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Weekly

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Viewpoint

The CBO estimate of the effects of the **2011 budget** deal struck last week shows negligible cuts relative to the baseline scenario. The battle now begins over the question of the **legal debt limit,** which is expected to be reached by 16 May.

Spain: doing "the right thing"

We continue to believe that Spain is a separate case from other peripheral countries. The government fully respected its commitments on the public finance front in 2010 and has made progress with the reforms. After two years of falling, GDP will resume growth on a more balanced path. The recapitalisation needs of the Cajas remain uncertain, but efforts this last year point in the right direction. Mot of the correction in the residential investment sector is now over; households should be able to digest the increased debt burden due to the hike in ECB rates.

Spain, a tough job

The rise in unemployment in Spain, well in excess of the European average, reflects the sharper cyclical correction in the economy but also the greater elasticity of employment to GDP, due to the marked duality of the Spanish labour market. The return to positive growth rates and the reforms implemented by the government in the last year should help employment recover as of 2012. However, some of the growth in unemployment might prove structural and have negative repercussions on domestic demand and the public finance balances. Thus, further progress on the reform front is crucial.

The week's market movers

Due out in the **Euro area** are the April confidence surveys (EU Comm., Bank of Belgium business confidence, PMI and INSEE). The indicators should show a slight dip in sentiment, still leaving it historically high and in expansionary territory.

The data in the **United States** should confirm the weakness of the real estate market and less robust growth rates in manufacturing. The March data on existing home sales, starts and permits should show levels close to the bottom end of the fluctuation range seen in the last six months. The Philadelphia Fed survey should be down in April after two months of exceptional gains.

Priced on 15.04.2011

Viewpoint

The CBO estimate of the effects of the **2011 budget** deal struck last week shows negligible cuts relative to the baseline scenario. The battle now begins over the question of the **legal debt limit,** which is expected to be reached by 16 May.

- The **CBO has published an estimate of the effects on the deficit of the deal signed last week** regarding the budget for fiscal year 2011. It could be entitled "Much ado about nothing". In fact, in the CBO estimates the USD 38.5Bn of cuts trumpeted in the deal in reality become a spending cut of just USD 352M. If to this is added the emergency military expenditure in Afghanistan and Iraq, USD +8Bn, spending for the fiscal year would actually be USD 3.3Bn higher than the current levels. The reason why most of the cuts announced would not have cash effects is that firstly they apply only to six months rather than the full fiscal year and, in addition, they cover items that cannot be cut immediately, but only gradually. Some of the cuts negotiated would have effects only in the medium term.

- The first implication of the CBO estimates is that **the tightening effect of the measures on growth in the coming quarters would be marginal.** The second is that the conservative wing of the Republican party is against the deal: 28 Republicans in the House voted against the agreement and will increase the pressure for an intransigent stance in the talks due to start shortly on the question of the **statutory debt limit**. The clash will be even more bitter than the one unleashed over the 2011 budget. In a letter to Congress dated 4 April, Treasury Secretary Geithner said that the federal debt would reach the legal limit of USD 14.29Trn by16 May. The projection is based on estimates of the income tax revenues that will be paid by 18 April, plus other estimated cash flows. The Treasury, once the legal limit is reached, may continue, at least temporarily, to honour the payments due via exceptional measures that were previously adopted during the 1995 debt crisis (see Weekly Economic Monitor, 14 January 2011). The Treasury estimates that these measures should keep the federal government solvent for eight weeks at most, i.e. through to 8 July at the latest.

- On 5 April, P. Ryan, president of the House Budget Committee, tabled **the Republicans' proposal for the 2012 budget** which includes a programme of draconian spending cuts over the next decade. In 2012, the deficit would be cut to USD 995Bn (from the current estimate of USD 1.4Trn). Over the decade spending would be cut by USD 6Trn, via the conversion of the Medicare programme into a private health insurance system with subsidies funded by the government; plus reform of the Medicaid programme. On the revenues front, the top rate on personal and business income tax would be cut to 25%.

- On 13 April, US president **Obama proposed a plan to cut the federal deficit** by around USD 4Trn over 12 years, including a mix of spending cuts and tax increases. The president's plan too, like that of the Republicans, includes a tax reform that would remove numerous deductions and simplify taxation; however, some of the increased tax take expected would also come from hikes in tax rates on high incomes. Of the USD 4Trn correction envisaged, around USD 1Trn would come from revenues. The remaining USD 3Trn would be secured through spending cuts, but would not alter the programmes regarding social security (also unchanged in the Republican programme) and healthcare (revolutionised in the plan presented by Ryan). The president has urged Republicans and Democrats to start talks through the mediation of vice-president Biden in early May. The Obama proposal is the starting base for the Democrats in addressing the clash over the increase in the statutory debt limit. The Republicans maintain the intransigent stance announced with the deficit reduction plan: to resolve the differences, there must be no tax hikes. The "disappointing" estimates of the effects of the deal over the 2011 budget and the distance between the Republican and Democrat plans increase the **likelihood of a prolonged battle over the debt limit.**

Spain: doing "the right thing"

Anna Maria Grimaldi

We continue to believe that Spain is a separate case from other peripheral countries. The government fully respected its commitments on the public finance front in 2010 and has made progress with the reforms. After two years of falling, GDP will resume growth on a more balanced path. The recapitalisation needs of the Cajas remain uncertain, but efforts this last year point in the right direction. Mot of the correction in the residential investment sector is now over; households should be able to digest the increased debt burden due to the hike in ECB rates.

The confidence of the markets in Spain's ability to manage the rebalancing process is crucial to the survival of Monetary Union. We still believe the country is a separate case from other peripheral countries. An analysis of the critical aspects of the Spanish economy gives a moderately positive view. Besides, the Zapatero government has succeeded in passing unpopular reforms, most recently the pensions reform in January. The 2012 elections will likely result in a change of government as flagged by the outcome of the recent administrative and regional elections. It is crucial to the future of the country and Monetary Union that the reform process is stepped up further to ensure the sustainability of the public finance balances and ensure more balanced growth in the years ahead.

In 2010 the government fully respected its commitment to reduce the deficit /GDP ratio to 9.2% from 11.1% the previous year, breaking an uptrend in several spending items (wages and salaries) which had in the past shown considerable inertia. Based on the 2011 Budget we expect the deficit GDP ratio to fall to 6.3%, three-tenths higher than the official estimates owing to the more subdued growth factored into our baseline scenario. The debt is expected to rise to 63.9% from 60.1% in 2010. More detailed information on the public finance dynamic will be forthcoming soon with the presentation and examination of the Stability Programmes by the EU Commission at the end of April.

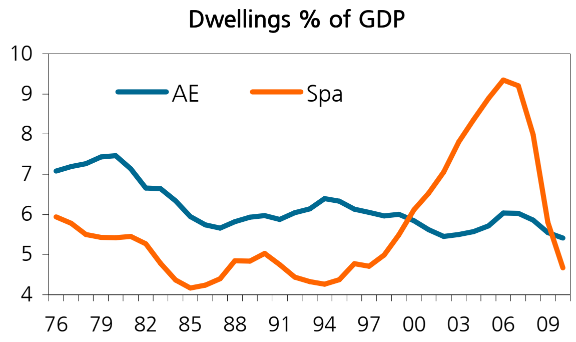
However, a is well known, the sovereign debt risk for Spain involves the solvency of the banking system which in turn is dependent on the correction of the bubble in the real estate market and adjusting budget balances in the private sector. A still protracted correction in the real estate sector could have repercussions on the size of the potential write downs, adding uncertainty to the public debt trajectory. Below we assess the outlook for the Spanish economy and the real estate sector in light of the recent trends and imminent tightening cycle.

The correction in residential investments should be virtually over

As is known, between 1997 and 2007 Spain grew on average 1.3% above the Euro area avg. and one point above its potential (then estimated at 3.6%). The fall in interest rates with entry into Monetary Union boosted domestic demand, notably in consumer spending and construction. The cumulative contribution of residential investments to Spanish GDP growth between 1997 and 2007 was 4.2%. At year-end 2007 residential investments as a share of GDP stood at 9.3%, over 3% above the Euro area percentage (excluding Spain). At year-end 2010 the percentage of residential investments fell to 4.2%, below the long-term avg. calculated since the late 1970s (4.7%). The fall in this cycle **is much more pronounced (-45%) than in the previous cycle** (90 - 95: -13%).

