



**Monographic May 2007:
Non Financial Corporations**

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1.- U.S.A.

High profits...this is the most striking aspect of the performance of non financial corporations over recent years in the United States. Of course, there have been important exceptions, the most significant in the car and airline industry.

Furthermore, this phenomenon has not only occurred in the United States. A large number of developed nations have witnessed succulent corporate profits in recent years, which, together with widespread minimal increases in real wages has led many to question the change in income distribution that the wave of globalisation is causing. What is more, some analysts emphasize the fact that this income redistribution in favour of capital is a source of resistance to globalisation. We will deal with this topic again shortly. Beforehand, let us detail the factors that have made the boom in corporate profits possible.

a) Exceptional Profit Trend

As can be appreciated in the graph on page 1 of OCEI May report, corporate profits after tax have grown over the past five years (2002-2006) and, therefore, since the end of the last recession, at an average annual rate of more than 15%. This spectacular rise occurred at the same time as a much more modest average annual increase in nominal GDP of 5.5%.

We have to go back to 1981-1985 to find a similar boom in profits (but then nominal GDP was growing at an annual rate of nearly 9%). Profits grew by even more over the period dating from 1975 to 1979, but with an annual increase in nominal GDP of more than 11%, above all due to the increase in

the deflator. In addition, the pattern in these two periods was much more erratic, with annual falls in some quarters.

In short, we would have to go back a long time to find such a sustained and prolonged climb in corporate profits that exceeds the sum of the increases in output and prices. How can this be justified?

In the first place, these results are commonly linked to operating leverage (the ability to increase profits without increasing costs, due to the latter being increased previously). In this sense, the high level of investment (in facilities, equipment and particularly in new technologies) over the best part of the 1990s has been bearing fruit since 2002 with no need to maintain a similarly upward trend in investment.

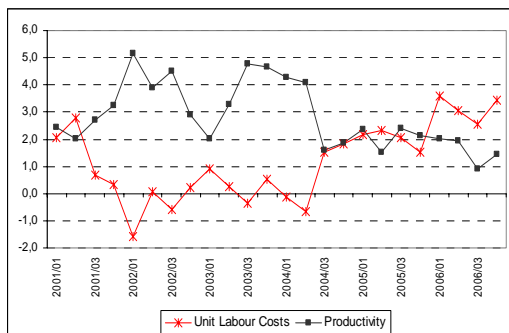
While it is doubtful that there was widespread overinvestment in the 1990s (bearing in mind the marked slump in investment during the recession that began in 1991), it is true that the massive commitment made towards new technologies meant a leap forward in productivity, both in terms of the cycle and, apparently, the structure. This contributed a great deal to the increase in corporate profits in the years that followed.

Two further elements must be added to the situation described above: firstly, the decrease in the cost of labour and intermediate inputs due to the effect of globalisation. In addition, there was a moderate surplus of available labour following the recession in 2001¹.

¹ The employment rate has risen by two and a half points since it hit its lowest point in the cycle, while the activity rate has dropped by one and a half points since it peaked.

Summarising, the trends observed in productivity and costs (Figure 1) are the prime factors in the ideal scenario over the past five years for corporate profits.

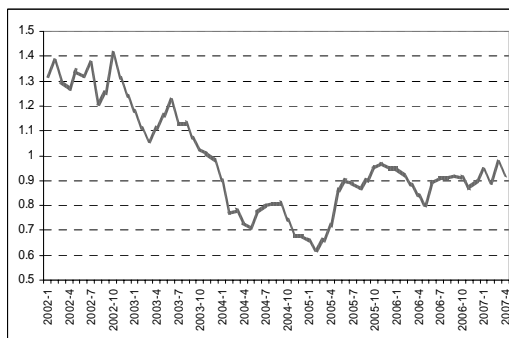
Figure 1: Productivity per Hour and Unite Labour Costs (annual growth rates)



Source: own elaboration with data from the BLS and FRED II

Another element in this favourable scenario is the exceptionally beneficial financial conditions. Not only short term interest rates have remained unusually low for a long period of time, but the time curve, which has been practically flat, also included highly favourable long term rates. Moreover, tremendous liquidity in domestic and international capital markets sparked a decrease in spreads (Figure 2) that has been beneficial even for those companies with mediocre credit ratings.

Figure 2: Interest Spread between AAA and BAA Issues (Moody's Credit Rating)



Source: own elaboration with data from FRED II

Another factor, which has been less relevant than the two described previously is that as the expansion has gone on the market has recovered a certain degree of power when it comes to how companies fix prices and above all this has occurred with a marked and sustained increase in consumption. As the gap between excess capacity and output narrowed, companies, at least in certain sectors, have been able to raise their profit margins.

Of course, observant readers will have realised that these three factors have worsened in recent quarters: productivity has slowed down abruptly, while costs, particularly wage costs, have risen in a labour market with much less margin. Interest rates for a long time now and time and risk premiums have been climbing recently (albeit timidly). Bearing in mind that economic growth is low, there will be less opportunity to raise profit margins.

For this reason, the times when corporate profits increased by double figures ended in this cycle in 2006.

Nevertheless, some positive factors remain. This is the case of costs due to globalisation and, above all (with a particularly weak dollar) the impact on the profits obtained outside the United States. A third of the income of the 100 largest companies on the S&P index are from abroad and exchanging euros, pounds or Canadian dollars (to give three examples) considerably inflates the final profit in US dollars.

Apart from the source of these excellent results, what is capturing the attention of most, as mentioned previously, is that it coincides with a period in which growth in real wages

has been poor if not non-existent². Globalisation appears to have biased income distribution in favour of capital and to the detriment of labour in developed nations.

Some analysts believe this is a logical corollary of a new scenario in which the labour available for production in the globalised world has practically doubled (hundreds of millions of Asian workers and, albeit to a lesser extent, from other continents have burst onto the labour scene), whereas capital has increased to a much lesser extent. As a result, the scarcest factor should win out in the new distribution of income³.

Other experts, who see the flip side of the coin, believe that capital, due to the wave of globalisation, has an increasingly strong pressure element (relocate their business) to force wage growth down in the West.

Whatever the case and regardless of whether the idea of a “wageless recovery” is more or less rigorous, what is true is that the difference between the growth in capital gains and wages is perceived by an increasingly large group of citizens as an insult, something which politicians should try to curb. But this lights the fuse of protectionism to which we have already devoted part of the first half of this report. The costs of such protectionism could be particularly high for those groups that feel they have been unfairly treated in the new international economic scenario. We insist: a good dose of precaution would be convenient

² For a more detailed discussion of this wage phenomenon, please consult our September 2006 Economic Environment Report (pages 15-17).

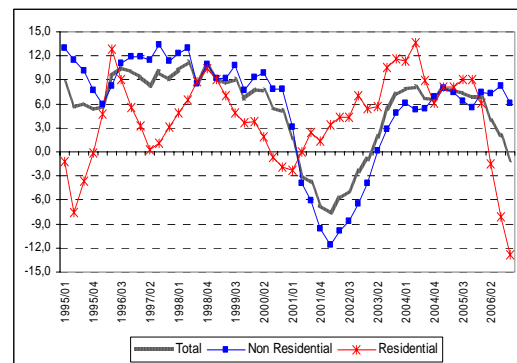
³ Albeit to a lesser extent, skilled labour experienced a similar situation.

before setting out on one of those so well known protectionist crusades.

b) Surprisingly Cautious Investor Behaviour and Excellent Financial Situation

One issue that has been widely debated during the current expansion in the US is the particularly conservative investment behaviour of non-financial corporations. And certainly, this contrasts entirely with the availability of resources following the explosive upturn in profits.

Figure 3: Annual Private Fixed Investment



Source: own elaboration with data from the BEA

Table 1 displays the striking fall in investment growth between the two periods immediately before and after the last recession (in 2001). As can be appreciated in Figure 3, 2002 prolonged the investment crisis (in contrast to both government spending and private consumption). Later, the rate at which investment recovered once the expansion had consolidated remained clearly below that observed in the second half of the 1990s.

Table 1: Average Annual Growth in Private Investment and its Components (%)

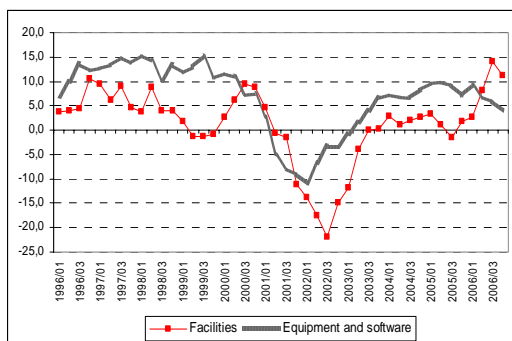
	1996-2000	2002-2006
TOTAL	8.7	3.8
Residential	4.9	5.6
Non residential	10.1	3.1
Facilities	4.9	-1.7
Equipment and software	11.5	3.9
Computer Equipment and software	20.7	5.7
Industrial Equipment	3.4	1.2
Transport Equipment	6.4	1.2

Source: own elaboration with data from the BEA

Moreover, this poor growth in investment is concentrated in the non residential sector, as investment in construction was favoured by the real estate boom and grew remarkably until the sector began to collapse in the second half of 2006.

