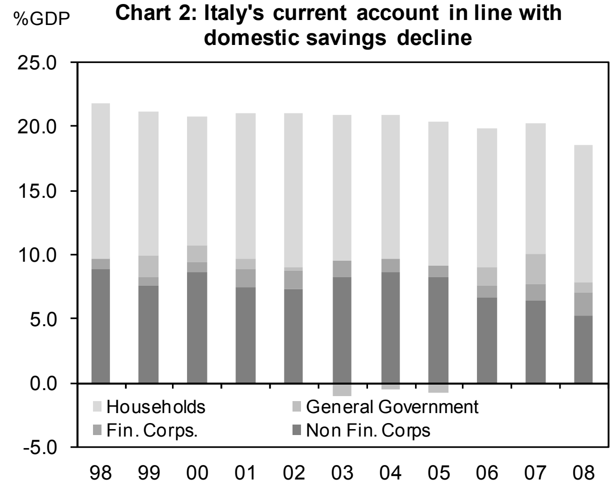
In the recent past, Italy has never really been characterized by a large current account imbalance, unlike Portugal or Spain. Yet, taken in isolation, the current account balance exhibited some degree of stickiness over time. Interestingly, when related to the internal dynamics of savings over the same period, the opening of the trade deficit, which became persistent in mid-2002, coincided with a gradual reduction in the gross

Chart 1: Italy's deficits milder than in rest of periphery

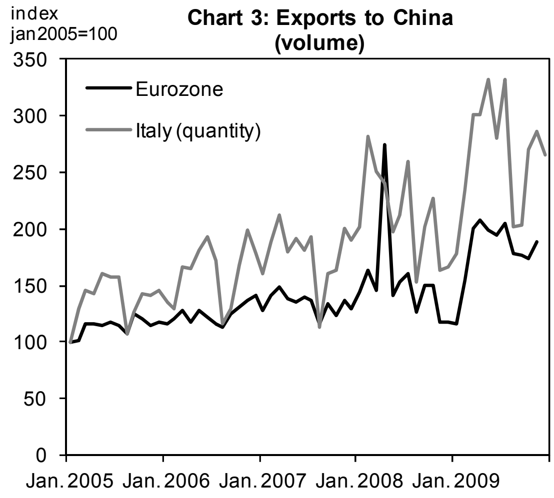


Source: Eurostat, National Statistics Offices

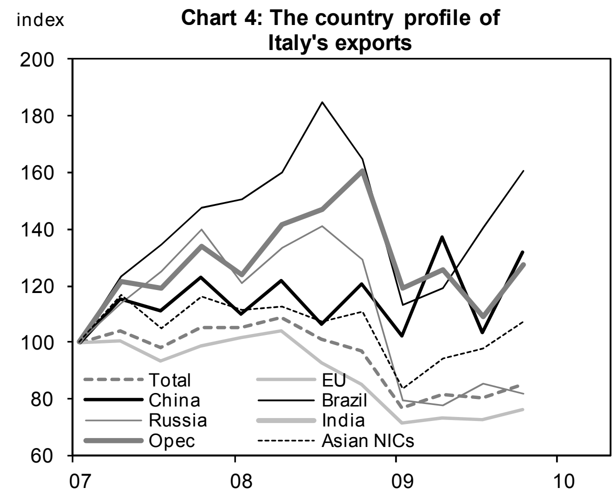
Chart 2: Italy's current account in line with domestic savings decline



Source: Istat, GS Calculations



Source: Eurostat, GS Global ECS Research



Source:Istat, GS Global ECS Research

domestic savings rate of the economy (see Chart 2, in particular savings of non-financial companies). Arguably, the endemic weakness in investment that prevailed over the same period could have offset the savings rate decline, but investment still turned out to be greater than the savings reduction, and therefore resulted in a net external financing need.

A victim of its strong energy dependence

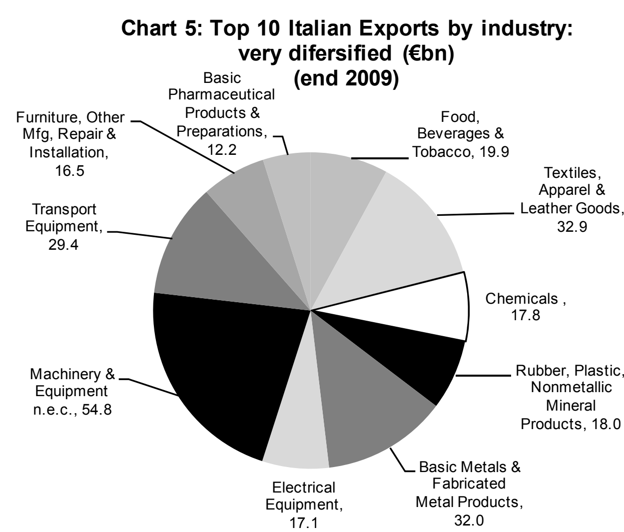
Imports strength, more so than exports, is to blame for the endemic negative trade contribution to growth. On most recent numbers, the worsening of the trade balance indeed comes from strong import growth rather than export weakness. In the three months leading up to February 2010, Italian extra-EU exports rose by more than 5%qoq, a performance overshadowed by the +9.2% rise in imports – a trade deficit structurally worsened by the energy dependence of the country. On preliminary data, the cumulated deficit since January this year stands close to EUR 4.8bn, while the country runs a *surplus* of close to EUR 3bn with non-EU countries when the energy component is excluded. This imbalance is also reflected in the geographical split of imports, which, in February, "boomed" from Russia (+32.9%yoy), Turkey (+24.3%) and OPEC countries (+23%), while imports from the US strongly declined (-11.3%yoy).

Exports to the BRICs: more to come?

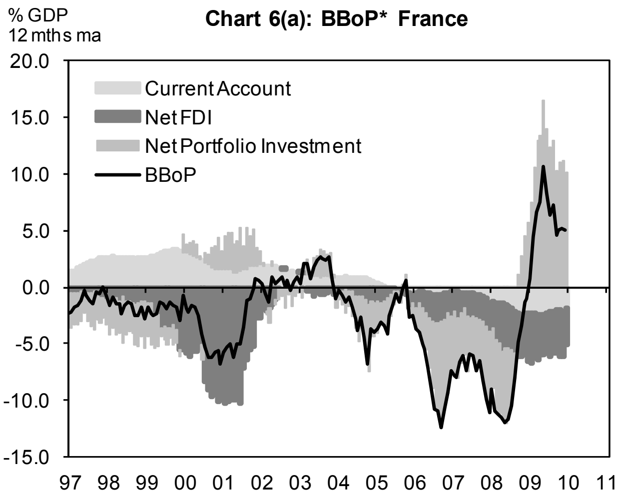
Arguably, such a drag from energy imports cannot be ignored. Yet, concentrating on the export sector (keeping the recent euro depreciation and the profile of world demand in mind) provides grounds for optimism, as discussed below.