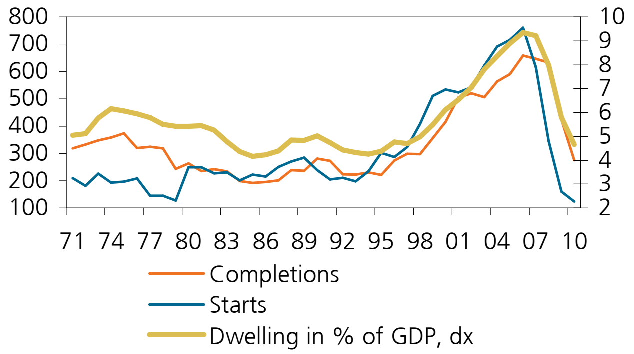
We do not rule out some undershooting going forward. In the last decade the share of construction investments was 7.4% vs. 4.7% in the previous 20 years; if the share returned to an average (5.2%) half a point higher than in 1980 - 2000 (4.7%), residential investments should still fall in the next three years. The fall in residential investments in this cycle **has been far more pronounced (-45%) than in the previous cycle** (90 - 95: -13%). **The reason lies in the massive response in supply** with a high of 760k new starts in 2007 vs. 300k in 1989.

The share of residential investment in GDP is back to historic average



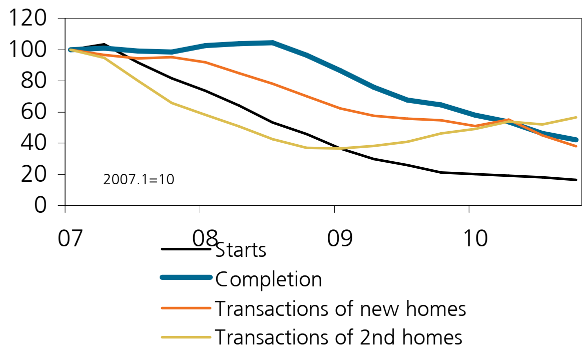
Source: Eurostat and Bank of Spain

The recent trend in housing starts and completions suggest we may see further decline ahead



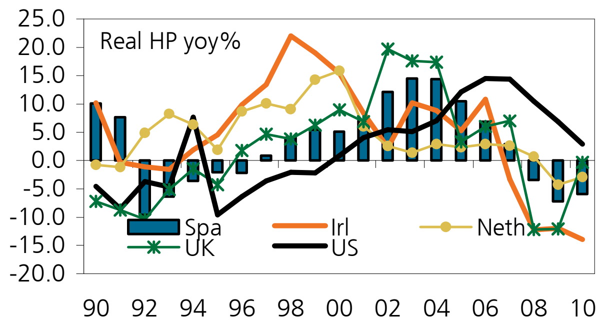
Source: Eurostat and Bank of Spain

The stock of unsold homes should re-absorb going fwd



Source: Bank of Spain

House prices fell less than elsewhere…



Source: Bank of Spain and EcoWin

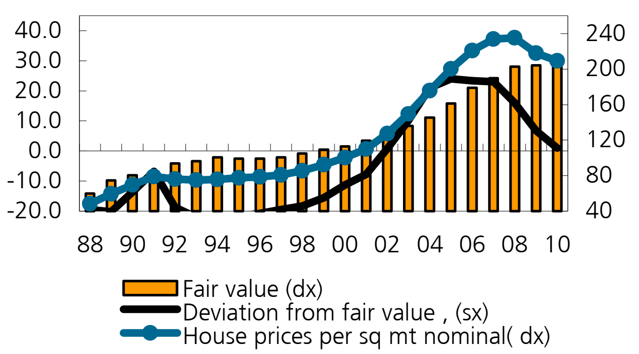
The residential construction sector should have seen most of the correction of terms of decline in investments. However, the further deflating of the bubble depends on the housing supply and demand dynamic and the stock of unsold homes. The supply of homes can be approximated by the number of starts/homes completed. Housing demand can be approximated by the number of new home sale completions recorded by notaries. At year-end 2010, finished homes totalled 276k, vs. 424k in 2009 and below the 2000-07 (555k). New home transactions in 2010 averaged 50k vs. 91k in 2000–07. The Bank of Spain estimates the stock of unsold homes as the cumulative difference at year-end 2003 between finished homes and new home transactions. The stock of unsold homes is reported to have grown sharply through to year-end 2009 since the fall in completed starts should have been offset by the fall in demand. The stock should have stabilised in 2010 just below 700k.[1] **Over the next 18 months,** given the fall in starts and permits it is reasonable to expect a fall in starts that should trigger **the gradual absorption of the stock of unsold homes,** especially if demand remains at the late 2010 levels. Demand could even accelerate slightly. The dynamic in home demand depends on the financial health of households and on the trend in labour income, demographics and the affordability of homes. The impact of demographics will be marginally expansionary since only limited population growth is expected. However, with the economic recovery and the return to the labour and real estate market of unemployed young people (currently living at home) latent demand should be freed up.

[1] Bank of Spain notes that there is some uncertainty in this estimate of 70 / 80k units corresponding to houses built by the owners that are not included in the official records.

House prices roughly in line with the fundamentals but undershooting cannot be ruled out

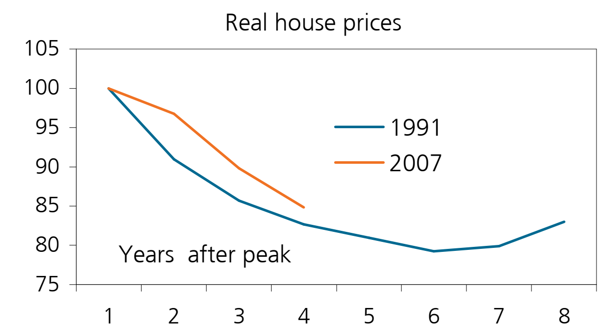
The correction in house prices has been around 7% in real terms from the 2008 high. The long-term models indicate that the overvaluation of house prices in real terms should subside although a correction below the long-term values cannot be ruled out. In the previous cycle house prices corrected for five years following the bursting of the bubble. The Bank of Spain notes that house prices in this cycle have shown marked downward rigidity since owners have preferred to wait and rent out property before concluding a sale. **Accordingly, house prices could correct by around 5% in the current two years.** A further correction in house prices might be exacerbated by monetary tightening over the next 18 months. Spanish households were still heavily indebted at year-end 2010 (90% of GDP). The financial leverage of households fell to 58% in 2010 from a high of 60% in early 2009. Some households, given the high level of debt, might be forced to liquidate real estate assets, which would impact significantly on prices. Such a risk might become more acute as ECB interest rates rise. Mortgages in Spain are linked to short-term rates with a lag of 12 – 18 months.

... seem back to "equilibrium levels



Source: Bank of Spain, INE and Intesa Sanpaolo estimates .For our model on House prices in Spain see A decade of austerity 15 January 2010

But there is room for some undershooting

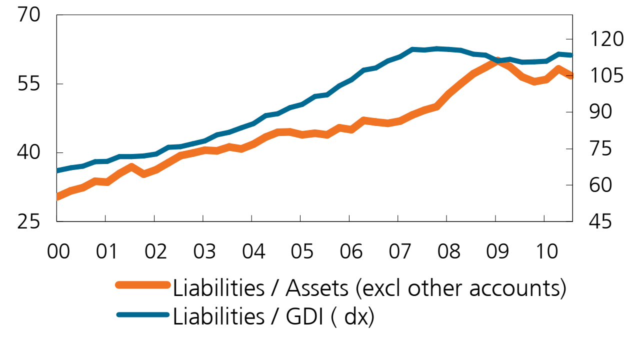


Source: Bank of Spain, INE and Intesa Sanpaolo calculations

Households should be able to digest the rate hike

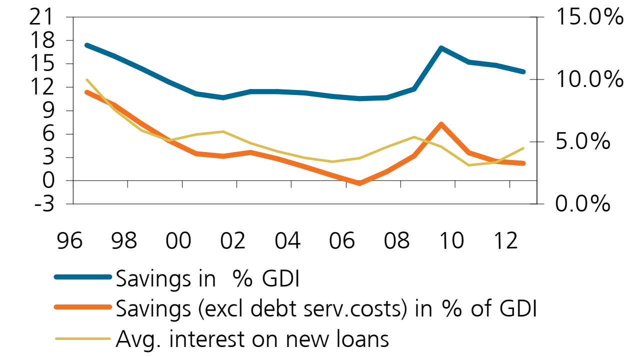
To assess this risk we take the dynamic in household spending netted of the debt expense. The saving rate netted of the debt servicing cost was marginally above zero at year-end 2007. At start 2010 saving rose to 7% but in 2H10 it fell back to c.4%. Barring rates at 5% by year-end 2012, a very aggressive and implausible scenario at this time, households should have a sufficient buffer to ride out negative developments on the growth front. Note that this approach does not take account of the differences by income class and type of consumer. The survey of Spanish household finances (see Bank of Spain January 2011 bulletin) includes details on the trend in the cost of debt for different groups of households. The Bank of Spain notes increased dispersion in the cost of debt. With steeper increases for consumers under 35. This group is the most indebted: around 68.6% of the total had contracted debt and the level of indebtedness at year-end 2009 was 450% of disposable income vs. 280% of the sample average income. In this group of consumers an increase is noted in the percentage of debt not honoured.