More specifically (Table 1; Figure 4), investment in facilities, which registered moderate growth in the second half of the 1990s, is the item that remained stagnant up to 2006. Investment in equipment and software, in contrast, has at least risen hesitantly over the past five years (albeit only a little more than a third of the spectacular 11.5% annual increase recorded between 1996 and 2000).

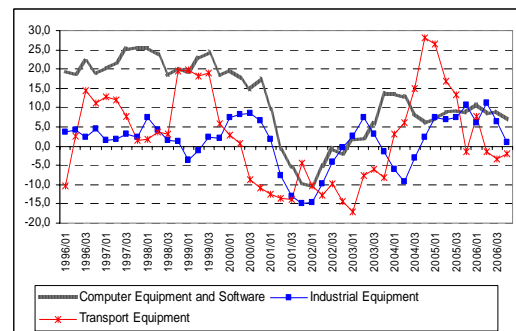
Figure 4: Annual Growth in Private Fixed Non Residential Investment Components



Source: own elaboration with data from the BEA

Of course, computer equipment and software played led the way in the last decade in terms of investment, as demanded by the ICT revolution⁴ (Table 1; Figure 13).

Figure 5: Equipment and Software Investment Components (annual growth)



Source: own elaboration with data from the BEA

But this leadership did not prevent overall productive investment from emulating growth, albeit recording a slightly lower annual rate of 6% over the period from 2002 to 2006, which pales before the 20% hike in the second half of the 1990s. Investment in industrial and transport equipment was much less buoyant then and practically non-existent since the end of the recession.

Now that we have described the long term trend in investment, it is even more interesting to try to explain it. One quite widespread idea is that there was over investment in the 1990s which anticipated the years to come, making it unnecessary to increase investment to respond to the requirements of buoyant consumer expenditure. It definitely took an enormous effort to technologically renew the productive system. However, it is much more difficult to use the same argument for the rest of the components of non residential

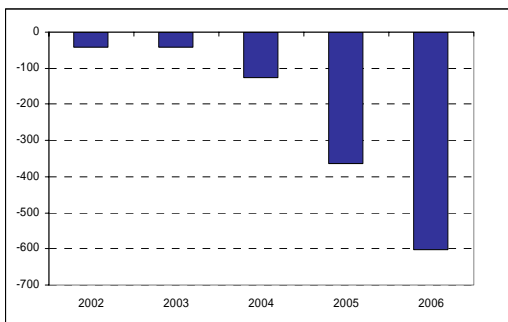
⁴ Information and Communication Technologies

investment, in which growth did not change during the 1990s (or decreases were recorded) with respect to previous periods of economic growth.

It is more convincing to base the explanation for the investment situation on two unquestionable factors: firstly, the negative impact of a high level of uncertainty (more geopolitical than economic) in recent years, which has led business executives to be incredibly cautious.

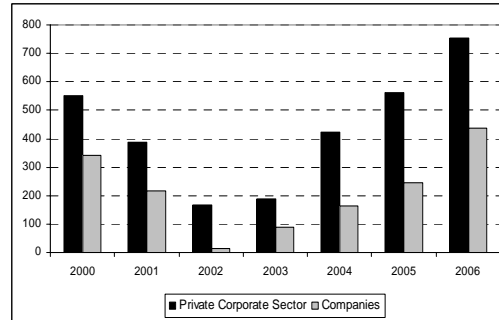
Secondly, the response of company chiefs following shareholder disgust over corporate scandals at the beginning of the current decade. This response involved postponing investments to enlarge and improve capacity to balance accounts and increase shareholder profits instead. Clear evidence of this is the massive decrease in shares circulating through companies buying them back. As a result, net issues have been negative in the United States for five years now, including a historical record of 600 billion dollars last year (Figure 6).

Figure 6: Net Non Financial Corporation Share Issues (millions of dollars)



Source: own elaboration with data from the Federal Reserve

Figure 7: Non Financial Corporation Loans (millions of dollars)

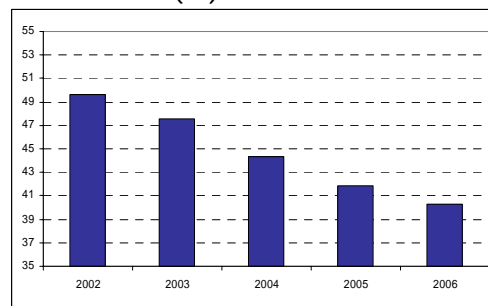


Source: own elaboration with data from the Federal Reserve

Not only have companies avoided resorting to issuing shares in order to obtain financing during the current period of economic growth, but also to bank loans over the first three years of this period (Figure 7). Certainly, this variable has risen strongly since 2004, although by 2006 the loan rate had only recovered a similar level to that observed at the end of the 1990s.

The combination of large profits, little investment and few bank loans or share issues (although other securities were positive in net terms) has allowed US companies to balance their finances, which as been seen as an implicit but not for this reason less evident objective. As a result, corporate borrowing (Figure 8) has dropped considerably in recent years.

Figure 8: Non Financial Corporation Borrowing as a Percentage of Equity at Market Prices (%)



Source: own elaboration with data from the Federal Reserve

Moreover, this decrease has coincided with medium term debt maturities being extended.

Finally, at the end of 2005 and the first half of 2006, the time seemed right for an upturn in investment (see Figures 3-5 again). Corporate balance sheets had been restructured, growth in GDP and consumption was solid and productive capacity utilisation had risen by seven and a half points since the recession, forcing companies to increase their capacity to respond to demand. For these reasons even investment in facilities, which has performed like a snail throughout this period of economic growth, rose markedly last year.

However, happiness was short-lived. This is also the time when factors are combining to threaten this new trend. It is at least worth indicating the increase in interest rates, the slowdown in economic growth, the end of certain tax benefits and the tendency of US factories to grow by using alternatives to increasing investment: foreign investment or by means of mergers and takeovers that are currently so in fashion.

While all these factors are beginning to curb the new upward trend in investment, there appears to be a need to both increase capacity as well as renew the technological investment made years ago. This is, therefore, a crucial period for non financial corporations when it comes to investment.

c) Still Top Competitors

As we have already pointed out on several occasions in our reports (including the first part of this report), there is a widespread but incorrect idea in the US regarding the origin of the

current account deficit. According to this viewpoint, the loss of competitiveness suffered by US companies is the result of unfair competition (through inadmissibly low costs and/or exchange rate manipulation) from certain emerging nations.

Of course, the United States should not look for their competitive edge in costs, but in factors linked to quality, value added and the development of new sectors. And in this field, the US economy and its companies in particular, are still international leaders. The World Economic Forum through one of its reputed competitiveness indexes, will act as proof of this situation.

The Global Competitiveness Index (GCI) assesses how competitive 125 countries are by measuring a large number of variables deemed to be important, to a greater or lesser extent, by theoretical and empirical research in competitiveness. The 2006 GCI ranked the United States sixth, thus losing its position at the top of the ranking that it held the previous year. However, when this decrease is analysed, it is due to the poor rating that the macroeconomic situation of the country receives (particularly due to the budget deficit): The United States is ranked 69th⁵ in this category. This has little to do with companies or trading partners, but a lot to do with mediocre fiscal policy.

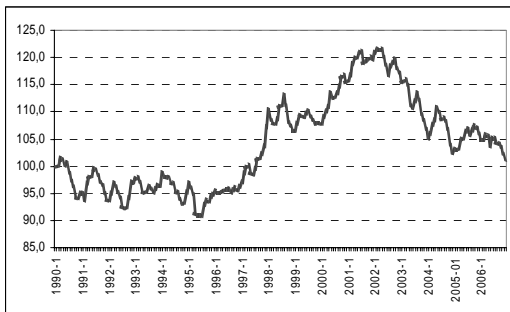
Moreover, the Business Competitiveness Index (BCI), which concentrates more on corporate

⁵ The US is also ranked in a not very honourable 40th place in "health and primary education". The rest of factors are valued much more favourably, together taking the overall GCI ranking to sixth.

competitiveness, ranked the United States number one for the third year in a row in 2006⁶. Both in terms of corporate strategy and transactions, as well as in the quality of their environment for corporate activity, all of which are factors included in the BCI, the United States remains on top.

As regards the indicators current competitiveness, based on prices and costs, recent trends cannot be considered negative for the interests of US corporations. We have already mentioned the exceptionally favourable trend in unit labour costs over the first half of this decade, together with wage cost restraint and the strong increase in productivity.

Figure 9: Real Effective Exchange Rate (broad basket; 1990:1 = 100)



Source: own elaboration with data from the Federal Reserve

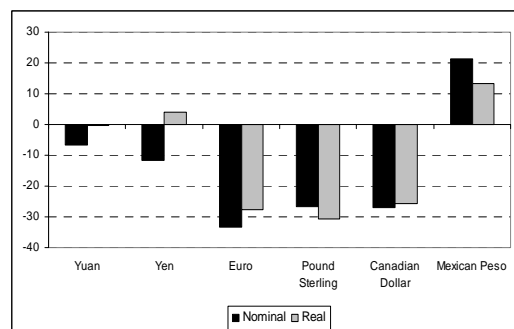
As regards the most traditional indicator in this context, the real effective exchange rate, Figure 9 shows how a substantial decrease has been witnessed (that is, depreciation and, therefore, an improvement in competitiveness) since 2002 that continues today. Following this decrease, the US has recovered the level of the 1990s. However, it is also worth remembering that the seven

⁶ The US has always been one of the two top-ranked countries in this indicator since it was first elaborated in 2001.

years prior to 2002 witnessed an extraordinary appreciation of the US dollar in real terms⁷, which had the opposite effect on competitiveness.