Stepping back, the share of exports in Italian GDP increased substantially in the early phases of the single currency, suggesting that the Euro tended to foster trade links between its member states, and, beyond, to the European Union as a whole: reduced exchange rate volatility, lower transaction costs across member states, increased depth of trading relations, and the end of "beggar thy neighbour" competitive devaluations would be the usual arguments. As a matter of fact, the EU is currently absorbing a large part of Italy's exports (57%). However, this number is not set in stone, and some rebalancing of Italian trade towards extra EU countries cannot be ruled out.

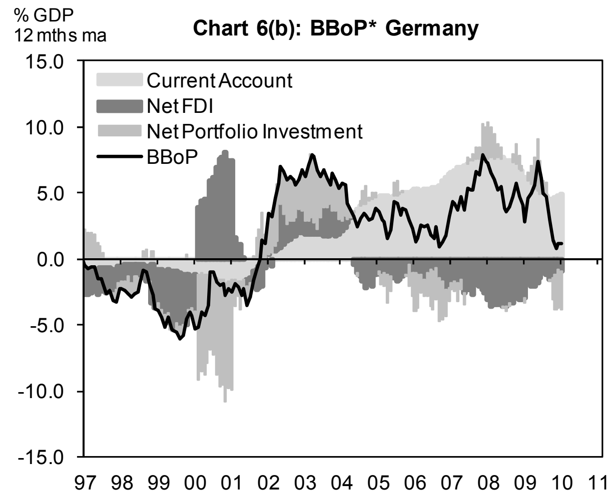
First, even though 2009 was a bad year for Italy's external performance, the contraction in trade flows occurred with some degree of differentiation between intra- and extra-EU trade. In value, Italian exports declined by 23.7% and 18.1% for EU and non-EU flows respectively. From a longer term perspective, Charts 3 and 4 show the evolution over time of Italy's exports with selected trading partners. In volume, Italy's exports growth to China since 2005 outpaced that of the Euro-zone (Chart 3). Since 2007 (Chart 4), the country profile is even more split, with a clear contraction of exports to the EU and Russia, while exports to China, OPEC countries and even more so Brazil, rose by 30 to 60%.



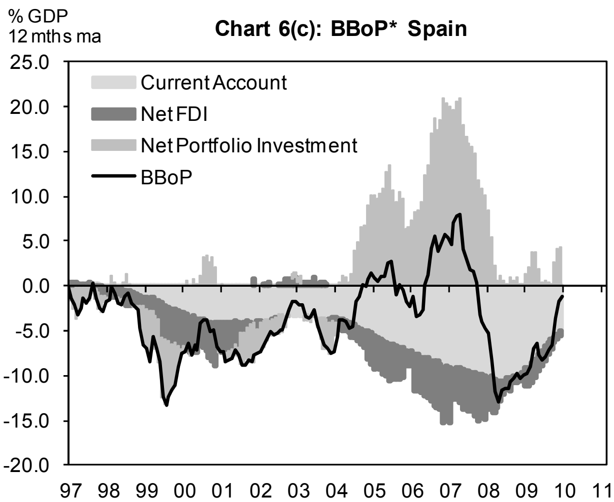
Source: Istituto Nazionale di Statistica