Despite high leverage households should be able to weather the upcoming hiking cycle



Source: Bank of Spain, INE and Intesa Sanpaolo

Only with a spike in rates to 5% households savings net od debt servicing costs would go back to zero



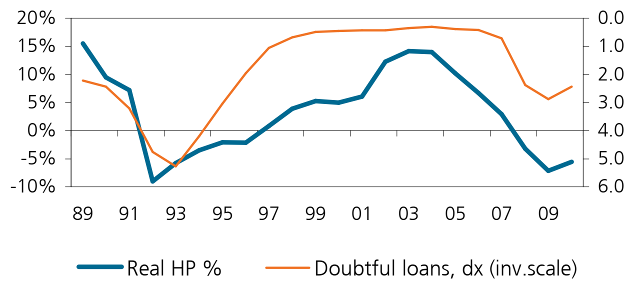
Source: Bank of Spain, INE and Intesa Sanpaolo estimates. We have simulated the impact of a Refi at 5% by end 2012 on debt servicing costs other things being equal

Improved prospects for doubtful loans

In principle, the fact that most of the correction in the real estate bubble is now over should limit negative developments on the credit front and the growth in watchlist loans and NPL. The trend in watchlist loans is related to house prices. Another factor containing watchlist loans should come from the gradual improvement in labour market conditions.

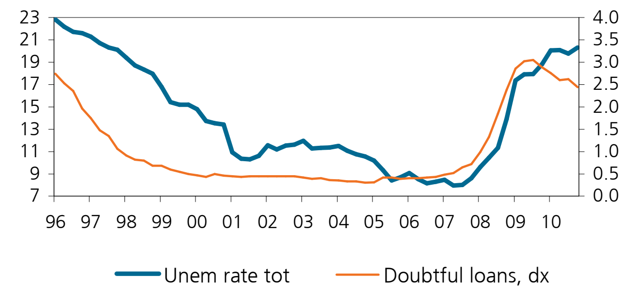
Nonetheless, there is still some uncertainty over the solidity of the Spanish savings banks and particularly the recapitalisation needs of the Cajas. However, major progress has been made on the regulatory front.

The correction of housing excess and...



Source: Bank of Spain, INE and Intesa Sanpaolo

... improvements in labour market conditions should limit the rise in doubtful loans



Source: Bank of Spain, INE and Intesa Sanpaolo

The reform of saving banks is an important step

The decree – law of July 2010 aimed at reforming legal and regulatory regime for saving banks[2].

Over the past year, in line with targets set with the reform, and with the aid of FROB funds the number of Cajas came down to 15 from 45. The consolidation process has affected more than 95% of the total assets of the sector. Savings banks have recognised additional losses on their loans and receivables and foreclosed assets for more than 20 billion euro.

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[2] The main objectives of the reform were: 1) allowing saving banks to have equity like instruments; 2) increasing the concentration of the sector- by giving the saving banks the option to (a) maintain their existing structure, (b) operate through a bank, (c) become part of a formal group of saving banks or (d) become a foundation; 3) reform corporate governance structure (prohibiting elected officials to be members of governing bodies.

The Bank of Spain Governor in a speech of April 5th highlighted that the exposure of savings bank to the construction and real-estate development sector amounted to 217 billion euro, of which 28 billion (13%) is made up of doubtful assets. Yet, the Bank of Spain forces banks to make for, assets acquired in payment of debt, as well as standard loans under surveillance owing to some observed weakness, even if payments are up to date. At the end of 2010, Cajas recognised as potential at risk. 100 bln euro of loans to the construction sector (46% of asset). Accumulated specific loan loss provisions represent 31% of these "extended" troubled assets, and if we add the general provisions this percentage reaches 38%. The Bank of Spain deems as adequate these provisions as noted by Ordonez "*taking into account the margin provided by the loan-to-value ratio and the fall in real estate prices that has already taken place, it would be necessary to make catastrophic assumptions, beyond all reasonable expectations, regarding the expected losses in order for the total losses to be well above the total volume of loan loss coverage*".

In addition the system of provisioning has been tightened with the reform so that the banks have even greater incentives to speed up the restructuring of balance sheets. Indeed, doubtful loans have to be fully provisioned within one year once the collateral has been taken into account. In addition the law require provisions of 30% for foreclosed assets that remain on balance sheets for two years.

Overall write downs of the Spanish banking system since 2008 amount to 96 bln euro (5 of GDP). Over the same period, banks have increase capital in excess of minimum requirements by 53 bln euro, partly with the aid of the FROB.

Further steps to consolidate the Spanish banking system were made with the Royal Decree Law of February 2011. The decree-law increases the capital requirements of Spanish banks, also promotes the raising of private capital and sets the timetable for recapitalisation of the banks that fail to reach the levels of capital targets. The FROB is set to participate in the process of raising private capital.

Core capital requirements have been raised to 8% for all credit institutions and to 10% for those institutions with a proportion of funding in whole sale markets exceeding 20% and / or with less than 20% of their share capital held by third parties.

The decree-law sets September 2011 as a deadline to raise capital through markets, even though banks planning to use IPOs might get an extension until 2012.Q1. If the capital raised through markets is not enough the FROB will intervene to close the gap with the initial target.

The decree-law establishes 5 steps for banks planning to use FROB resources:

1) The FROB will only acquire ordinary share

2) If the banks were not in the position to issue share they would need to change their status to commercial bank

3) The FROB will operate as a special director on the governing body of the bank issuing shares

4) The saving banks presented recapitalization plans that have been examined by the Bank of Spain. Thirteen institutions out of 114 examined needed have to raise capital by 15 bln euro.

5) The FROB will sell acquired shares no later than 5 years

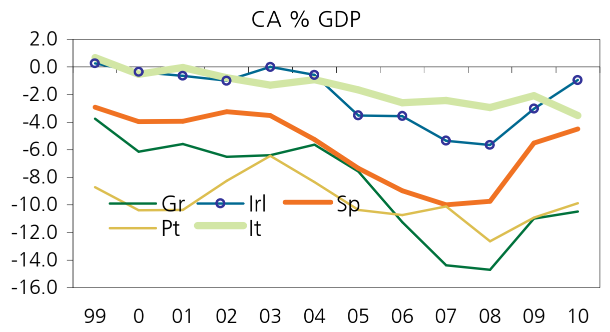
Towards more balanced growth

Bearing in mind that the correction in the real estate bubble should be nearly over and that the reform of the Cajas should have improved the position of the banking system, some of the risks to Spain's solvency appear to be dissipating. Assuming an orderly emergence from the real estate bubble without further repercussions on banking system losses, Spain's credibility still depends on reducing the domestic imbalances via further progress with the reforms. The external imbalances have partly been reduced as shown by the fall in current account deficit, moreover less marked than in Ireland. Consequently, the external net financial position worsened further in 2010. The reduced indebtedness of the private sector stems from bank deleveraging while household and business debt has remained roughly at the 2009 levels. Public sector liabilities have also increased further.

GDP growth is set on a more balanced path emerging from this crisis and we expect a smaller contribution from consumption and a more positive trend in foreign trade and business investments. However, for this trend to be confirmed competitiveness must be recouped. To date, the more favourable trend in the unit labour cost might be due simply to a cyclical upturn in productivity. Further progress on the wage bargaining reform front is crucial, as is the re-absorption of workers dismissed in this crisis, notably in construction. Indications on this front will come at the end of April (see in this issue of WEM: *Spain: a tough job*).

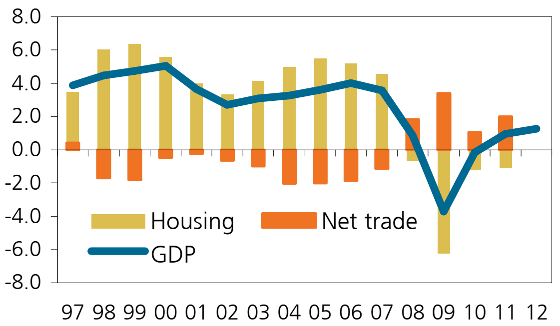
With regard to the sustainability of public spending in the medium term the recent pensions reform marks an important step. The measures taken in the coming years must ensure that current expenditure continues to fall.