If we examine the US' main trading partners (Figure 10), it is worth highlighting the fact that the price gap trend has given the United States a competitive edge over Western Europe and Canada. Meanwhile, the already minimal nominal appreciation in the yuan and the yen have been entirely offset by the fact that prices have risen less in China and Japan than in the US. More ammunition for protectionists. However, these are only numerical grounds, as internal US stakeholders (consumers and the Federal Government) are behind the trend in the price gap) due to excessive spending and their savings deficit.

Figure 10: Nominal and Real Bilateral Exchange Rates (main trading partners between 2002 and 2006)



Source: own elaboration with data from the Federal Reserve

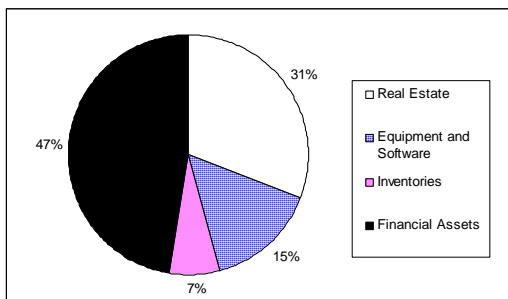
d) A Brief Summary

We are going to end this section on the future prospects of non financial corporations by displaying in Figures 11 and 12 the distribution of total assets

⁷ Certainly, the real appreciation was outpaced by the nominal appreciation due to prices rising less in the United States than in the countries with which the US trades as a whole.

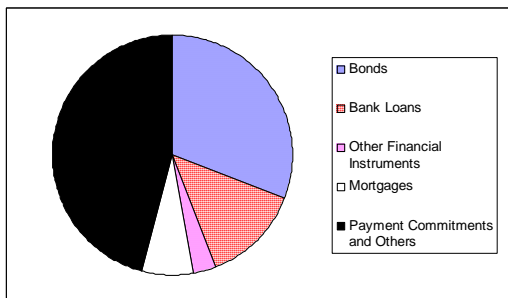
and liabilities of the sector as a whole (excl. farms). Data refer to outstanding amounts at the end of 2006; total assets at that time amounted to approximately 34.7 trillion dollars, compared to 14.7 trillion in liabilities. As a result, the net worth of US non financial corporations (excl. farms) amounts to some 20 trillion dollars.

Figure 11: Non Financial Corporation Asset Distribution (%)



Source: own elaboration with data from the Federal Reserve

Figure 12: Non Financial Corporation Liability Distribution (%)



Source: own elaboration with data from the Federal Reserve

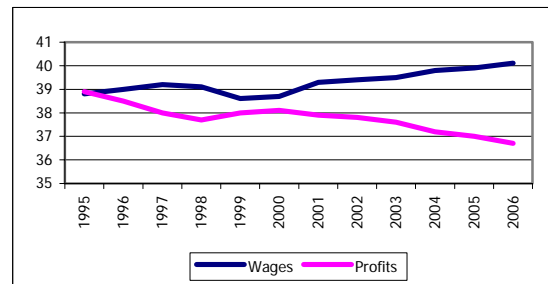
Vicente J. Pallardó

2. Eurozone

a) Corporate Profits

Corporate profits and wages recorded completely different trends in 2005-2006. While total profits in relation to GDP were similar to wages in 1995, the gap between the two has increasingly widened in favour of corporate profits since then. Now the gap is 3.4 percentage points when both are taken as a percentage of GDP, which really indicates that the increasingly favourable situation for companies has not resulted in a similar improvement in real wages.

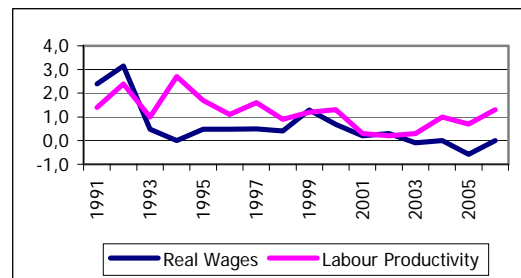
Figure 1: Gross Wages and Profits before Interest and Tax (% of GDP)



Source: Eurostat

Indeed, the clear gap between real wages and productivity growth is perfectly visible. Real wages have remained on a tight leash, while labour productivity has grown more, resulting in companies chalking up large profits and increasing the profit/GDP ratio.

Figure 2: Growth in Real Wages and Labour Productivity



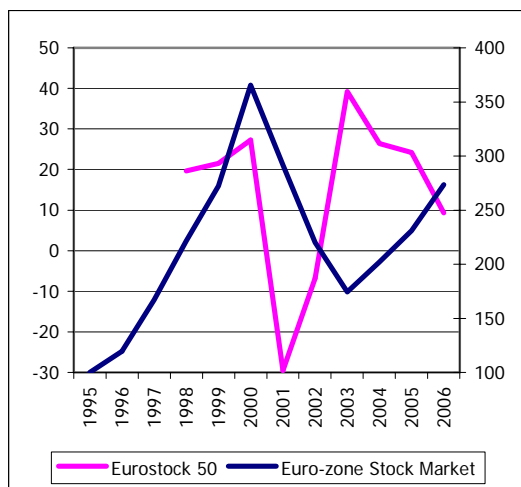
Source: ECB

The weak growth in real wages and, therefore, the decoupling of the wage and productivity trends is due to workers losing negotiating power.

This loss of power is closely tied to the following factors: the risk of production being relocated in other countries where wages are lower, particularly in sectors that are intensive in unskilled labour and, consequently, subject to competition; the increase in outsourcing in certain sectors and corporate functions; the effect of immigration; the increase in the domestic market share held by products from emerging nations and the dominance of temporary and part-time contracts.

Moreover, this situation has sparked a move on behalf of unskilled workers from sectors that are subject to the risk of relocation towards sectors that are not subject to foreign competition and which absorb workers with limited qualifications. Such sectors include real estate, retail trade and consumption related services.

Figure 2.3: Increase in Return on Equity on Eurostock 50 and the Accumulated Rise in the Euro-zone Stock Market Index



Source: Eurostat and Natixis

The increase in Return on Equity (ROE) on the Eurostock 50 and the revaluation accumulated by the reference Euro-zone stock market also ratifies the favourable trend in corporate profits. The average annual gain on the Eurostock 50 was approximately 15% over the period dating from 1998 to 2006, while the Euro-zone stock market index has increased by 2.75 times over the last 11 years.

The ROE in 2006 was similar in Europe and the United States, but considerably lower in Japan (Euro-zone 16%, United Kingdom and United States 17% and Japan 10%).

In the Euro-zone, the sectors that recorded the highest ROE were energy (28%) and telecommunications (26%), while the lowest were observed in the car industry and retail trade with 15%.

Table 1: ROE 2006 in the Euro-zone by Sector

	ROE 2006
ENERGY	28%
INDUSTRY	20%
CONSTRUCTION	23%
CAR INDUSTRY	15%
RETAIL TRADE	15%
TELECOMMUNICATIONS	26%
CHEMICAL INDUSTRY	19%
FOOD	23%
MEDICAL CARE	15%
TECHNOLOGY	19%
SUPPLIERS	22%

Source: Natixis, Datastream

The obsession of the corporate world to increase annual profits substantially and maintain a high level of ROE has its good points and bad points.

The positive effects include an increase in the profitability of savings and that more efficient management is promoted. On the other hand, this

situation also encourages offshoring, distorts income distribution and deindustrialisation.

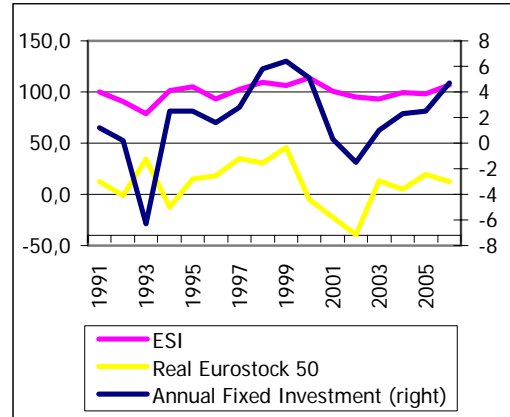
b) Corporate Investment and Components

Gross fixed capital formation displays a similar trend to that of GDP over the period 1991-2006. The two interim periods in which investment recovered and accelerated were between 1994 and 2000 (particularly from 1998 to 2000) with real growth rates exceeding 5% and that which began in 2003, which peaked last year at 4.7%.

Corporate profits and synthetic confidence indicators, as well as prior GDP are responsible for boosting fixed investment.

Fixed investment can be divided on the one hand into investment in construction and investment in equipment and machinery, both of which represent approximately 50% and on the other hand into public and private sector investment. While private fixed investment accounts for between 17.4% and 18.9% of GDP, public investment is the equivalent of approximately 2.4%. In fact, the productive investment of Euro-zone companies in 2006 represented 11.75% of GDP, while the same variable in the United States was the equivalent of 10.8%. However, the importance of private investment in the US has grown over the past few years and dropped in the case of the Euro-zone.