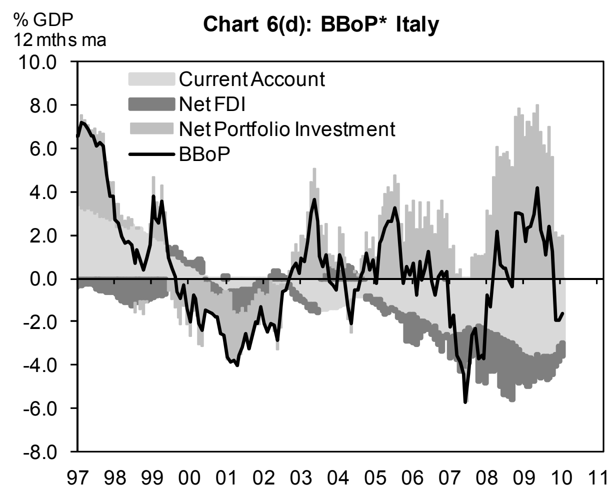
Source: GS Calculation, Banco de Espana



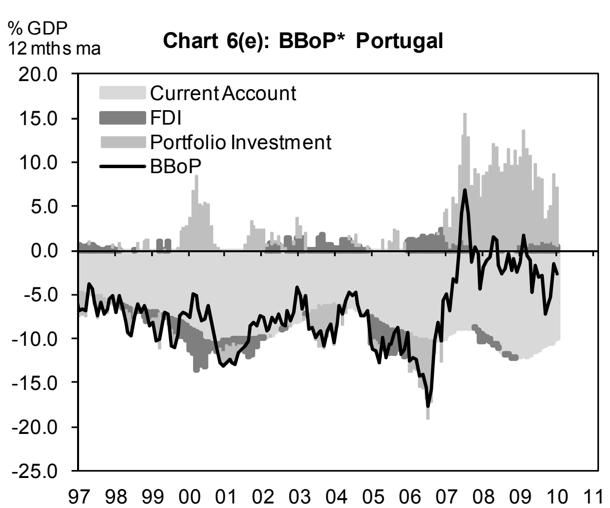
Source: GS Calculation, Banco de Espana



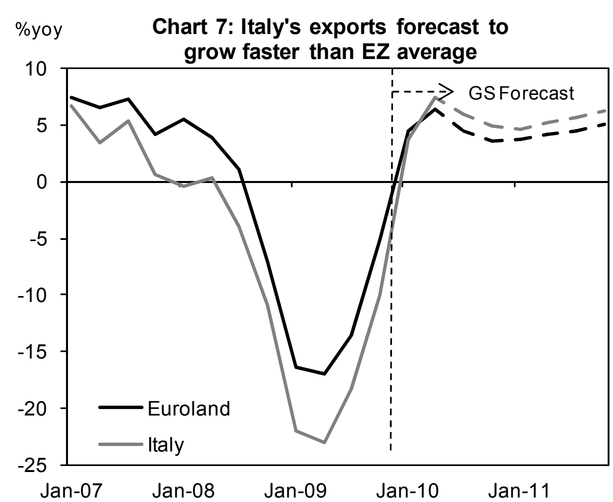
Source: GS Calculation, Banco de Espana



Source: GS Calculation, Banco de Espana



Source: GS Calculation, Banco de Espana



Source: GS Global ECS Research

From a more cyclical perspective, numbers are strong. In February 2010, exports to Turkey (+52.3%yoy), Mercosur countries (+43.6%yoy), India (+33.2%yoy) and China (+28.1%yoy) stood in strong contrast to those to Japan (-7.7%yoy, all preliminary estimates) or to the US (+0.5%yoy). While this data does not imply rising Italian world market shares (in fact, looking at producer prices, Italy is still losing price competitiveness), the country should undoubtedly benefit from the ongoing strength of emerging market demand (details of Italy's export sectors and trading partners profiles are provided in Tables 1 and 2).

Second, and this is less known, Italy's exports are remarkably diversified (Chart 5). We are all aware that Italy is good at producing and exporting high margin luxury clothes, bags, fine food and furniture, but it is often ignored that the country is as good in machinery, transport equipment, pharmaceutical, chemical, metal, and electrical equipment sectors.

For sure, it will not be easy for Italy to gain non-EU market shares given its low productivity and resultantly poor competitiveness. However, studies based on firm-level data (the aggregate figures are extremely misleading given the marked heterogeneity of Italy's productive forces, both sectorally and geographically) have shown that over the first EMU decade, Italian exporters have adjusted to international competitive pressures by (i) self-selecting themselves (only the ex ante most efficient firms survived in the export sector) and by (ii) focusing on the "best" goods so as to improve company-level productivity numbers (dropping goods, increasing margins and productivity!)[1].

BBOP: Italy between France and Spain

A final point that is often made pertains to the assumed homogeneity of Southern European countries when it comes to external imbalances. We already touched upon differences across current account readings. More comprehensive measures of external imbalances, in particular our Broad Balance of Payments (BBOP) concept that encompasses the financial account and takes into account direct investment flows and net inward portfolio investment, suggest that Italy falls between "non-Germany core" and "periphery" EMU countries. Charts 6(a) to (e) compare the BBOP of Italy, France, Spain and Greece and suggest that since the Euro was introduced, Italy's BBOP has been broadly "mean-reverting" around zero. Between mid-2007 and mid-2009, at a time when the current account settled in negative territories, Italy's BBOP was actually turning positive thanks to solid positive net portfolio investments, which ended more than offsetting the trade deficit and FDI outflows. In addition, in Italy just as in France, the scale of net portfolio investments is much wider than the current account imbalance, unlike in Spain and Portugal. Generalizing across the Southern Euro-zone economies would, in this case, therefore be misleading.

In the end, at a time when such generalizations are tempting, differences between Eurozone's core and periphery, but also those within periphery countries, should be kept in mind. And in light of the dynamics of Italy's non-EU exports (in particular exports to the BRICs), and the strength of world demand as highlighted in our 2010-2011 global scenario, we anticipate that Italian exports should grow more strongly than the Euro-zone average (Chart 7).

Natacha Valla

1. See for example "Export, productivity and product switching: the case of Italian manufacturing firms", by Sergio De Nardis and Carmine Pappalardo, ISAE Working Paper 110, 2009.

Table 1: Sectoral profile of exports to China, Brazil, US and EU27

	China		India		Brazil		US		UE27	
	Quantity (% of total exports)	Value	Quantity	Value	Quantity	Value	Quantity	Value	Quantity	Value
	as % of total Exports									
Food and beverages	1.3	1	1.3	0.6	5.9	2.4	13.2	9.5	18.6	7.9
Industrial supplies	83.2	31.4	66.2	28.8	40	21.3	35.4	21.3	53.8	32.2
Fuels and lubricants	3.4	0.5	7.2	2.2	22	3.4	38.2	6.8	14.5	3.6
Capital goods (Exc. Transport eq.))	9.3	52.9	18.6	52.8	13.8	43	6.3	24.5	4.7	21.9
Transport eq. and parts and accessories	1.3	5.2	5.1	11.4	12.5	22.6	2.9	15.9	2.6	13.4
Consumer goods	1.4	8.9	1.6	4.2	1.6	6.3	3.2	21.4	5.4	19.4
Other	0.1	0.1			4.2	1	0.8	0.6	0.4	1.6
Total (quantity: kT, value: € Bn)	2231	6.4	756	3.1	757	3.35	7215	23	71755	383.2