Still running a current account deficit



Source: Bank of Spain, Datastream and Intesa Sanpaolo

Yet, the economy should move to a more balanced growth path



Source: Bank of Spain, INE and Intesa Sanpaolo

Spain, a tough job

Alessandra Gaia

The rise in unemployment in Spain, well in excess of the European average, reflects the sharper cyclical correction in the economy but also the greater elasticity of employment to GDP, due to the marked duality of the Spanish labour market. The return to positive growth rates and the reforms implemented by the government in the last year should help employment recover as of 2012. However, some of the growth in unemployment might prove structural and have negative repercussions on domestic demand and the public finance balances. Thus, further progress on the reform front is crucial.

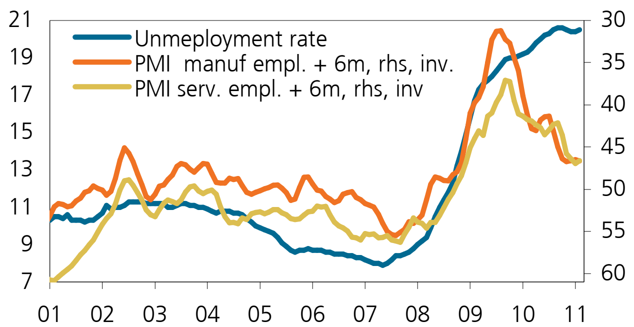
The crisis in Spain has had for more pronounced repercussions than in the rest of the Euro area, not just in terms of output but on employment too. **The adjustment in labour input was made entirely through redundancies rather than reductions in hours worked,** generating an increase in unemployment well in excess of the European average. In February, the ILO unemployment rate hit 20.5% in Spain, the highest in the Euro area, the maximum in 28 years. Between summer 2007 and first quarter 2010 almost 2M jobs were lost (1,963,800), leaving the jobless total at 4.72M.

The rise in unemployment, far more pronounced than in the rest of the Euro area, reflects the "dual" structure of the Spanish labour market. The percentage of workers on fixed-term contracts at the end of 2010 (24.9%) was still 10 points above the Euro area average (15.8%), even though the percentage had been falling since late 2006. Note that total payrolls in Spain continued to increase through to the start of 2008.

The large percentage of fixed-term workers accounts for the explosion in the jobless total in this cycle

Source: OECD data and estimates, Intesa Sanpaolo calculations

The economic indicators signal a less dramatic fall in payrolls in the coming months



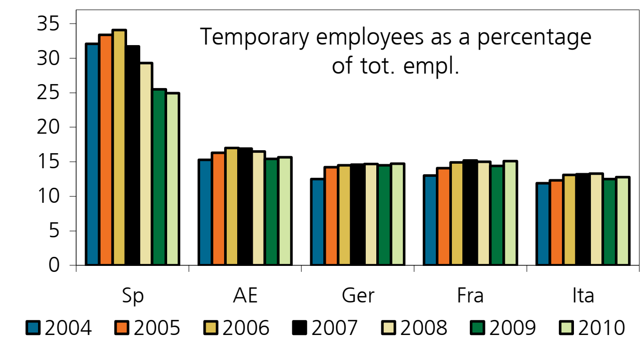
Source: Eurostat, Markit Economics; Intesa Sanpaolo calculations

A dual labour market

The downtrend in the percentage of fixed-term contracts within total employment started to slow in 2010. In absolute terms the number of fixed-term contracts is back at the levels of the late 1990s, from the high of 34.6% recorded at the end of 2006.

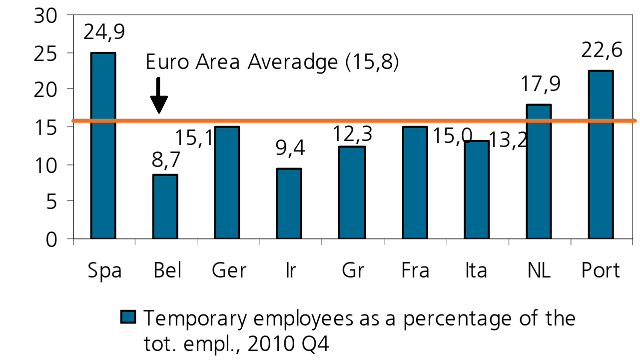
The outlook for the labour market remains uncertain but the economic indicators appear to suggest that the decline in employment should moderate this year. Hiring might pick up again in 2012. A marked fall in unemployment will only be seen in mid-2012.

The percentage of workers on fixed-term contracts in Spain has fallen sharply in recent years...



Source: Eurostat; Intesa Sanpaolo calculations

... but it is still much higher than other Eurozone countries and the Euro area as a whole



Source: Eurostat; Intesa Sanpaolo calculations

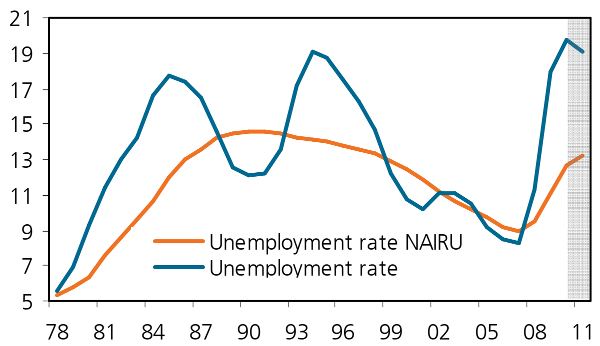
The strong expulsion of temporary workers may have more negative consequences in terms of composition of employment and productivity dynamics. In fact, it is possible that workers with contract types that allow a less onerous dismissal are excluded from employment rather than less efficient workers. If so, employment would be composed, leading to negative consequences on productivity of medium-long period.

Cyclical or structural unemployment

Labour market very sensitive to economic performance

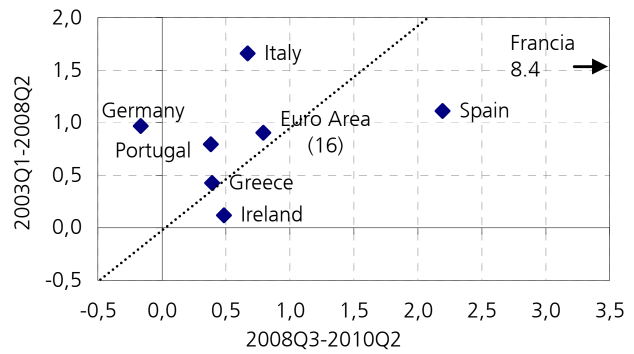
The Spanish labour market shows extremely high elasticity of employment to GDP. As mentioned above, in the event of negative shocks firms tend increasingly to dismiss workers than reduce the hours worked. The chart shows that the elasticity of employment to GDP during the 2008-10 crisis was more pronounced than the historical value. in the period 3Q08-4Q09, the elasticity of employment to GDP rose sharply vs. 1Q03-2Q08. In addition, consumption growth and employment growth have a close correlation of close to 90% in Spain, and consequently changes in the labour market provide an important key to understanding household consumption, which accounts for almost 75% of GDP[3].

Structural unemployment rate rising



Source: OECD, Intesa Sanpaolo calculations

Marked elasticity of employment to GDP



Source: Eurostat, Oxford Economics, Intesa Sanpaolo calculations

Cyclical or structural unemployment?

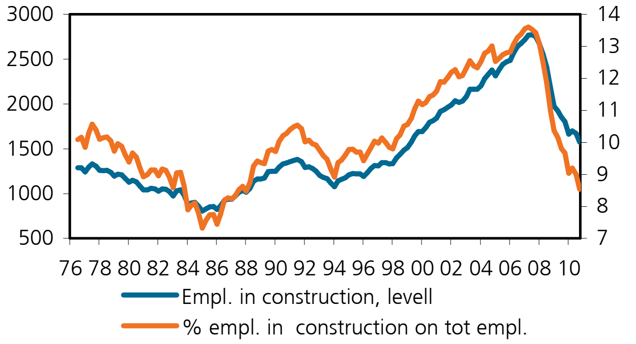
The risk is that the recent rise in the unemployment rate may translate into an increase in NAIRU. *A priori* it is hard to say whether the recent rise in unemployment will translate into a

[3] Economics and Interest rate strategy, Spain: On the Mend, Morgan Stanley, March 7 2011

rise in long-term unemployment, which would impact negatively on the growth outlook and the public finance balances. According to OECD data, structural unemployment started growing in 2008, reaching 12.6% in 2010, close to the level of a decade ago. However, the structural unemployment rate is not back at the early 1990s levels; and, in the OECD projections, this rate is expected to grow further in 2011, albeit at a less rapid pace than in recent years.