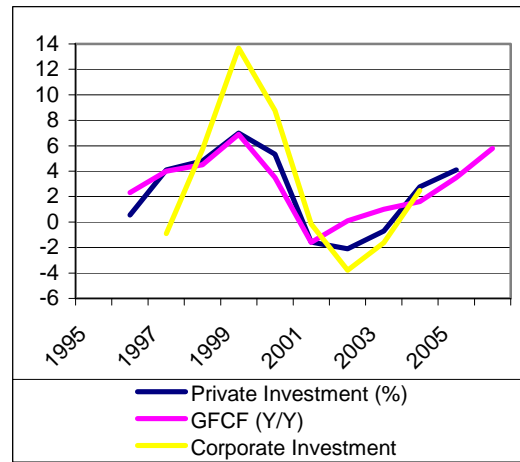
Figure 4: Gross Fixed Capital Formation, Economic Sentiment Indicator and Real Annual Growth in the Eurostock 50



Source: BCE

The public and private sector trends within gross fixed capital formation and corporate investment have been very similar over time, although the latter has been more changeable. Over the period dating from 2001 to 2003, investment in machinery and equipment and private investment were weaker than that recorded by gross fixed capital formation. This means that the strength of public investment has minimised this impact on the overall investment aggregate.

Figure.5: Private Investment, Corporate Investment and Gross Fixed Capital Formation



Source: ECB and Eurostat

c) Corporate Financing

Non financial corporations in the Euro-zone resort to radically different sources for financings to those used by US companies. While it is easier for the latter to receive financing from capital markets, either in variable or fixed income, Euro-zone companies are mainly financed by the loan market.

According to the Bank for International Settlements (BIS), in 2005, US companies received 78.3% of their financing from international bond markets and 21.7% through loans, while bank financing accounted for 84.5% of Euro-zone corporate financing and bonds only represented the remaining 15.5%.

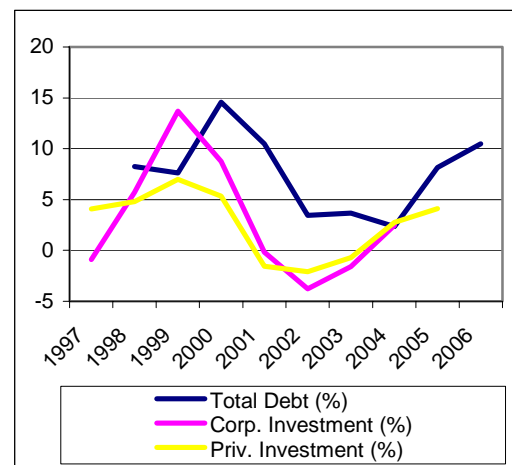
One of the possible reasons for this is that the capital markets in the two regions have different depths, although they are tending towards convergence. US investors (both individual and institutional) have more risk propensity. A few years ago, the high yield bonds absorbed a 16% share of the US market, double the figure in Europe. The situation outlined above for bonds is also valid for the variable income market. There is strong demand for variable income on behalf of US households and US and UK institutional investors, while demand is weak in both the Euro-zone and Japan. The close-knit and historical relationship between the banking and corporate worlds, resulting from the industrial bank model with clear ties between the boards of directors in both types of organisation also contributes to the above situation.

Another reason could perhaps be that loan price fixing does not directly reflect clients' risk and profitability because other compensations are granted that are not valued in market terms. In this

sense, the profitability of a bond demanded by an investor who cannot enjoy other compensations cannot be compared to that offered by a bank loan. This obviously discourages capital market transactions.

Total outstanding corporate debt has grown considerably over the past few years, after three consecutive years in which weak growth rates were observed, in line with Euro-zone corporate investment and GDP growth.

Figure 6: Growth in Corporate Debt and Corporate and Private Investment



Source: ECB and Eurostat

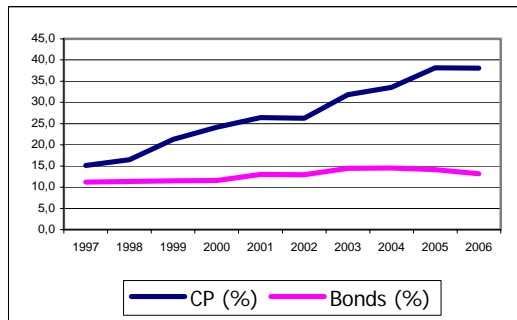
Bonds and commercial paper represents 13.1% of total debt in the financial structure of non financial corporations, two points more than in 1996. Long term debt accounts for 68% of total debt, which is perhaps a little low.

As regards external financing in securities, the marked surge in the use of commercial paper figures prominently over the period 1997-2006, which has multiplied by five over this period and which now accounts for 38.1% of total debt in securities.

Approximately 97% of total debt is in euros and the rest mainly in US dollars,

Swiss francs and pound sterling. As regards total outstanding bonds, 78.1% have a fixed interest rate.

Figure 7: Bond Share of Total Financing and Commercial Paper Share of Fixed Income



Source: ECB

It is also worth analysing whether or not total corporate financing is for investing in machinery and equipment or whether there are other goals.

Considering the large profits made by Euro-zone companies, a great deal of investment is internally financed. This ratio has risen from 77.9% in 2000 to 90.5% today. In the United States the level of self financing has been close to 100% since 2003, whereas in the United Kingdom and Japan it ranged from 130% to 140% and 110% and 140% respectively.

The high level of internal financing on behalf of Euro-zone companies and the strong call for external financing such as share issues has been used to fund investments in financial assets. That is, mergers, takeovers and Leveraged Buyouts (LBOs) in particular. Private funds channelled to LBOs amounted to 71,800 million euros in 2005 and total merger and takeover operations amounted to 564,500 million US dollars. According to Thomson Financial, 38% of the funds received through syndicated loans in the Euro-zone are

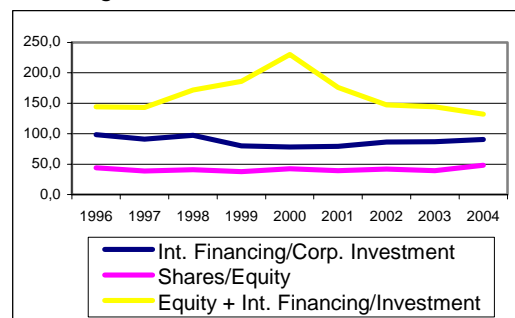
used for LBOs and mergers and takeovers.

The fact that corporations have increased both debt and shares has not raised their leverage.

In contrast, US companies have used their large profits to buy back their own shares in order to raise their profitability.

Corporate debt loan spreads have narrowed since 2003, due to the improvement in the scenario and excess liquidity. High yield bond spreads have narrowed from 800bp to 250bp and BBB-rated bonds from 250bp to 70bp in 2007. Bearing in mind the studies regarding probable default by rating in different time horizons elaborated by rating agencies, particularly Standard and Poors, if the probability of default in seven years for a BBB-rated bond is 1.17% and for a junk bond it is 16.65%, the spreads listed on the market do not seem to be that unusual. Spreads are more negatively correlated to GDP in the US than in the Euro-zone. In the case of junk bonds, by -0.10% in the Euro-zone and by -0.76% in the US.⁸

Figure 8: Internally-Financed Investment, Shares over Total Equity and the Sum of Total Resources Captured and Internal Financing over Investment



Source: ECB and own elaboration

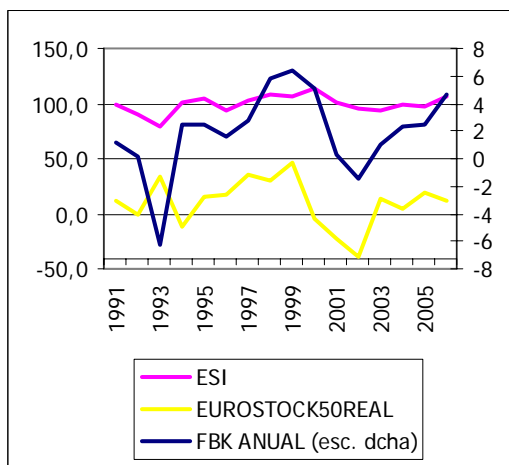
⁸ Natixis Flash N° 2006-393 3-10-2006

d) Competitiveness and the Impact on Sectors of the Euro-zone Economy

Euro-zone corporations have attempted to reduce wage costs by outsourcing certain process and services in order to maintain or increase profits. This explains the increase in inputs from emerging nations and why direct investment is channelled to these economies.

Real wage moderation and the increase in productivity explain the favourable trend in unit labour costs in recent years, which together with the positive trend observed in the real effective exchange rate since 1994, is boosting competitiveness.