Source: Istat, GS Global ECS Research

Table 2: characteristics of Italy's trading partners

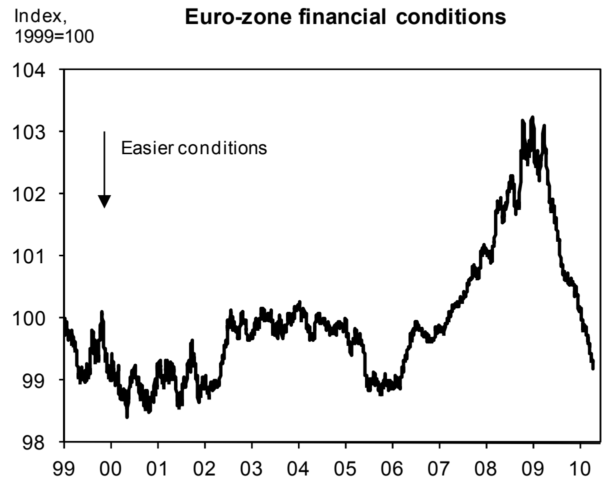
Trading partners	Share of Italian exports 2008	Developments Italy's export markets																
		Domestic demand, YoY (March 2010)			Manuf. PMI, sa			Exchange rate against Euro1 (↑ Euro apprec)					Purchase of Italian products, Value (EUR) % qoq			
		09	10(f)	11(f)	Aug-08	trough	latest (Feb - 10)	Aug-08	latest (Feb - 10)	3m (f)	6m (f)	12m (f)	2009Q2	2009Q3	2009Q4	2009Q4 %y-o-y
UK	5.1	-5.3	1.2	2.5	44.6	35.1	56.6	100	110.5	109.7	106.0	106.0	14.5	-2.5	1.0	-12.6
Sweden	0.9	-4.8	1.4	3.2	-	-	-	100	105.9	102.1	100.0	95.8	-1.8	-2.8	10.1	-19.3
Denmark	0.6	-5.8 (f)	-0.9	2.5	48.3	29.1	54.0	-	-	-	-	-	-6.5	-3.4	8.6	-26.2
Switzerland	4.7	1.7	0.5	1.4	51.7	32.9	57.4	100	90.5	88.8	87.6	86.4	0.5	-4.3	9.8	0.8
Turkey	2.0	-7.6 (f)	8.1	5.9	48.3	32.6	50.9	100	117.5	123.4	118.9	108.7	32.8	10.8	4.3	7.0
Euroland	43.8	-3.4(f)	0.3	1.2	47.6	33.6	54.2	100	-	-	-	-	0.6	-0.2	4.8	-8.8
Europe 27	**57.1**	**-3.6(f)**	**0.6**	**1.7**	-	-	-	-	-	-	-	-	**2.7**	**-0.9**	**4.8**	**-10.7**
Russia	2.2	-8.2(f)	2.9	8.0	49.4	33.8	50.2	100	113.9	115.9	114.0	107.9	-2.0	9.3	-4.1	-36.6
OPEC	6.2	-	-	-	-	-	-	-	-	-	-	-	5.3	-13.0	16.3	-20.7
Russia+OPEC	**8.4**	-	-	-	-	-	-	-	-	-	-	-				
China	2.3	13(f)	12.4	9.9	49.2	40.9	55.8	100	91.1	96.5	96.5	85.4	34.4	-24.5	27.2	9.1
Asian NICs/ASEAN2	3.0	-	-	-	50.6	44.3	51.9	100	91.9	96.6	95.1	86.6	12.8	3.3	9.7	-3.6
Japan	1.3	-4.0(f)	1.5	1.3	46.9	29.6	52.5	100	75.5	81.5	83.3	80.9	-11.9	15.7	-3.8	-16.6
India	0.9	4.9(f)	7.6	9.7	58.0	44.4	58.5	100	98.4	98.9	97.6	90.0	7.4	5.8	25.4	12.7
South Korea	0.8	-3.5(f)	5.3	4.1	46.4	39.7	58.2	100	101.1	106.5	101.8	90.5	17.4	-7.1	3.7	-13.9
Asia	**8.3**	**5.1(f)**	**8.2**	**7.4**	-	-	-	100	-	-	-	-	-	-	-	-
US	**5.9**	**-3.3**	**2.3**	**1.8**	**49.3**	**32.5**	**56.5**	**100**	**91.4**	**96.8**	**96.8**	**90.2**	**15.4**	**-11.8**	**7.4**	**-24.3**
Latam3	**1.5**	**-2.8(f)**	**6.1**	**4.9**	-	-	-	**100**	**110.9**	**110.9**	**114.5**	**111.4**	**5.5**	**16.1**	**15.2**	**-5.5**
Other	**18.7**	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
w'ed average		**-0.5(f)**	**4.4**	**4.4**	**48.3**	**33.8**	**55.2**	-	-	-	-	-	-	-	-	-

Source: Eurostat, Goldman Sachs, Markit, ISM 1) ECB 2) PMI and FX: Singapore 3) FX: avg Mexico and Brazil, Exports: Mercosur

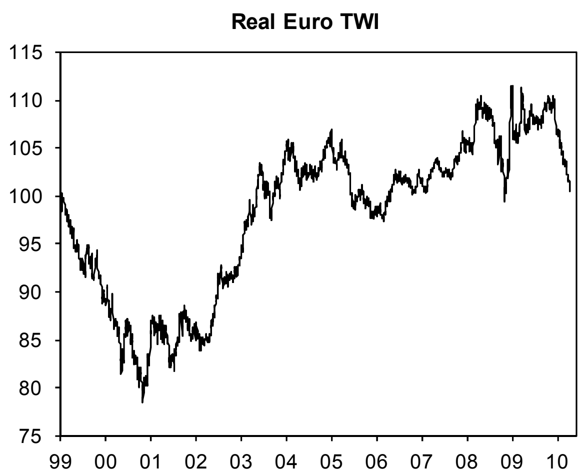
Weekly Indicators

After having peaked in the immediate aftermath of the financial crisis, the *GS Euroland Financial Conditions Index* has eased significantly and is now back below August 2007 levels. More than half of this easing can be explained by the fall in corporate bond yields. The fall in short-term rates as a result of easing by the ECB has also contributed, in addition to the rally in equity markets.

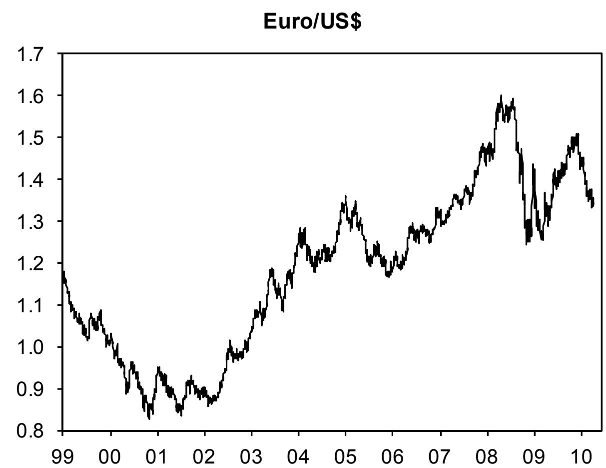
Euro-zone data releases in March surprised to the upside, mainly reflecting stronger-than-expected industrial production figures.