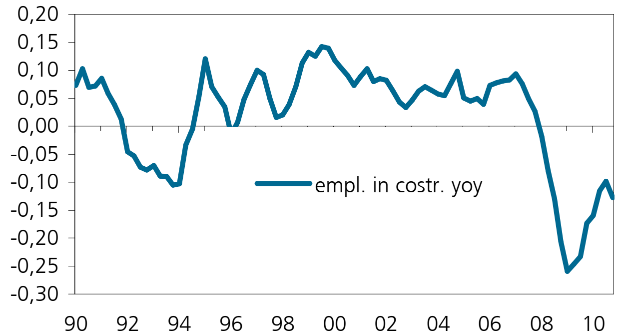
Undoubtedly unemployment might also prove higher owing to the scaling back of the construction sector. The year-on-year change in the number of jobless who before dismissal worked in the construction sector jumped from 5.7% yoy in 2007 to 71.1% yoy in 2008, and continued to grow very robustly in 2009 (62.5%). The haemorrhaging of jobs in the construction sector eased off in 2010 (returning to 5.7% yoy). In 4Q10 sector payrolls were back at the late 1990s levels: the scaling back of the sector is even more apparent when we consider that in 4Q10 construction sector workers accounted for just 8.5% of total payrolls (as in the late 1980s). Most of the decline in employment appears to be over and another significant correction looks unlikely at this stage.

Construction sector payrolls are back at late 1990s levels and the weight of the sector within total employment is much reduced…



Source: National Statistics Institute, (ENS), Intesa Sanpaolo calculations

… following the sharp contraction stemming from the bursting of the real estate bubble



Source: National Statistics Institute, (ENS), Intesa Sanpaolo calculations

The government has already taken major steps to counter the duality of the labour market via the reform package passed last September (See text box).

The chief measures in the **September 2010 Reform** include increased working day flexibility for firms and fewer restrictions on job-shedding at times of economic crisis. The main such measures adopted include:

a) Reduction in working hours: working hours may be reduced from 10% to 70% for economic, technical, organisational or production reasons.

b) "Penalisation of temporary contracts": Contracts become permanent after three years for workers who are hired more than once by the same company or group of companies for the same or a different job. The aim is to prevent employers hiring staff on a succession of temporary contracts designed to avoid permanent contracts.

c) Extension of application of allowance of 33 days' pay for each year worked in the event of unfair dismissal. This is a lighter pay-out than the 45 days envisaged for workers on standard open-ended contracts.

d) Creation of a public fund to cover dismissal compensation.

e) Simplification of dismissal procedure for companies with current or forecast losses or a steady decline in turnover.

f) Possibility of dismissal for absenteeism: should the average absenteeism top 2.5% the firm may dismiss those workers absent from their job for over 20% of working days in two consecutive months or 25% in four non-consecutive months, considering a time period of 12 months.

Spain has one of the highest levels of severance pay in the Euro area and its interpretation of fair dismissal is more rigid. Severance pay is 20 days' salary per year of service in the case of fair dismissal and ranges from 33 to 45 days for unfair dismissal (to a maximum of 24 and 42 months respectively). These levels are well above the Euro area avg. Conversely, compensation is just 8 days per year worked in the event of fixed-term contracts[1].

Compensation in case of fair or unfair dismissal (in months' pay)

Country	Fair dismissal			Unfair dismissal
	9 months employment	4 years employment	20 years employment	20 years employment
Austria	0	0	0	6
Belgium	0	0	0	14
Denmark	0	0	0	1.5
Finland	0	0	0	14
France	0	0.8	6.7	16
Germany	0.2	1	5	18
Greece	0.3	1	6	6
Ireland	0	0.4	1.9	24
Italy	0	0	0	15
Luxembourg	0	0	6	5
Netherlands	0	3	9	7
Portugal	3	4	20	15
Spain	0.5	0.7	12	22
Sweden	0	0	0	32
United Kingdom	0	0.5	2.3	8
EU	0.3	0.9	4.7	14.1

Source: IMF based on OECD data

Important steps have been taken to reduce the duality of the labour market

The rigidity of the Spanish labour market calls for the completion of the reform of the wage bargaining system negotiation take place at the intermediate level[4] and provide forms of linking to inflation for over 69% of contracts vs. an average of 34% in the Euro area. Wage indexation continues to impact in relative terms on the Spanish labour cost dynamic, skewing competitiveness. In a note dated 13 April, Valeriano Gòmez, labour and immigration minister, voiced the need for pay moderation and stressing the importance of adjusting company margins to recover competitiveness.

Spain: pay indexing level (percentage of workers affected)

	Spain	Euro area	France	Italy	Belgium
Automatic link to past inflation	38	16	8	1	9
Automatic link to expected inflation	16	4	2	0.5	0
Indirect relation with past inflation	10	9	21	3	0
Indirect relation with expected inflation	5	5	8	2	0
No link with inflation	29	64	59	94	2

Source: IMF based on Bank of Spain data

[4] This system is indicated in the literature as less favourable to employment compared with fully decentralised or completely centralised systems. In addition, wage bargaining is tightly anchored to inflation. (See Calmfors and Driffill, 1988 in "The Spanish Labour Market in a Cross Country Perspective, Jaumotte F., IMF Working Paper").

Despite the urgent need to decouple pay from inflation, on 7 April 2011 pay rises of 3.06% were agreed for 1,462 contracts affecting 327,270 firms and over 2.78M workers, with economic effects on 2011[5].

Although these increase are worrying given the situation in Spain, progress on this front should come at the end of April with the conclusion of talks between unions, employers and government.

Awaiting for more reforms in "education and training"

To counter the rise in unemployment and revive the labour market, schemes to retrain redundant workers are vital. On this front too important signals are being seen. The Secretary of State for Employment, Mari Luz Rodriguez, said on 8 April that EUR 2.600M would be spent on job training courses. The labour market reform has also launched measures to incentivise ongoing training and education. First, the duration of the training and apprenticeship contract has been extended, as have the age limits for eligibility; second, workers on this type of contract are entitled to apply for unemployment benefits; third, firms may apply for a 100% reduction in social security contributions in respect of training contracts. However, further steps are necessary. According to an OECD[6] report, the Spanish Government should make less complicated the institutional setting of continuous training and improve the access of small business to subsidised continuous training. In addition, companies should have more opportunity to choose the type of training to ensure that the training meets the firms' needs, hence rendering the subsidy more effective. Finally, the government could also consider offering scholarships to cover tuition fees for training courses or indirect costs in terms of foregone income. This will facilitate learning by encouraging competition between educational institutions and offering a wider range of training opportunities.

Conclusions

In summary, the Spanish government has made major steps towards a commitment to the reform front, but the road ahead is still long. In the next months, the government would proceed to review wage bargaining system. At the same time, the announcement of new investment in education and continuous training should help to reduce the rise in structural unemployment.

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[5] A note from the Spanish government states that for now it has only been possible to record the deals relating to pay rises at a fixed rate agreed in advance: consequently, most contracts agreed through to March have a wage increase relating to past inflation, which in December 2010 was 3% yoy, while not included yet are the deals based on expected inflation, the weight of which in collective pay bargaining is quantitatively significant. Thus, according to the Spanish government, the figures in the first few months of the year are overstating the average pay increase and the agreements stipulated in the coming months will trigger a reduction in the average pay increase in 2011.

[6] OECD, Survey of Spain, Feb 2011.

The week's market movers

Due out in the **Euro area** are the April confidence surveys (EU Comm., Bank of Belgium business confidence, PMI and INSEE). The indicators should show a slight dip in sentiment, still leaving it historically high and in expansionary territory.

The data in the **United States** should confirm the weakness of the real estate market and less robust growth rates in manufacturing. The March data on existing home sales, starts and permits should show levels close to the bottom end of the fluctuation range seen in the last six months. The Philadelphia Fed survey should be down in April after two months of exceptional gains.

Monday 18 April

Euro area

- The **EU Commission index of consumer confidence** might ease to -11 in April, remaining slightly above the long-term mean calculated since 1985 (-12). According to the GfK survey, household confidence slipped in Germany, while in the peripheral countries the adoption of new tightening measures might further dent consumer sentiment.

United States

- The **NAHB** index should be steady at 17 in April, as in March (when the first improvement came after four months at 16). In last month's survey, current sales were steady (at 17), and future sales rose to 27 from 25.

Tuesday 19 April

Euro area

- The **composite PMI** for the Euro area might ease to 57.3 in April from 57.6 in March. The dip in sentiment should be due to a slightly gloomier view both in manufacturing (on fears of a slowdown in global demand and a stronger euro) – we estimate 57.1 vs. 57.5 – and in services (57 vs. 57.2). The composite index would still be comfortably expansionary, and in fact would point to a marked acceleration in GDP (in the area 1% qoq).