Figure 9: Unit Labour Costs, Producer Prices and Accumulated Change in the Real Effective Exchange Rate



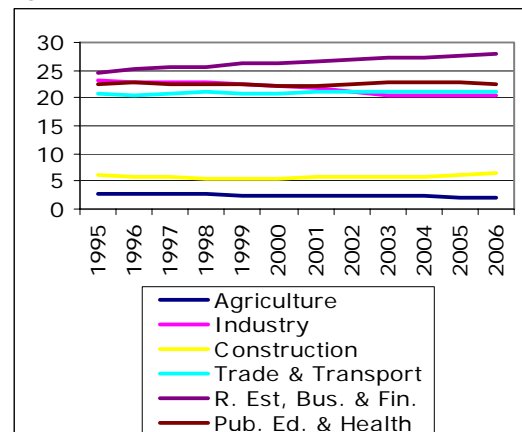
Source: ECB

However, unit wage costs are in any case much lower in emerging nations than in the United States or the Euro-zone. Wage costs in China only represent 30% of US unit wage costs and the Euro-zone 25% above the United States. Furthermore, building a factory in China or India is estimated to cost half the amount it would in the United States or Europe.

In this sense, it is no surprise that developing nations have quickly conquered a larger share of the world export market. While in 1996 exports from these countries represented 25% of world exports, in 2006 the figure stood at 40%, while the sum of US, European and Japanese exports as a whole has dropped from 27% to 19%.

As being cost competitive is very difficult for Euro-zone companies, which are forced to extend the relocation of parts of their production and some services, the alternative that makes companies less vulnerable is to search for greater product differentiation.

Figure 10: Sector Share of GVA

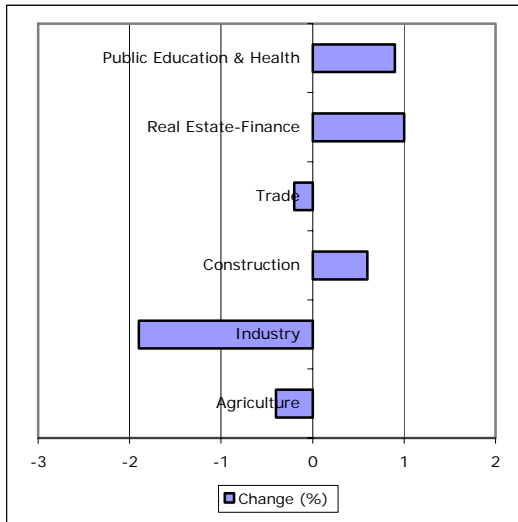


Source: Eurostat

Germany is a clear example, with by far the largest share of exports among Euro-zone countries which makes it a lot less sensitive to the exchange rate than Italy, Spain or France.

In the Euro-zone as a whole, emerging nation competition has undoubtedly affected GDP, job creation and exports, particularly in productive sectors.

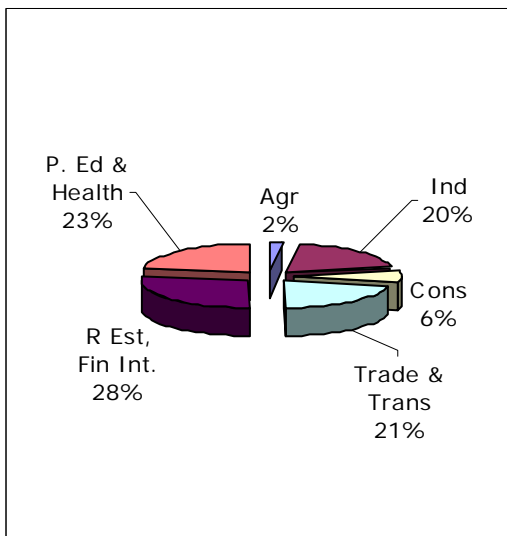
Figure 11: Change in Employment Share by Sector - 1998-2006



Source: Eurostat and own elaboration

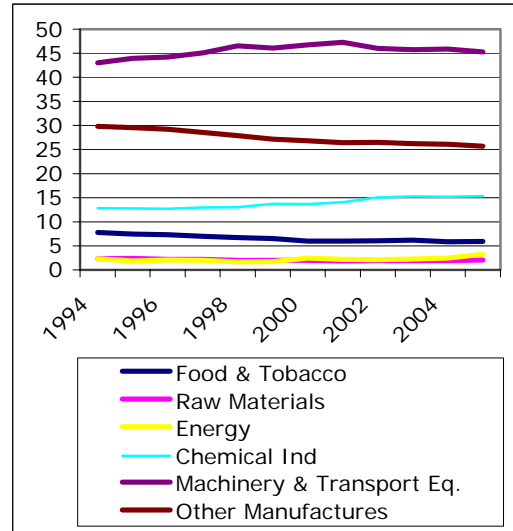
As regards GVA, the loss suffered since 1995 by the primary sector (-0.8%) and industry (-2.9%) has been offset by the rest of sectors, particularly real estate, financial services, rentals and business with an increase of 3.1% which is the sector with the largest share of total GVA (27.8%)

Figure 14: Share of GVA by Sector



Source: Eurostat

Figure 13: Export Share by Sector



Source: Eurostat

In the case of net employment, the primary sector (-0.4%) and industry (-1.9%) also saw their share reduced, while real estate, financial services, rentals and business displays an increase (1%) as is the case with public education and health (0.9%) and construction (0.6%).

Finally, in the case of exports over the period 1994-2005, there were also significant changes in the share of each sector. Machinery and transport material, which is the most important, has increased its share by 2% since 1994, but the opposite would be the case if the period were taken from 2002. Another sector that has recorded a gain is the chemical industry, with an increase of 3.5%. In contrast, food (-2%) and other manufactures (-4%) are now less important.

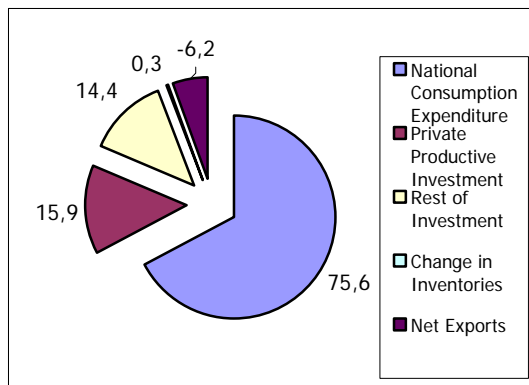
Valencia, June 5 2007
Nicolás Jannone

3. Spain

a) Corporations, Investment and GDP

The National Accounts, elaborated by INE, provide information regarding the income and expenditure of three large sectors: Households and Non Profit making Institutions Serving Households (NPISH); companies; and government administration. With the income they earn, households (and NPISH) make decisions regarding consumption expenditure (private consumption) and (residential) investment. Government spending is also broken down into public spending and investment. Finally, companies are responsible for private productive investment which includes both investment in equipment and non residential investment.

Figure 1: Demand Component Percentage Share of GDP in Market Prices in 2006



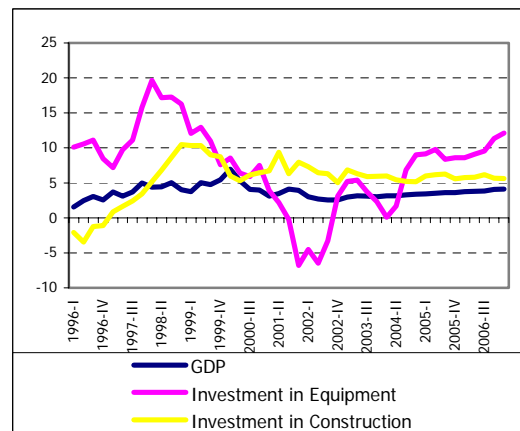
Source: own elaboration with data from INE and Banco de España

In 2006, final consumption (households, NPISH and government) represented around 75.6% of GDP (Figure 1), total investment 30.3% and private productive investment 15.9%. Private productive investment is vital for growth and has grown remarkably in Spain in recent years (see Figure 2 in our OCEI May report).

This monograph analyses the main determinants of non financial corporation (NFC) expenditure.

Figure 2 displays GDP and investment trends, differentiating between investment in equipment and in construction. We can see how investment has been more erratic than GDP due to investment (particularly in equipment) being more sensitive to expectations. Similarly, we can also see that investment has been an extremely important source of growth. In fact, a certain degree of complementarity is seen to exist between investment in equipment and investment in construction. In the second half of the 1990s, productive investment recorded considerably higher growth rates. At the end of the decade, investment in construction picked up at the same time as investment in equipment waned, even suffering decreases in some quarters. Finally, in recent years investment in construction has slowed down smoothly while investment in equipment has recovered vigorously.

Figure 2: GDP and Investment (annual percentage change after seasonal adjustment)



Source: own elaboration with data from INE and Banco de España

Another aspect of Figure 2 that is worth highlighting is that growth in investment in construction has outpaced GDP practically uninterruptedly since 1998. Finally, investment in equipment has accelerated substantially since 2005, coinciding with the recovery in industry.

b) Determinants of NFC Expenditure

NFC expenditure decisions depend mainly on corporate income (fundamentally corporate profits), but also on real interest rates, wage costs and their expectations.

Corporate Income

Table 1 presents information on employee wages and the gross operating surplus (GOS) as a percentage of GDP at factor costs. The main source of funding for NFCs is the GOS. The table shows how the share of GOS in NFCs over total GOS and mixed income (although the latter increased their share in GDP at factor costs) decreased slightly between 2000 and 2005 from 69.84% to 68.04%. The result was that the GOS of NFCs increased its percentage of GDP by around 2.3% to 32.15%, following the favourable trend in corporate profits over this period.