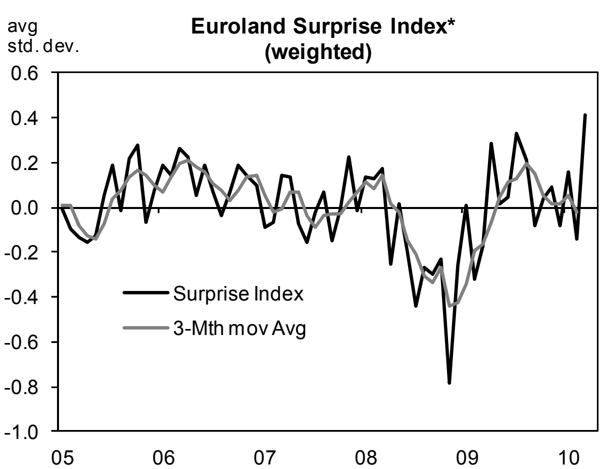
Source: GS Global ECS



Source: GS Global ECS Research



Source: GS Global ECS Research



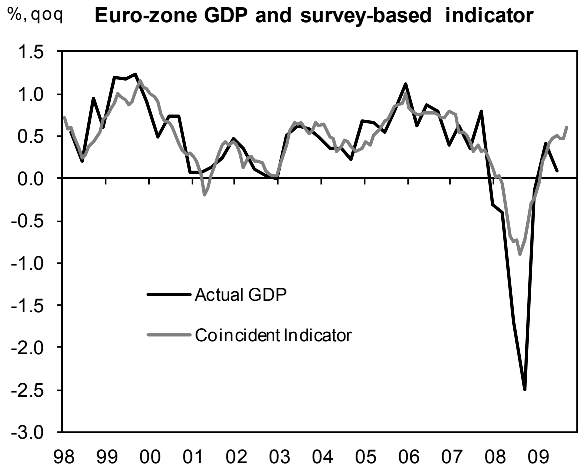
*excluding US non-farm payrolls
Source: GS Global ECS Research

Indicator	Latest Reading	Month	Consistent with (qoq) growth of:
Services PMI	54.1	Mar	0.5
Composite PMI	55.5	Mar	0.6
German IFO	98.1	Mar	0.7
Manufacturing PMI	56.6	Mar	0.8
French INSEE	94.0	Mar	0.2
Belgian Manufacturing	-6.5	Mar	0.5
EC Cons. Confidence	-17.3	Mar	0.2
EC Bus. Confidence	-10.1	Mar	0.4
Italian ISAE	84.1	Mar	0.2
Weighted* Average			**0.5**

* Weights based on relative correlation co-efficients

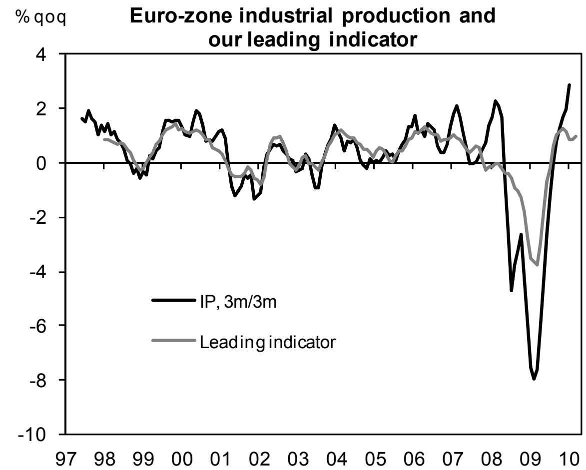
GS Leading Indicators

Our survey-based GDP indicator is now pointing to a +0.5%qoq expansion in Q1.



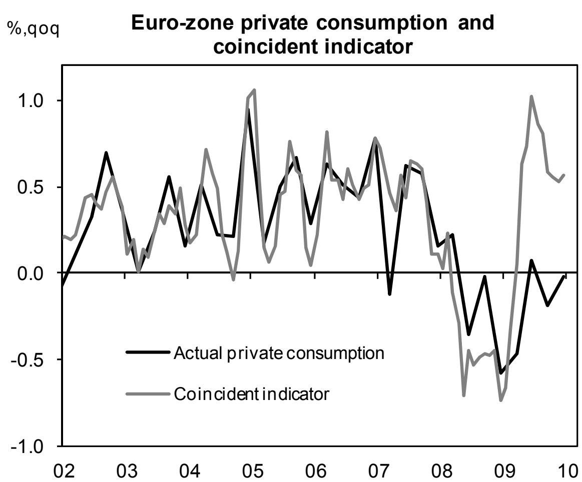
Source: Eurostat, GS Global ECS Research

Our leading indicator, calibrated on IP, is showing sustained industrial momentum.



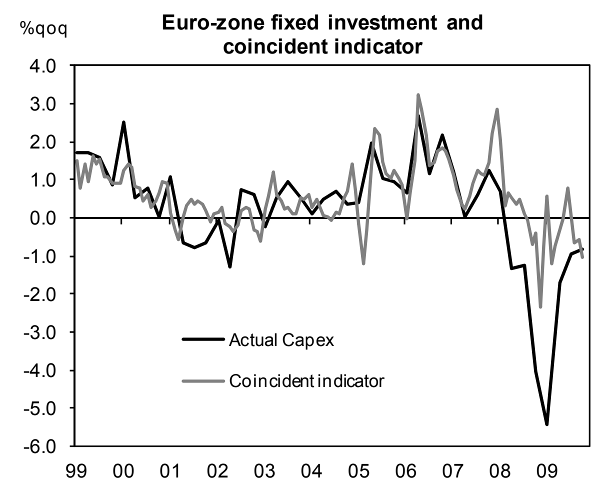
Source: Eurostat, Ifo, Markit, GS Global ECS Research

Our consumption indicator suggests improving prospects for consumption growth.



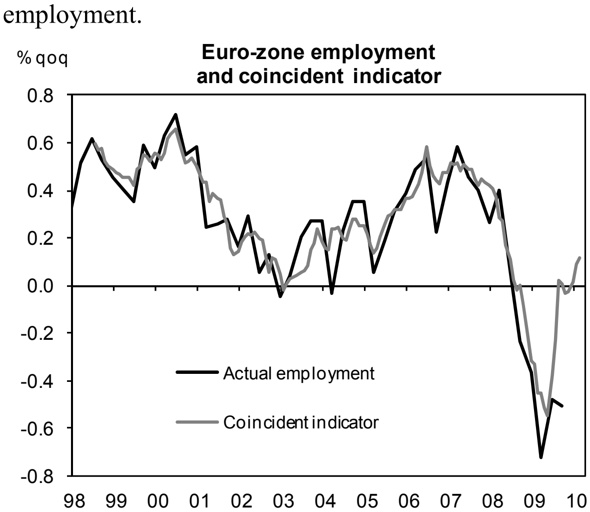
Sorce: Eurostat, GS Global ECS Research

Our capital expenditure indicator points to continued weakness in investment.