United States

- New **starts** should rise to 515k in March from 479k in February, returning them to the levels seen for most of the second half of 2010. Starts were extremely volatile in the first two months of the year due to the weather. In February, sites fell by 22.5% mom to 479k, just above the all-time series low (477k in April 2009). **Building permits** are expected to rise to 540k in March from 534k in February, still close to the bottom end (544k) of the range seen since September 2010.

Wednesday 20 April

United States

- **Sales of existing homes** are expected to grow to 5.1M units ann. in March from 4.88M in February. February witnessed a plunge in sales of -9.8% mom, partly due to the weather. The sector remains weak: pending home sales were down in December and January and expectations of an increase in actual sales are based on the modest jump in pending home sales in February. Home prices are falling again year-on-year in both average and median terms; the negative trend should not change in the coming months.

Thursday 21 April

Euro area

- **Germany.** The **IFO** index might slip slightly for the second straight month in April, easing to 110.7 from 111.1 in March. The level is still close to the series' 20-year highs. This month too should show a dip in expectations (to 105.4 from 106.5) and a further improvement in the view of the present situation (116.1 vs. 115.8). The level of the IFO index remains consistent with an year-on-year acceleration in German GDP of around 5%.

- The **Bank of Belgium business confidence** index might be little changed in April, at 6.1 vs. 6.2 in March. The index, seen as a leading indicator of the industrial cycle in Germany (the largest outlet market for Belgian manufacturers), is not far off the series' over-30-year highs.

United States

- The April **Philadelphia Fed** index should correct from the high recorded in March (43.4, highest since January 1984). The forecast is for the index to fall to 37.5, still close to the 2004 highs like the ISM. The April survey should show a correction in new orders from 40.3 in April (highest since November 1983), along with further rises in prices paid from 63.8 in March. Expectations six months forward should also fall from 63 in March. The signals from manufacturing in this quarter should point to growth stabilising/slowing owing to the transitory effects of the earthquake in Japan.

Friday 22 April

Euro area

- **France. Manufacturing business confidence** might be unchanged at 109 in April, well above its long-term average (100). The new orders component could retrace after last month's jump (to -5 from -17). The levels of the production and selling price sub-indices should remain high.

Calendar of macroeconomic data and events

Calendar of macroeconomic data (18-22 April)										
Date		Time	Country	Data release	*	Period	Previous		Consensus	Intesa Sanpaolo
Mon	4/18	16:00	EUR	Euro-Zone Consumer Confidence (flash)	*	APR	-10.6		-11.0	-11.0
		16:00	USA	NAHB Housing Market Index		APR	17		17	17
Tue	4/19	07:00	JAP	Consumer Confidence Households		MAR	40.6			
		09:00	FRA	PMI Manufacturing (prelim.)	*	APR	55.4		55.4	
		09:00	FRA	PMI Services (prelim.)	*	APR	60.4		60.0	
		09:30	GER	PMI Manufacturing (flash)		APR	60.9		60.1	
		09:30	GER	PMI Services (flash)		APR	60.1		59.8	
		10:00	EUR	PMI Composite (flash)	**	APR	57.6		57.1	57.3
		10:00	EUR	PMI Manufacturing (flash)	**	APR	57.5		57.0	57.1
		10:00	EUR	PMI Services (flash)	**	APR	57.2		56.9	57.0
		14:30	USA	Building Permits		MAR (517)	534	k	540	540
		14:30	USA	Housing Starts	*	MAR	479	k	525	515
Wed	4/20	01:50	JAP	Adjusted Merchnds Trade Bal.		MAR	556	bln	327.5	
		01:50	JAP	Tertiary Industry Index (MoM)		FEB	2.1	%	0.1	
		08:00	GER	PPI (YoY)		MAR	6.4	%	6.6	
		08:00	GER	PPI (MoM)		MAR	0.7	%	0.8	
		10:00	ITA	Industrial Sales n.s.a. (YoY)		FEB	8.0	%		
		10:00	ITA	Industrial Sales s.a. (MoM)		FEB	1.0	%		
		10:00	ITA	Industrial Orders n.s.a. (YoY)		FEB	17.5	%		
		10:00	ITA	Industrial Orders s.a. (MoM)		FEB	-0.3	%		
		16:00	USA	Existing Home Sales		MAR	4.88	mln	5.0	5.1
Thu	4/21	07:00	JAP	Leading Index CI (final)		FEB	104.2			
		10:00	GER	IFO - Business Climate	**	APR	111.1		110.6	110.7
		10:00	GER	IFO - Expectations		APR	106.5		105.9	105.4
		10:00	GER	IFO - Current Assessment		APR	115.8		115.5	116.1
		10:30	GB	Retail Sales (YoY)		MAR	1.3	%	1.1	
		10:30	GB	Retail Sales (MoM)		MAR	-0.8	%	-0.5	
		14:30	USA	Initial Jobless Claims		week	412	k		
		15:00	BEL	Business Confidence Level. Sa	*	APR	6.2		5.6	
		16:00	USA	Leading Indicators		MAR	0.8	%	0.3	
		16:00	USA	House Price Index MoM		FEB	-0.3	%		
		16:00	USA	Philadelphia Fed.	*	APR	43.4		37.0	37.5
Fri	4/22	08:45	FRA	Business Confidence Indicator	*	APR	109		109	109
		10:00	ITA	Retail Sales (YoY)		FEB	-1.2	%		

(?) First likely date; (**) very important; (*) important; in column "*Previous*" in parenthesis data before the revision

Source: Intesa Sanpaolo Research Department

Calendar of macroeconomic data (25–29 April)

Date		Time	Country	Data release	*	Period	Previous		Consensus	Intesa Sanpaolo
Mon	4/25	16:00	USA	New Home Sales	*	MAR	250	k		
Tue	4/26	15:00	USA	S&P/CS Composite-20 YoY		FEB	-3.1	%		
		16:00	USA	Consumer Confidence	*	APR	63.4			
Wed	4/27	01:50	JAP	Retail Trade YoY		MAR	0.1	%		
		03:00	JAP	Small Business Confidence		APR	49.5			
		10:00	ITA	Consumer Confidence Ind. sa		APR	105.2			
		10:30	GB	GDP (QoQ) (flash)	**	Q1	-0.5	%		
		11:00	EUR	Industrial New Orders YoY		FEB	(20.9) 22.1	%		
		11:00	EUR	Industrial New Orders SA MoM		FEB	(0.1) 1.1	%		
		14:30	USA	Durable Goods Orders	*	MAR	(-0.9) -0.6	%	1.0	
		14:30	USA	Durables Ex Transportation		MAR	(-0.6) -0.3	%		
		NA	GER	Consumer Price Index (YoY) (prelim.)	*	APR	(2.1) 2.1	%		
		NA	GER	Consumer Price Index (MoM) (prelim.)	*	APR	(0.5) 0.5	%		
		NA	GER	CPI - EU Harmonised (YoY) (prelim.)	**	APR	(2.3) 2.2	%		
		NA	GER	CPI - EU Harmonised (MoM) (prelim.)	**	APR	(0.6) 0.5	%		
Thu	4/28	01:30	JAP	Household Spending (YoY)	*	MAR	-0.2	%		
		01:30	JAP	Natl CPI YoY	**	MAR	0.0	%		
		01:30	JAP	Natl CPI Ex-Fresh Food YoY	**	MAR	-0.3	%		
		01:30	JAP	Job-To-Applicant Ratio		MAR	0.62			
		01:30	JAP	Jobless Rate		MAR	4.6	%		
		01:50	JAP	Industrial Production (MoM) (prelim.)	*	MAR	1.8	%		
		08:45	FRA	Consumer Spending (MoM)	*	MAR	0.9	%		
		09:55	GER	Unemployment Rate (s.a)		APR	7.1	%		
		09:55	GER	Unemployment Change (000's)	**	APR	-55	k		
		10:00	ITA	Business Confidence	*	APR	103.8			
		14:30	USA	Core PCE QoQ (advance)	**	Q1	0.4	%		
		14:30	USA	GDP QoQ (Annualized) (advance)	**	Q1	3.1	%	2.1	
		14:30	USA	GDP Price Index (advance)	**	Q1	0.4	%		
		14:30	USA	Initial Jobless Claims		week	-			
Fri	4/29	09:00	SPA	CPI (EU Harmonised) (YoY) (prelim.)	*	APR	3.3	%		
		10:00	EUR	Euro-Zone M3 s.a. (YoY)	*	MAR	2.0	%		
		10:00	ITA	Monthly Unemployment Rate SA (prelim.)	*	MAR	8.4	%		
		11:00	EUR	Euro-Zone CPI Estimate (YoY)	**	APR	2.6	%		
		11:00	EUR	Euro-Zone Consumer Confidence (final)		APR	-			
		11:00	EUR	Euro-Zone Indust. Confidence		APR	6.6			
		11:00	EUR	Euro-Zone Services Confidence		APR	10.8			
		11:00	EUR	Euro-Zone Economic Confidence	**	APR	107.3			
		11:00	EUR	Euro-Zone Unemployment Rate	*	MAR	9.9	%		
		11:00	ITA	CPI - EU Harmonized (YoY) (prelim.)	*	APR	-			
		11:00	ITA	CPI - EU Harmonized (MoM) (prelim.)	*	APR	-			
		11:00	ITA	CPI (NIC incl. tobacco) (YoY) (prelim.)	*	APR	-			
		11:00	ITA	CPI (NIC incl. tobacco) (MoM) (prelim.)	*	APR	-			
		12:00	ITA	PPI (YoY)		MAR	5.7	%		
		12:00	ITA	PPI (MoM)		MAR	0.6	%		
		14:30	USA	Employment Cost Index	*	Q1	0.4	%		
		14:30	USA	PCE Core (YoY)	*	MAR	0.9	%		
		14:30	USA	PCE Core (MoM)	*	MAR	0.2	%		
		14:30	USA	PCE Deflator (YoY)	*	MAR	1.6	%		
		14:30	USA	Personal Income		MAR	0.3	%		
		14:30	USA	Personal Spending	*	MAR	0.7	%		
		15:45	USA	Chicago Purchasing Manager	*	APR	70.6			
		15:55	USA	U. of Michigan Confidence (final)		APR	-			