Table 1: Distribution of GDP at Factor Costs (%)

	2000	2005
Employee Wages	54.99	52.75
Gross Operating Surplus	45.01	47.25
/ Gross Mixed Income		
*of which:		
Non Financial Corporation GOS	69.84	68.04

Source: own elaboration with data from INE and Banco d España

Tables 2 and 3 analyse where NFC resources come from and how they are employed in more detail. NFC Gross disposable income rose by 20.4% over the period 2000-2005, due to a marked increase of 40.9% (see Table 3) in its main component (GOS), which was partly offset by the downturn in the net property gains (63%), especially interest payments and corporate distributed income. This trend is the result of growing corporate profits, which together with the accommodating financial scenario boosted investment by increasingly resorting to outside financing (see Table 2).

Table 2: NFC Income and Expenditure

	2000	2005	Change
	Millions of €	Millions of €	%
RESOURCES			
Gross Disposable Income	64620	77823	20.4
Adjustment for household			
Shares in pension plans	228		
Net Capital Transfers	5817	5369	-7.7
Total recursos	70665	83192	17.7
USES			
Fixed Investment	96661	143280	48.2
[1]	487	560	15.0
Total uses	97148	143840	48.1
Borrowing Capacity (+)			
/ requirements (-)	-26483	-60648	129.0

Notes: [1] Purchases less concessions of non financial assets not produced

Source: own elaboration with data from INE and Banco de España

The bottom part of Table 2 shows the strong increase in investment which rendered the substantial increase in income insufficient and resulting in the extraordinary increase in NFC borrowing requirements over this period.

Table 3: NFC Gross Disposable Income Components

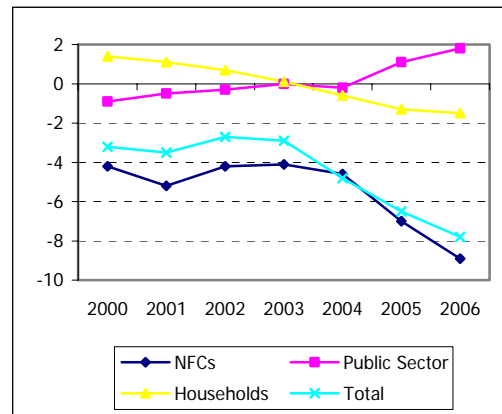
	2000		2005	
	Millions of €	%	Millions of €	%
Gross Operating Surplus	110510	9	155668	135
Property Gains	-24642	-29	-40169	-35
Total Income	85868		115499	
Other Current Transfers	4101		7570	
Social Contributions	4714		5892	
Direct Taxation	16919		30106	
Total uses	25734		43568	
Total Gross Disposable Income	60134		71931	

Source: own elaboration with data from INE and Banco de España

Figure 3 shows the recent trend in borrowing requirements for the main economic agents (excluding NFCs). NFCs traditionally resort to savings of others or from abroad to finance investment, which makes them net demanders of financing year in year out. However, foreign borrowing requirements have witnessed an upturn since 2004, coinciding with the period of strong productive investment (see Figure 2). Figure 3 also displays the growing borrowing needs of households together with the favourable trend in the government's accounts. Finally, we can see the growing borrowing requirements of the economy as a whole, which represent the equivalent of 7.8% of GDP and are the result of savings being insufficient to cover investment (which represents more than 30% of GDP).

As regards NFC financing, Table A.1 in the appendix shows how corporations mainly resort to loans to finance their investment. In addition to this, it is worth highlighting the decrease in the net balance in cash and deposits, while share purchasing has increased.

Figure 3: Net Annual Financial Balance of Various Economic Agents (% of GDP)

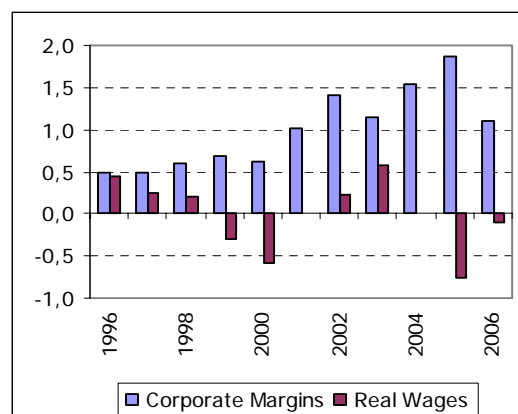


Source: own elaboration with data from INE and Banco de España

Real Wages

The marked growth in corporate income that can be observed in Table 3, can also be appreciated in Figure 4, which shows the trend in corporate profit margins and real wages.

Figure 4: Corporate Profit Margins and Real Wages (annual growth rates)



Source: own elaboration with data from INE and Banco de España

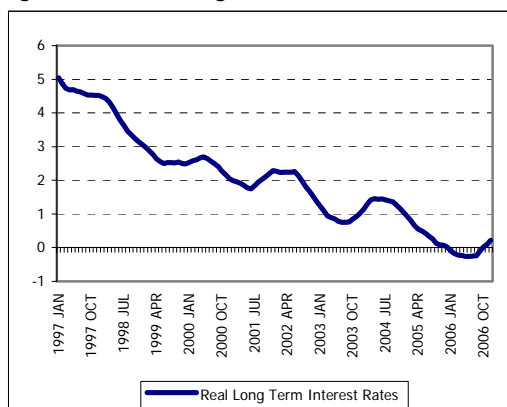
The former have risen remarkably, while growth in real wages has been moderate. The arrival of a substantial number of immigrants is behind this trend and has also favoured complementary factors (capital factor and skilled workers) thus increasing the

expected profitability of investment projects. Therefore, both factors (substantial growth in corporate profits and real wage sluggishness) have helped to boost NFC investment expenditure.

Real Interest Rates

One of the main factors that marks corporate investment decisions is the real interest rate trend, in light of the nature of investment projects. NFCs are traditionally net demanders of savings (see Figure 3), which means they resort to borrowing in order to finance their investment. At first glance, Figure 5 shows the extraordinary monetary conditions for borrowing that corporations have enjoyed over the past few years, which explain the strong growth in both productive and real estate investment, as well as the increasing level of corporate (and household) debt. In fact, it is worth asking whether such financial conditions have pushed companies (and of course households) into investing in projects whose profitability is dubious.

Figure 5: Real Long Term Interest Rates



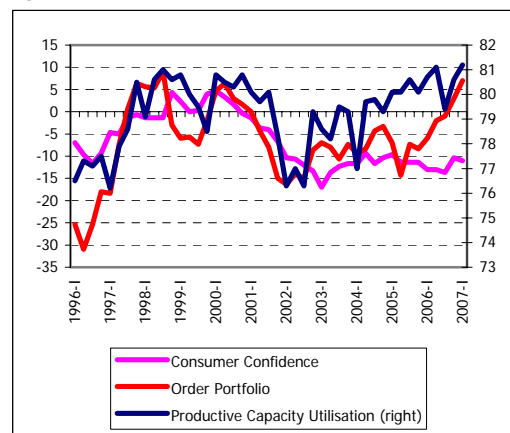
Source: own elaboration with data from Banco de España

Note: Long term interest rate: 10-year bonds
Price index: Harmonised Index of Consumer Prices (average over the past 12 months)

Expectations

Figure 6 shows the outlook for the economy based on opinion polls. Consumer confidence remains relatively low, but is resisting to fall, which will probably result in a smooth slowdown in private consumption (see OCEI Report by country, May 2007).

Figure 6: Expectations



Source: own elaboration with data from Banco de España

Furthermore, both the order portfolio indicator and capacity utilisation have recovered remarkably since 2004, coinciding with the upturn in productive investment that can be observed in Figure 2. The economic recovery in the Euro-zone and particularly in Germany is undoubtedly behind this situation, especially in 2006.

c) Sector Trends

Table A.2 in the Appendix shows real output and employment trends by sector over the period 2000-2004. One issue that immediately catches the eye is the minimal progress made in productivity per worker. In addition, the strong growth in the output of the construction and financial intermediation sectors is also striking, although machinery, mechanical equipment and other non metallic

mineral products also recorded significant increases in output. The small rise in employment in financial intermediation suggests there has been a marked increase in productivity per worker in this sector, in which Spanish companies are highly competitive.

The sectors to record the smallest increases in output include food, beverages and tobacco, wood and cork, chemical products and transport equipment. Output even shrank over this period in the textile, leather and footwear sector and in electrical and optical equipment, a situation that was combined with significant staff reductions.

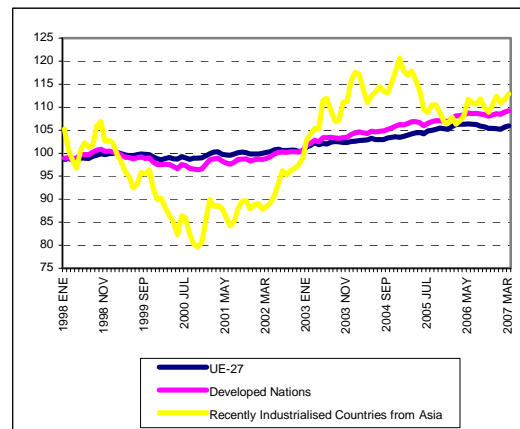
Table A.2 reveals some of the problems that traditional manufacturing faced at the beginning of this decade, probably related to these businesses' loss of competitiveness. However, the information in this table dates to 2004, which means we are unable to analyse the situation in 2005 and 2006, years that witnessed a recovery in industry (see graph on page one of this report).