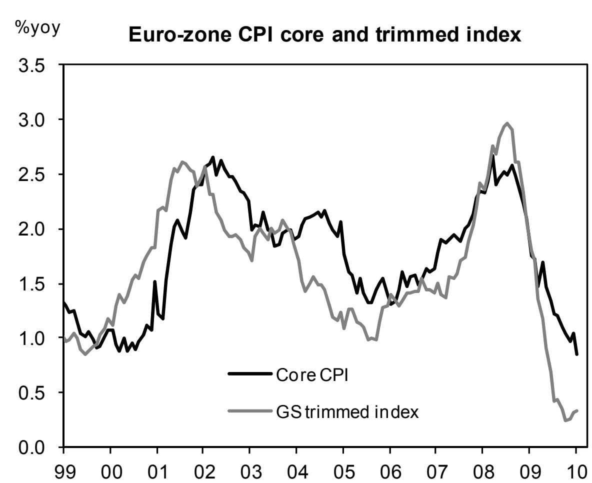
Source: Eurostat, GS Global ECS Research

Our labour market model suggests a stabilisation in employment.



Source: Eurostat, Markit, Labour office, GS Global ECS Research.

The GS trimmed index indicates further easing in Euro-zone core CPI.



Source: Eurostat, GS Global ECS Research

Recent European Research

Date	Related-Research Archive	Publication	Author
08-Apr-10	ECB press conference summary	European Views	Erik Nielsen
08-Apr-10	Greek update; IMF deal likely in coming weeks	European Views	Erik Nielsen
07-Apr-10	European central bank meetings tomorrow: Very important stuff to come out of the ECB	European Views	Erik Nielsen
06-Apr-10	Greece: A bad day at the office	European Views	Erik Nielsen
25-Mar-10	The Greek crisis: Why and when the IMF will be involved, and what a support package might look like	European Weekly Analyst 10/11	Erik Nielsen
25-Mar-10	Summary of thoughts on today's news out of EU and ECB with regards to Greece	European Views	Erik Nielsen
24-Mar-10	EU-clearance imminent for IMF involvement in Greece; Program negotiations could start shortly	European Views	Erik Nielsen
24-Mar-10	Workmanlike indeed	European Views (UK)	Ben Broadbent and Adrian Paul
24-Mar-10	Expect a busy but small-scale Budget - big picture still to show only gradual correction of deficit	European Views (UK)	Ben Broadbent, Kevin Daly and Adrian Paul
18-Mar-10	Euro-zone to expand East, despite problems in the South	European Weekly Analyst 10/10	Anna Zadornova
18-Mar-10	Taking stock of Euro-zone's banks' balance-sheet adjustments	European Weekly Analyst 10/10	Dirk Schumacher
18-Mar-10	Greece and the IMF	European Views	Erik Nielsen
16-Mar-10	Euro-zone pledges support for Greece; but little details and no cash	European Views	Erik Nielsen
11-Mar-10	Norway: Hiking with a strong currency	European Weekly Analyst 10/09	Jonathan Pinder
11-Mar-10	The Euro-zone recovery: Riding on external demand	European Weekly Analyst 10/09	Nick Kojucharov
10-Mar-10	Heads-up for SNB March meeting: No change in tone yet; expect first hike in September	European Views	Dirk Schumacher
04-Mar-10	ECB liquidity, Euro-zone disinflation, and the fiscal tale of Belgium	European Weekly Analyst 10/08	Javier Perez de Azpillaga and Nick Kojucharov
04-Mar-10	ECB - summary of press conference	European Views	Natacha Valla
03-Mar-10	Greece announces further fiscal measures; likely to be enough for now for the 2010 fiscal target	European Views	Erik Nielsen
03-Mar-10	ECB on Thursday - moderation of the expected interest rate path	European Views	Erik Nielsen
02-Mar-10	Managing the fiscal correction	UK Economics Analyst 10/03	Ben Broadbent, Kevin Daly and Adrian Paul
01-Mar-10	Updated Greek roadmap	European Views	Erik Nielsen
25-Feb-10	Dissecting Greece's fiscal plan: Scenarios for how it may need to change	European Weekly Analyst 10/07	Nick Kojucharov
18-Feb-10	Sweden and Switze rland on the mend: Interest rates to start normalising in Q3	European Weekly Analyst 10/06	Kevin Daly and Adrian Paul
11-Feb-10	Euro-zone guarantees financial stability—quantifying the size of the problem	European Weekly Analyst 10/05	Ben Broadbent and Nick Kojucharov
11-Feb-10	Greek road map post EU statement	European Views	Erik Nielsen
11-Feb-10	Riksbank—A hawkish shift	European Views (Sweden)	Kevin Daly
10-Feb-10	Dovish Inflation Report, we change our UK rate view	European Views (UK)	Ben Broadbent and Kevin Daly
10-Feb-10	Now clarification of 2009 Greek budget numbers from the Greek finance ministry	European Views	Erik Nielsen
10-Feb-10	Clarification of 2009 Greek budget numbers	European Views	Erik Nielsen
10-Feb-10	Greece revises their 2009 fiscal deficit up - latest thoughts on tomorrow's summit	European Views	Erik Nielsen

Main Economic Forecasts

	GDP (Annual % change)			Consumer Prices (Annual % change)			Current Account (% of GDP)			Budget Balance (% of GDP)		
	2009	2010(f)	2011(f)	2009(f)	2010(f)	2011(f)	2009(f)	2010(f)	2011(f)	2009(f)	2010(f)	2011(f)
Euroland	-4.0	1.2	1.9	0.3	1.1	1.6	-0.6	-0.4	-0.3	-6.0	-6.5	-6.1
Germany	-4.9	1.9	2.1	0.2	1.0	1.5	3.9	3.5	3.4	-3.9	-4.7	-4.4
France	-2.2	1.8	2.3	0.1	0.9	1.4	-2.1	-0.3	1.3	-8.7	-8.9	-7.5
Italy	-4.9	1.0	1.6	0.8	1.3	1.8	-4.3	-3.5	-2.8	-5.4	-5.3	-4.9
Spain	-3.6	-0.6	1.1	-0.3	1.4	2.0	-4.7	-2.2	-1.3	-11.9	-10.2	-8.9
Netherlands	-4.0	1.4	1.8	1.0	0.8	1.6	5.8	1.0	1.5	-5.0	-6.0	-4.5
UK	-4.8	1.8	3.4	2.1	2.2	1.5	-1.8	-0.6	0.1	-10.3	-10.6	-8.4
Switzerland	-1.5	1.7	1.9	-0.5	0.8	1.2	5.5	5.0	5.5	-0.7	-1.4	-1.3
Sweden*	-4.7	2.0	3.6	-0.3	1.4	2.7	7.4	8.1	9.1	-2.1	-3.4	–
Denmark	-4.6	1.5	2.2	1.1	1.6	1.7	4.1	4.6	4.5	-2.0	-4.6	-3.7
Norway**	-1.4	2.1	2.3	2.2	1.6	2.3	13.8	17.2	17.9	—	—	—
Poland	1.5	3.0	4.5	3.5	1.9	2.3	-1.2	-3.5	-4.4	-6.0	-7.0	-5.0
Czech Republic	-4.1	1.9	3.0	1.0	1.5	2.5	-1.0	-0.1	-0.9	-6.6	-5.4	-5.1
Hungary	-6.2	-0.4	2.8	4.2	3.7	2.5	-1.1	-1.4	-2.0	-4.0	-4.5	-4.0