(?) First likely date; (**) very important; (*) important; in column "*Previous*" in parenthesis data before the revision.

Source: Intesa Sanpaolo Research Department

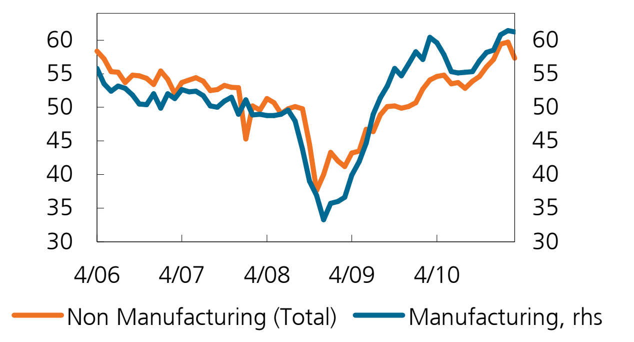
Calendar of events (18 -22 April)					
Date		Time	Country	*	Event
Mon	4/18	16:30	USA		Fed's Fisher, Lockhart to Discuss Globalization in Atlanta
		18:00	USA		Fed's Bullard to Speak on Banking Rules in Kentucky
		18:30	USA		Fed's Fisher to Speak on US Economic Outlook in Atlanta
Wed	4/20	10:30	GB	*	Bank of England Releases Monetary Policy Committee Minutes
Thu	4/21	03:30	JAP		BoJ Deputy Governor Nishimura to Speak in Yokohama City

(**) very important; (*) important.

Source: Intesa Sanpaolo Research Department

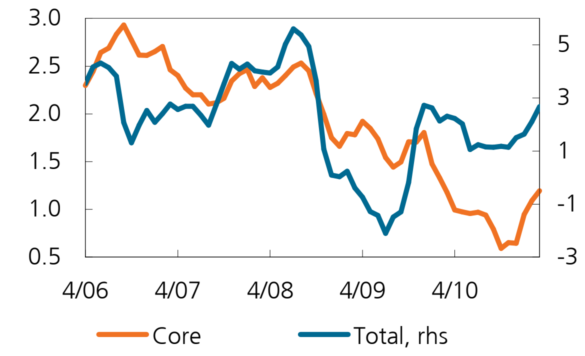
United States

ISM surveys



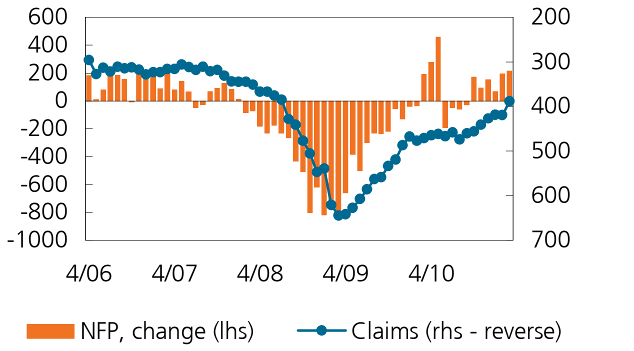
Source: EcoWin

CPI – y/y % change



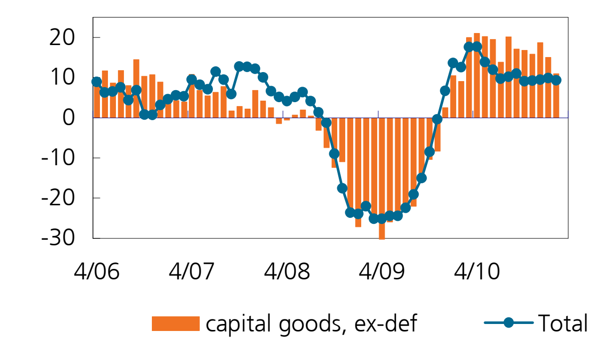
Source: EcoWin

Nonfarm payrolls & jobless claims ('000)



Source: EcoWin

New orders – y/y % change



Source: EcoWin

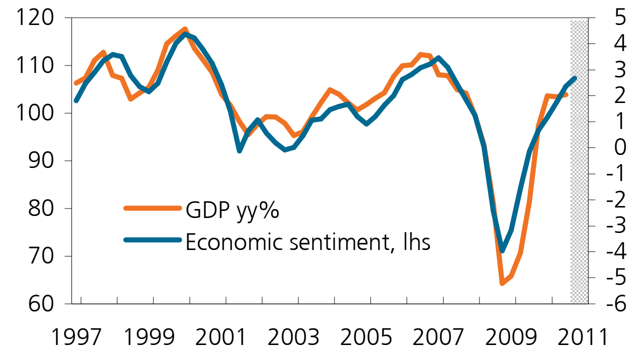
Forecasts Table

				2010		2011				2012	
	2010	2011	2012	3	4	1	2	3	4	1	2
GDP (1996 US$,y/y)	2.9	3.1	2.9	3.2	2.8	3.1	3.2	3.2	3.0	2.9	2.9
q/q annual rate				2.6	3.1	3.2	3.0	3.2	2.5	2.9	3.1
Private consumption	1.7	3.0	2.9	2.4	4.0	3.0	3.1	3.2	2.8	2.5	2.5
Fixed investment - nonresid.	5.7	10.8	9.5	10.0	7.7	12.1	10.3	9.6	8.8	9.6	8.6
Fixed investment - residential	-3.0	3.9	9.8	-27.3	3.3	10.2	12.7	10.3	8.4	9.4	11.3
Government consumption	1.0	-0.1	-0.5	3.9	-1.7	-1.0	-0.8	-0.5	-0.5	-0.4	0.5
Export	11.7	9.1	8.8	6.7	8.6	11.0	10.0	8.0	8.0	8.5	10.0
Import	12.6	8.2	7.6	16.8	-12.6	8.3	9.7	7.9	6.8	6.9	7.7
Stockbuilding (% contr. to GDP)	1.4	0.6	-0.5	0.4	-0.8	0.0	0.0	0.1	-0.5	-0.2	-0.1
Current account (% of GDP)	-3.2	-3.7	-3.8	-3.5	-3.1	-3.6	-3.7	-3.7	-3.7	-3.7	-3.8
Federal Deficit (% of GDP)	-9.9	-9.5	-7.7								
Gov. Debt (% of GDP)	93.0	98.3	101.7								
CPI (y/y)	1.6	2.9	1.6	1.2	1.3	2.1	3.0	3.3	3.1	2.2	1.5
Industrial production	5.7	5.2	4.1	6.4	3.0	5.8	6.1	4.5	3.5	3.1	3.8
Unemployment (%)	9.6	9.0	8.2	9.6	9.6	9.0	9.2	9.1	8.9	8.6	8.3

Note: Percentage annualised growth rates over previous period. if not otherwise specified.
Source: EcoWin. Intesa Sanpaolo