Summary: the Challenge to Be Competitive

This report has analysed the situation of Spanish non financial corporations. In recent years, their resources have increased as a result of large corporate profits and the favourable economic scenario. Furthermore, highly accommodating financial conditions have boosted investment in construction and in recent years in equipment. Consequently, productive investment appears to be replacing investment in construction (see graph on page one of this report and Figure 2 in the section on economic environment).

However, these favourable results are not repeated when it comes to evaluating the competitiveness of the economy. We have underlined the productivity problems that are causing Spain to lose competitiveness in various reports. These reports focused on the trends in productivity, wages and unit labour costs compared to the EMU, which includes Spain's main trading partners. Figure 7 provides more detailed information in that it presents the competitiveness indexes for Spain in comparison to the UE-27, developed nations and recently industrialised countries in Asia (which compete with Spain's traditional manufacturing sector). In increase in the index means competitiveness is lost. The Spanish economy has seen its competitiveness worsen uninterruptedly since 2000 with respect to all three groups of countries.

Figure 7: Competitiveness Indexes



Source: own elaboration with data from Banco de España

Note: The increase in the index implies a loss of competitiveness

The group of developed nations includes Germany, Austria, Australia, Belgium, Canada, Denmark, Slovenia, United States, Finland, France, Greece, Netherlands, Italy, Ireland, Japan, Luxembourg, Norway, New Zealand, Portugal, United Kingdom, Sweden and Switzerland.

Recently industrialised countries in Asia include: China, South Korea, Philippines, Hong-Kong, India, Indonesia, Malaysia, Singapore, Taiwan and Thailand.

Spain's loss of competitiveness is significant considering the increasing globalisation, which means the unavoidable challenge of enhancing the competitiveness of the Spanish economy. It remains to be seen whether the incipient progress in (apparent labour) productivity in recent quarters is the result of extraordinary growth in investment in equipment in recent years.

Silviano Esteve
June 1 2007

Table A.1: Non Financial Corporation Financial Transactions Accounts

	Net Financial Transactions (€1,000s)	Share of Total Net Financial Transaction Balance (%)						
		Cash and Deposits	Non-share Securities	Loans	Shares and other Participations	Shares	Technical Insurance Reserves	Other Outstanding Receipts
1996	-3496342	-204.1	-70.2	326.5	8.4	20.2	5.1	34.4
1997	-5211978	-304.0	-33.1	384.6	2.0	45.9	-2.3	52.8
1998	-7157766	-120.0	-27.2	439.6	-81.4	-41.7	-13.7	-97.4
1999	-16749428	19.9	-29.4	259.6	-100.8	-99.3	-8.4	-41.0
2000	-26214605	-44.8	-26.4	227.1	-36.0	-41.4	-11.3	-8.5
2001	-35657766	-37.9	-16.2	168.0	-10.1	-11.2	-11.5	7.7
2002	-30596239	-65.8	-22.0	200.4	-16.0	-11.0	-11.0	14.5
2003	-31768143	-35.5	-21.6	219.8	-56.8	-21.2	-6.3	0.3
2004	-38890439	-35.0	6.2	187.6	-39.1	-19.6	-5.6	-14.1
2005	-63522613	-45.2	-3.0	215.3	-54.8	-46.6	-2.5	-9.9
2006	-86526096	-45.1	-16.2	259.9	-88.5	-82.5	-1.9	-8.2

Source: own elaboration with data from Banco de España

Note: a negative figure in the column referring to "Share of Total Net Financial Transactions (%)" indicates that the net purchasing of financial assets outweighs the net liabilities in the corresponding category.

Table A.2: GVA Growth and Employment by Sector (2000-04)

	GVA	Employment
TOTAL	13.3	12.5
Agriculture, cattle farming and fishing	-0.3	-5.4
Energy	12.1	10.3
CA+CB+DF Extraction of energy products		
Extraction of other minerals		
Coking plants, refineries and nuclear fuels	-1.7	10.4
EE Electricity, gas and water	18.1	
Industry	4.4	3.6
DA Food, beverages and tobacco	0.7	6.1
DB+DC Textiles, dressmaking, leather and footwear	-15.0	-16.0
DD Wood and cork	1.3	4.1
DE Paper, publishing and graphic arts	7.5	7.4
DG Chemical industry	5.6	5.5
DH Cork and plastics	9.3	10.3
DI Other non metallic mineral products	12.4	5.7
DJ Metallurgy and fabrication of other metallic products	10.7	13.3
DK Machinery and mechanical equipment	11.4	8.7
DL Electrical, electronic and optical equipment	-7.3	-10.5
DM Fabrication of transport equipment	6.0	3.5
DN Various manufacturing industries	2.2	8.4
Construction	27.5	19.8
Services	13.7	15.5
GG Trade and repairs	10.3	12.3
HH Hotels, restaurants and cafés	7.9	19.6
II Transport and communications	11.3	18.6
JJ Financial intermediation	31.7	2.8
KK Real estate agents and corporate services	14.5	24.4
LL.....PP Other services	14.1	14.2

GVA: Chain-linked Index. 2000 = 100.

Employment in 1,000s of jobs

Source: own elaboration with data from INE

4.- Germany & France

a) Corporate Profits

The trend observed in Non Financial Corporation (NFC) profits between 1997 and 2004, judging by the table below, clearly reflects the crisis during this period. Both before and after tax, profits have faltered, as can be appreciated by the zig-zag trend. Furthermore, data reveals that the public sector has maintained relative tax collection figures based on corporate profits and, therefore, one cannot say that the government helped to resolve the crisis, nor did it make things worse.

Table 1: Profits in Germany in Billions of Euros

	Annual Profit Before Tax	Tax	Annual Profit
1997	106.9	25.0	82.0
1998	121.4	30.1	91.3
1999	120.6	32.1	88.5
2000	128.6	33.1	95.5
2001	130.3	30.3	100.0
2002	124.8	27.5	97.3
2003	122.1	28.1	94.0
2004	135.4	30.2	105.2

Note: Industry, including mining, construction, trade, transport excluding railways and services related to corporations are included.

Source: Bundesbank

In the case of France, we have the gross operating surplus of companies and the total for NFCs. The situation is healthier than in Germany, particularly since the turn of the century. The crisis in France was not as serious as in Germany and this can be appreciated in the trend displayed by the gross operating surplus.

Table 2: Gross Operating Surplus – France in Billions of Euros

	Companies	Total NFCs
1995	186.8	272.5
1996	182.9	269.8
1997	194.9	279.9
1998	214.3	302.9
1999	213.5	305.4
2000	226.5	321.7
2001	238.2	341.0
2002	240.7	345.1
2003	250.0	354.0
2004	258.8	365.2
2005	262.0	369.9
2006	274.5	388.1

Source: INSEE

b) Investment

One of the most important variables when it comes to analysing corporate behaviour is investment. As a result, this section will analyse the trend in private investment in both countries. Measured as a percentage of GDP, investment in both countries confirms our initial conclusions. As far as France is concerned, investment as a percentage of GDP was in 1995 much lower than in Germany, which could be interpreted as a sign of less economic-corporate activity in the French economy during that year. However, since then the ratio has diverged entirely in both economies, rising in the case of France and falling in the case of Germany. Consequently, the French ratio stood at 17.1% in 2006, higher than the 16.4% ratio recorded in Germany the same year. We believe the decrease in private investment as a percentage of GDP in Germany is a fairly clear sign of just how serious the crisis in the German economy was.

Table 3: Private Sector Fixed Investment as a % of GDP

	France	Germany
1995	14.9	19.7
1996	14.7	19.3
1997	14.6	19.2
1998	15.1	19.3
1999	15.8	19.4
2000	16.4	19.7
2001	16.5	18.3
2002	15.8	16.7
2003	15.8	16.2
2004	16.2	16.0
2005	16.5	15.9
2006	17.1	16.4

Source: Eurostat

As regards investment in construction, figures also display different trends in the two countries, similar to those described above for total private sector investment. While investment in construction in France was lower than in Germany in 1999, the increase in France and the decrease in Germany since then has seen roles reversed from 2002 onwards. It is striking that investment in construction in France is around 25% higher than in Germany, when at that time, the relation between both countries' GDPs in favour of Germany was identical. In any case, these figures certainly do not indicate a similar-sized construction sector to that in the Spanish economy.

Table 4: Gross Investment in Construction in Millions of Euros

	France	Germany
1995		
1996	2887.2	
1997	2565.9	
1998	2886.8	
1999	3241.1	5840.2
2000	3858.1	5582.0
2001	3975.5	4263.9
2002	4052.2	3808.3
2003	4280.5	3264.2
2004	4333.5	3156.4

Source: Eurostat

c). Borrowing

As regards borrowing, data display that the ratio of debt with respect to the

overall balance of NFCs in Germany has decreased. As can be observed in the table below, total NFC borrowing has decreased considering both short and long term debt. This indicates that German NFCs have resorted to capitalisation to a greater extent for funding throughout the crisis. The 25% decrease in long term borrowing with respect to the initial figure is striking when compared to the slightly more than 8% drop in the case of short term debt.