*CPIX **Mainland GDP growth, CPI-ATE

Quarterly GDP Forecasts

% Change on Previous Quarter	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4
Euroland	-2.5	-0.1	0.4	0.0	**0.4**	**0.4**	**0.3**	**0.3**	**0.5**	**0.6**	**0.5**	**0.5**
Germany	-3.5	0.4	0.7	0.0	**0.6**	**0.5**	**0.4**	**0.3**	**0.6**	**0.7**	**0.6**	**0.6**
France	-1.4	0.3	0.2	0.6	**0.4**	**0.6**	**0.5**	**0.6**	**0.6**	**0.7**	**0.5**	**0.5**
Italy	-2.7	-0.5	0.6	-0.3	**0.4**	**0.3**	**0.4**	**0.4**	**0.5**	**0.4**	**0.4**	**0.4**
Spain	-1.6	-1.1	-0.3	-0.1	**0.1**	**0.1**	**-0.4**	**-0.1**	**0.4**	**0.6**	**0.7**	**0.7**
Netherlands	-2.3	-1.1	0.5	0.2	**0.3**	**0.4**	**0.5**	**0.4**	**0.4**	**0.5**	**0.4**	**0.5**
UK	-2.5	-0.7	-0.4	0.6	**0.4**	**0.8**	**0.9**	**0.9**	**0.9**	**0.9**	**0.6**	**0.7**
Switzerland	-0.9	-0.3	0.3	0.4	**0.3**	**0.4**	**0.3**	**0.4**	**0.5**	**0.5**	**0.6**	**0.6**
Sweden	-0.8	0.3	0.2	0.5	**0.6**	**0.6**	**0.8**	**0.8**	**0.9**	**0.9**	**1.0**	**1.0**
Denmark	-1.3	-2.6	0.5	1.0	**0.6**	**0.4**	**0.4**	**0.4**	**0.6**	**0.6**	**0.8**	**0.7**
Norway*	-0.9	0.1	0.3	0.3	**0.6**	**0.7**	**0.9**	**0.8**	**0.9**	**1.0**	**1.0**	**0.9**
Poland	0.3	0.7	0.6	1.2	**0.8**	**0.6**	**0.7**	**1.0**	**1.2**	**1.2**	**1.3**	**1.5**
Czech Republic	-4.1	-0.3	0.6	0.7	**0.5**	**0.4**	**0.3**	**0.6**	**0.8**	**1.0**	**0.9**	**0.9**
Hungary	-2.3	-1.4	-1.2	-0.4	**0.5**	**0.4**	**0.3**	**0.4**	**1.0**	**0.8**	**0.8**	**0.8**

*Mainland GDP

Interest Rate Forecasts

%		Current	3-Month Horizon Forward	3-Month Horizon Forecast	6-Month Horizon Forward	6-Month Horizon Forecast	12-Month Horizon Forward	12-Month Horizon Forecast
Euroland	3M	**0.6**	0.7	**1.2**	0.9	**1.3**	1.4	**1.5**
	10Y	**3.1**	3.2	**3.3**	3.2	**3.3**	3.3	**3.4**
UK	3M	**0.7**	0.7	**0.8**	0.9	**1.3**	1.5	**2.4**
	10Y	**4.0**	4.2	**4.0**	4.3	**4.0**	4.6	**4.3**
Denmark	3M	**1.3**	1.8	**1.4**	1.9	**1.7**	2.0	**0.0**
	10Y	**3.4**	3.5	**3.6**	3.6	**3.6**	3.8	**0.0**
Sweden	3M	**0.5**	0.7	**0.5**	1.1	**1.0**	1.8	**2.5**
	10Y	**3.1**	3.2	**3.3**	3.3	**3.4**	3.4	**3.8**
Norway	3M	**2.3**	2.3	**2.6**	2.8	**2.9**	3.0	**0.0**
	10Y	**4.4**	4.5	**4.7**	4.5	**4.7**	4.7	**0.0**
Switzerland	3M	**0.3**	0.3	**0.3**	0.4	**0.5**	1.2	**1.0**
	10Y	**1.8**	1.9	**2.0**	2.0	**2.1**	2.1	**2.3**
Poland	3M	**4.1**	4.3	**4.3**	4.4	**4.5**	4.6	**5.1**
	5Y	**5.1**	5.2	**6.1**	5.3	**6.3**	5.5	**6.3**
Czech	3M	**1.4**	1.9	**1.8**	2.0	**1.9**	1.8	**2.3**
Republic	5Y	**3.0**	3.2	**3.8**	3.4	**4.0**	3.8	**4.4**
Hungary	3M	**5.5**	5.3	**6.1**	5.2	**6.1**	5.3	**6.3**
	5Y	**5.9**	5.9	**6.5**	6.0	**6.6**	6.1	**6.8**
Euroland-US	10Y	**-77**	-88	**-23**	-99	**2**	-119	**-13**

Close 07 April 10, mid-rates for major markets. We are currently using June 2010, September 2010 and March 2011 contracts for 3-month forward rates.

We, Erik Nielsen, Javier Perez de Azpillaga, Natacha Valla and Nick Kojucharov, hereby certify that all of the views expressed in this report accurately reflect personal views, which have not been influenced by considerations of the firm's business or client relationships.