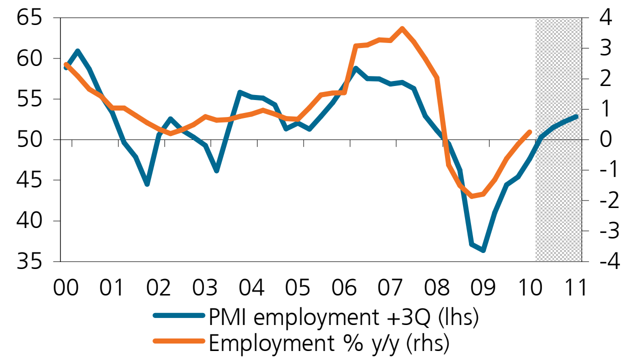
Euro Area

GDP



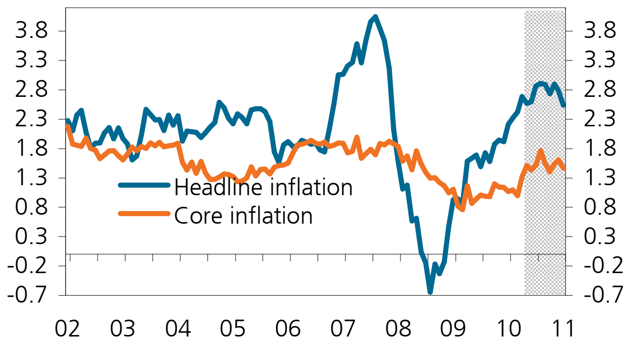
Source: EUROSTAT, UE Commission

Employment



Source: EUROSTAT, Royal Bank of Scotland, Markit Economics

Inflation



Source: Eurostat, Intesa Sanpaolo forecast

Inflation forecasts

%	2010	2011	2012
January	**0.9**	**2.3**	2.0
February	**0.8**	**2.4**	2.1
March	**1.6**	**2.7**	1.8
April	**1.6**	2.6	2.0
May	**1.7**	2.6	2.0
June	**1.5**	2.9	2.0
July	**1.7**	2.9	1.9
August	**1.6**	2.9	2.0
September	**1.9**	2.7	2.2
October	**1.9**	2.9	1.5
November	**1.9**	2.8	2.2
December	**2.2**	2.5	2.2

Source: Eurostat

Forecasts Table

				2010		2011				2012	
	2010	2011	2012	3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	**1.7**	1.9	1.4	**1.9**	**2.0**	2.3	1.8	1.8	1.8	1.5	1.4
- q/q change				**0.3**	**0.3**	0.7	0.4	0.4	0.3	0.4	0.4
Private consumption	**0.7**	1.2	0.8	**0.1**	**0.4**	0.3	0.4	0.3	0.1	0.2	0.2
Fixed investment	**-0.8**	1.2	1.9	**-0.1**	**-0.6**	0.5	0.5	0.4	0.4	0.5	0.5
Government consumption	**0.7**	0.0	0.1	**0.4**	**0.1**	-0.1	-0.2	-0.2	0.0	0.1	0.1
Export	**10.6**	8.0	5.4	**2.2**	**1.8**	2.0	1.6	1.4	1.3	1.3	1.3
Import	**8.7**	5.9	5.5	**1.4**	**1.1**	1.5	1.1	1.2	1.3	1.4	1.4
Stockbuilding (% contr. to GDP)	**0.4**	0.0	0.4	**-0.2**	**-0.2**	0.2	-0.1	0.0	0.1	0.2	0.1
Current account (% of GDP)	**-0.4**	0.0	-0.1	**-0.4**	**-0.6**	-0.2	0.3	0.1	-0.2	-0.4	0.2
Deficit (% of GDP)	-6.1	-4.3	-3.5								
Debt (% of GDP)	83.6	86.5	86.9								
CPI (y/y)	**1.6**	2.6	1.9	**1.7**	**2.0**	**2.5**	2.6	2.6	2.5	1.9	1.8
Industrial production	**7.3**	5.9	1.8	**1.1**	**1.9**	1.7	1.3	1.0	0.4	0.1	0.4
Unemployment (%)	**10.0**	9.7	8.9	**10.0**	**10.0**	9.9	9.8	9.7	9.4	9.2	9.0
3-month Euribor	**0.8**	1.5	2.2	**0.9**	**1.0**	**1.1**	1.4	1.7	1.9	2.1	2.2

Note: Percentage annualised growth rates over previous period, if not otherwise specified.
Source: EcoWin, Intesa Sanpaolo

Interest Rates Forecasts

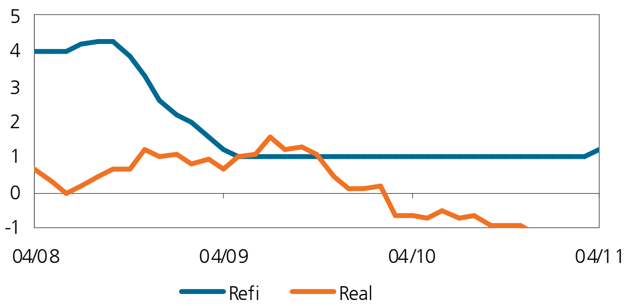
Eurozone

	Sep-10	Dec-10	Mar-11	**15/4**	Jun-11	Sep-11	Dec-11	Mar-12
Refi rate	1.00	1.00	1.00	**1.25**	1.25	1.50	1.75	2.00
1m Euribor	0.63	0.79	0.98	**1.17**	1.17	1.55	1.85	2.10
3m Euribor	0.89	1.01	1.24	**1.33**	1.42	1.75	1.95	2.15

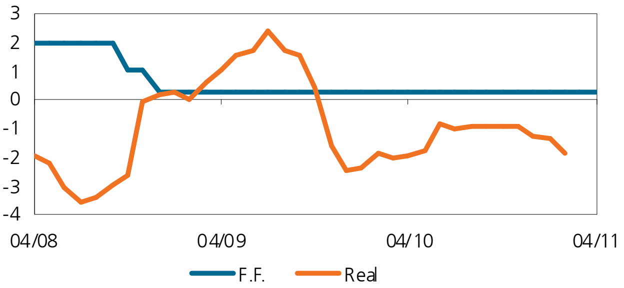
United States

	Sep-10	Dec-10	Mar-11	**15/4**	Jun-11	Sep-11	Dec-11	Mar-12
Fed Funds	0.25	0.25	0.25	**0.25**	0.25	0.25	0.25	0.50
3m Libor USD	0.29	0.30	0.30	**0.28**	0.32	0.39	0.48	0.88

Eurozone



United States



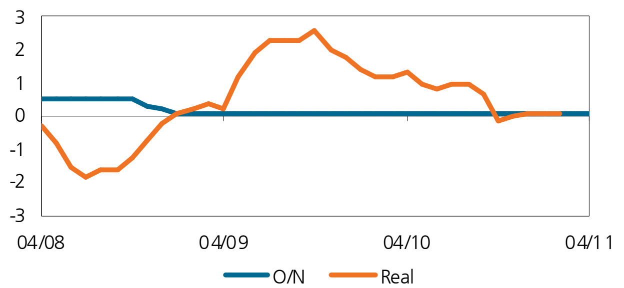
Japan

	Sep-30	Dec-31	Mar-31	**15/4**	Jun-30	Sep-30	Dec-31	Mar-31
O/N target	0.10	0.10	0.10	**0.10**	0.10	0.10	0.10	0.10
3m Libor JPY	0.22	0.19	0.20	**0.20**	0.25	0.40	0.45	0.45

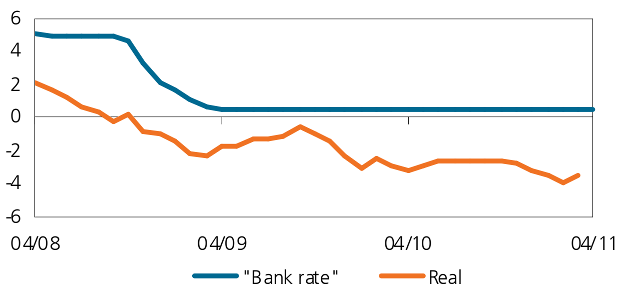
United Kingdom

	Sep-30	Dec-31	Mar-31	**15/4**	Jun-30	Sep-30	Dec-31	Mar-31
Base rate	0.50	0.50	0.50	**0.50**	0.50	0.50	0.75	1.50
3m Libor GBP	0.73	0.76	0.82	**0.82**	0.75	0.80	1.35	1.80

Japan



United Kingdom



Source: Intesa Sanpaolo elaborations on Thomsons Reuters data

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Appendix

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