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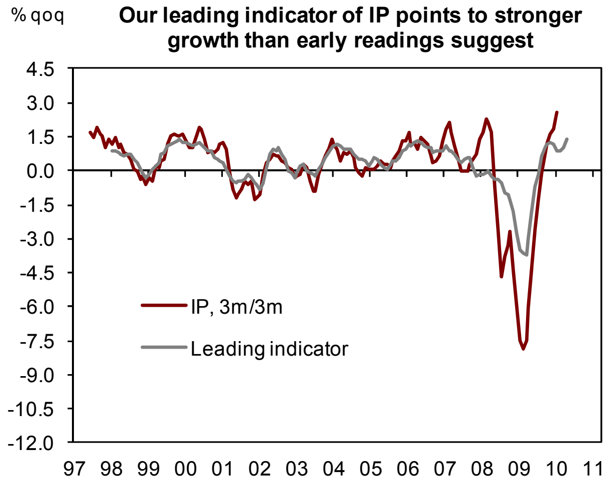
European Calendar

Focus for the Week Ahead

Industrial production (Wednesday). IP is a key input into GDP calculations, and the February round of numbers will be critical in our assessment of growth prospects for Q1. Germany and Spain already reported weaker-than-expected, and if the remaining major EMU countries come in line with our expectations, the Euro-zone aggregate should be roughly flat on the month. This is slower than the pace suggested by our leading indicator of IP.

Full inflation report (Friday). Headline inflation surprised to the upside in March, rising from +0.9%yoy +1.5%. While we doubt that core inflation was behind the spike, the full component breakdown should shed some some light on which components were the principle drivers.



Source: Eurostat, Ifo, Markit, GS Global ECS Research

Economic Releases and Other Events

Country	Time (UK)	Economic Statistic/Indicator	Period	Forecast mom/qoq	Forecast yoy	Previous mom/qoq	Previous yoy	EMEA MAP Relevance
Friday 9th								
Germany	07:00	Trade Balance	Feb	+EUR11.0bn	—	+EUR8.7bn	—	3
France	07:45	Industrial Production	Feb	+0.1%	—	+1.6%	+3.5%	5
Czech Republic	08:00	Consumer Prices	Mar	+0.0%	+0.5%	+0.0%	+0.6%	0
Czech Republic	08:00	Industrial Output	Feb	—	+7.0%	—	+5.3%	4
Czech Republic	08:00	Unemployment Rate	Mar	—	—	+9.9%	—	3
Sweden	08:30	Budget Balance	Mar	—	—	SEK 43.9bn	—	—
Sweden	08:30	Industrial Production	Feb	—	—	+1.6%	–0.2%	3
Norway	09:00	Consumer Prices (CPI-ATE)	Mar	—	—	—	+1.9%	0
Norway	09:00	Manufacturing Production	Feb	—	—	–0.4%	—	4
USA	15:00	Wholesale Trade	Feb	—	—	–0.1%	—	—
Monday 12th								
Italy	09:00	Industrial Production	Feb	+0.2%	—	+2.6%	+0.1%	5
USA	19:00	Federal Budget Balance	Mar	—	—	–$191.6bn	—	—
Tuesday 13th								
Hungary	08:00	Consumer Prices	Mar	+5.8%	—	+0.3%	+5.7%	0
Sweden	08:30	CPI	Mar	+0.4%	+1.3%	+0.6%	+1.2%	0
Czech Republic	09:00	Current Account Balance	Feb	—	—	+CZK15.6bn	—	0
Poland	13:00	Current Account Balance	Feb	—	—	—	–EUR710m	2
USA	13:30	Trade Balance	Feb	–$40.0bn	—	–$37.3bn	—	—
USA	13:30	Import & Export Prices	Mar	—	—	–0.3%	—	—
Wednesday 14th								
Euroland	10:00	Industrial Production	Feb	flat	—	+1.6%	+1.1%	5
Hungary	13:00	Minutes of MPC Meeting	Mar-29	—	—	—	—	—
USA	13:30	Consumer Prices	Mar	+0.1%	—	Flat	—	—
USA	13:30	CPI - Ex Food & Energy	Mar	+0.1%	—	+0.1%	—	—
USA	13:30	Consumer Price Index NSA	Mar	218.8	—	216.7	—	—
USA	13:30	Retail Sales	Mar	—	—	+0.3%	—	—
USA	13:30	Retail Sales - Ex Autos	Mar	—	—	+0.8%	—	—
USA	15:00	Business Inventories	Feb	—	—	Flat	—	—
USA	19:00	Fed Beige Book	—	—	—	—	—	—
Thursday 15th								
Spain	07:00	Consumer Prices	Feb	—	+1.4%	—	+0.9%	0
Czech Republic	08:00	Producer Prices	Mar	—	—	—	–2%	0
Euroland	10:00	Trade Balance	Feb	—	—	EUR 3.3bn	—	0
Poland	13:00	Consumer Prices	Mar	+2.6%	—	+0.2%	+2.9%	0
USA	13:30	Initial Jobless Claims	—	—	—	—	—	—
USA	13:30	Empire Manufacturing Survey	Apr	—	—	22.9	—	—
USA	14:00	Net Long-term TIC Flows	Feb	—	—	—	—	—
USA	14:15	Capacity Utilization	Mar	+73.6%	—	+72.7%	—	—
USA	14:15	Industrial Production	Mar	+1.1%	—	+0.1%	—	—
USA	15:00	Philadelphia Fed Survey	Apr	21.4	—	18.9	—	—
USA	18:00	Home Builders Survey - HMI	Apr	—	—	15.0	—	—
Friday 16th								
Euroland	07:00	Car Sales	Mar	—	—	890k(sa)	—	—
Hungary	08:00	Gross Average Wages	Feb	—	—	—	+6.5%	2
Switzerland	08:15	Producer & Import Prices	Mar	—	—	–0.3%	–1%	0
Euroland	10:00	Harmonised CPI	Mar	+0.9%	+1.5%	+0.3%	+0.9%	0
USA	13:30	Housing Starts	Mar	+5.0%	—	–5.9%	—	—
USA	14:55	U. of Michigan Consumer Sentiment - Provisional	Apr	—	—	73.6	—	—

Economic data releases are subject to change at short notice in calendar. [1] Consensus from Bloomberg. Complete calendar available via the Portal — https://360.gs.com/gs/portal/events/econevents/.