Table 5: Short and Long Term Debt – Germany as a % of Total Balance

	Short Term Debt	Long Term Debt
1997	47.2	17.3
1998	45.9	17.5
1999	45.3	17.2
2000	46.3	16.1
2001	46.1	15.4
2002	45.1	14.5
2003	44.6	14.4
2004	43.6	13.8

Note: Industry, including mining, construction, trade, transport – excluding railways – and corporate services are included

Source: Bundesbank

Unfortunately, not such complete information is available in the case of the French economy. In this case, we only have the trend in loans granted to NFCs in relation to GDP, broken down into types between 2003 and 2005. These figures only enable us to conclude that NFCs are tended to increase borrowing during this period, regardless of the type of loan. Furthermore, as can be appreciated in the table below, NFCs displayed growing financing requirements over the three years under consideration, which could be linked to their economic crisis. That is, these data do not indicate a tendency towards balancing accounts at all, unlike the case of Germany.

Table 6: Loans Granted to NFCs in France as a % of GDP

	2003	2004	2005
Investment	12.98	13.02	13.38
Treasury	8.56	8.69	9.12
Other	10.73	10.89	11.23

Source: INSEE

Table 7: Borrowing Capacity or Requirements in France in Billions of Euros

	2003	2004	2005
NFCs	-17.5	-28.3	-52.0

Source: INSEE

d) Competitiveness

We are now going to analyse another good indicator of corporate performance – competitiveness. In order to do so, two variables are considered: growth in unit labour costs and the real effective exchange rate (REER). As regards the former, both economies recorded a substantial decrease in unit labour costs throughout the period 1995-2006. The growth rate was negative throughout the best part of the period, giving rise to a remarkable overall decrease in unit labour costs. The decrease witnessed in Germany between 2004 and 2006 was particularly striking.

Table 8: Growth in Unit Labour Costs (%)

	France	Germany
1995	-0.4	0.0
1996	-0.3	-0.5
1997	-1.0	-1.4
1998	-1.0	-0.4
1999	0.9	0.1
2000	-0.2	1.3
2001	0.3	-0.4
2002	0.6	-0.6
2003	-0.1	-0.3
2004	-0.5	-1.3
2005	0.0	-1.7
2006	-0.4	-1.5

Source: Eurostat

Notwithstanding, these conclusions are not as firm in the case of unit labour costs in industry. In this sector in France, unit labour costs have risen clearly since 2000, the first year of

available data. In Germany, the overall downward trend appears to hold in industry, and it is worth highlighting the marked decreases in certain years, the 5.3% fall in 2005 figuring prominently.

Table 9: Growth in Unit Labour Costs in Industry (%)

	France	Germany
1994		-2.1
1995		0.1
1996		-0.2
1997		-2.6
1998		-1.5
1999		0.9
2000	-1.2	0.9
2001	1.3	0.2
2002	0.9	-1
2003	1.6	-0.7
2004	-1.2	-3
2005		-5.3

Source: Eurostat

In any case, the REER is the main indicator of how competitive an economy is, measuring the exchange relationship between the goods from different countries. It is a well known fact that an increase in this index means the country in question is less competitive. Well, this variable has decreased in both countries in global terms during the period 1995-2006. While there are differences, as the REER in Germany dropped throughout the period except for the odd increase in isolated years, in France only 2000 witnessed a decrease, from which time this variable has risen again. As a result, Germany has almost constantly gained competitiveness throughout the period under study, which explains the strength of this country's exports in recent years, while France displays a more erratic trend in this area, losing competitiveness since 2000.

Table 10: Real Effective Exchange Rate
1999=100

	France	Germany
1995	109.62	117.37
1996	109.55	112.53
1997	103.55	103.97
1998	102.73	103.15
1999	100.00	100.00
2000	94.67	93.82
2001	94.78	92.36
2002	96.89	92.48
2003	101.54	96.79
2004	102.52	96.65
2005	102.31	93.24
2006	103.26	91.45

Source: Eurostat

e) Employment by Sector

As regards growth in employment by sector, the data available indicate that the shift towards the services sector in France intensified over the period 1996-2004. The sectors to lose jobs over this period in absolute terms were mining, industry and electricity, gas and water supply, while construction, trade and car repairs, hotels and restaurants, transport, warehousing and communications and particularly real estate all recorded increases.

Table 11: Employees per Sector in France

	1	2	3	4
1996	57524	4036655	200443	1401466
1997	48546	3988954	199770	1370797
1998	46505	3979120	197694	1365607
1999	42529	3984755	196586	1398205
2000	42289	4026591	201660	1436543
2001	40464	4069632	201825	1458342
2002	38973	4038522	201072	1470596
2003	37895	3940739	196006	1494723
2004	39250	3887900	196190	1547640
	5	6	7	8
1996	2805206	663596	1378031	1949179
1997	2826865	669951	1388055	2061140
1998	2843574	679392	1428194	2244418
1999	2907884	704833	1453821	2415385
2000	3053993	770830	1529367	2666651
2001	3109965	796433	1553911	2796196
2002	3181916	847700	1587626	2789313
2003	3204833	846430	1580425	2787891
2004	3255130	884380	1571330	2904690

Note: 1: Mining
2: Industry
3: Electricity, gas and water
4: Construction

5: Trade, car repairs
6: Hotels and Restaurants
7: Transport, warehousing and communications
8: Real Estate

Source: Eurostat

In the case of Germany, the serious crisis was felt in that the loss in employment between 1998/99 and 2004 affected practically all the sectors of the economy under consideration, although the decrease in the services sector is less pronounced than in industry. In any case, only trade and car repairs maintained employment figures between the beginning and the end of the period.

Table 12: Employees per Sector in Germany

	1	2	3	4
1996				
1997				
1998			333903	
1999	135525	7503831	317518	2262660
2000	128712	7551269	294831	2164129
2001	107169	753585	285072	1987741
2002	11875	7337847	285081	1824337
2003	96187	7293159	271340	1697818
2004	95640	7228200	283700	1623970
	5	6	7	8
1996		1181100		
1997		1160600		
1998		1076200		
1999	4436747	1044221	2055000	4086000
2000	4407893	1061611	1536228	3106907
2001	4366334	1082339	1748534	3723349
2002	4183325	1033152	1880878	3884670
2003	4518801	1166037	1802386	3826355
2004	4464160	1163850	1848550	3979370

Note: 1: Mining
2: Industry
3: Electricity, gas and water
4: Construction
5: Trade, car repairs
6: Hotels and restaurants
7: Transport, warehousing and communications
8: Real estate

Source: Eurostat

Antonio Cutanda
Valencia, May 31 2007

5.- China

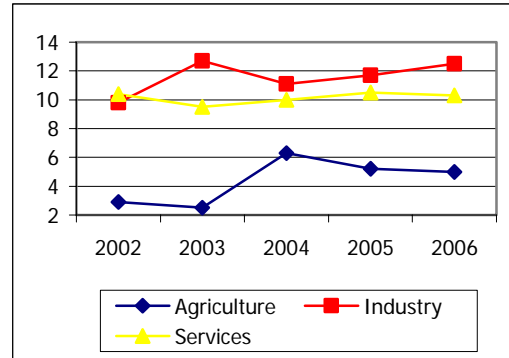
Industrial reform has involved opening up to foreign trade and began at the end of the 1970s. Nowadays, foreign trade is one of the main drivers of Chinese economic growth, although more than 90% of the country's exports result from the output of foreign companies. Abundant cheap labour, the enormous domestic market and the favourable treatment foreign companies have always received has attracted foreign capital for more than two decades. Only a few months ago, a tax rate of 15% was levied on foreign companies compared to that of 33% levied on local companies.

There is an enormous lack of corporate initiative and the State maintains a strong presence in the productive framework. Today, 37% of industry is run by the State and, moreover, the State owns more than two thirds of total heavy industry. The main problems faced by public companies are inefficiency and low profitability.

Forbes publishes the list of the 50 top Asian companies on an annual basis and in 2006 only five were Chinese, compared to 12 from India. Furthermore, only 30 made it into the top 200 companies with less than 1,000 million dollars in sales.

Industry value added is quite low and is based almost exclusively on the low wages paid to workers. China imports semi finished products which are transformed by a foreign company or, on occasions, the process is subcontracted to a local company.

Figure 1: Value Added Growth



Source: Asian Development Bank

However, the large Chinese corporations are beginning to get a name on the international scene, both due to their export capacity and how much they invest abroad. These companies invest abroad due to their need for raw materials, to purchase technology and to achieve recognition for their brand names.

Privatising State Industry

The process of converting state-run firms into privately managed companies dates back to 1988. Later, in 1993, the system of public limited companies began to be standardised⁹ and in November 2003 the deregulation of investment in state-run firms was approved. This was an important change with respect to previous Chinese policy, which impeded foreign and private investment in large state-run corporations. The government announced that it would support large and medium-sized state-run companies in order for them to develop by means of mergers, takeovers and public share offers and by embarking on joint projects with foreign investors.

However, the government has always clear stated its intention to maintain

⁹ This law enabled private companies to work

absolute control of strategic sectors such as energy, transport and basic goods.

The last decade has been characterised by the restructuring of state-run companies and the creation of private companies, main in Special Economic Zones (where taxes are low and workers lack protection). The number of state-run companies has been cut in half in only ten years, resulting in more than 40% of their employees being made redundant¹⁰, a number that emerging private companies will find difficult to absorb. Therefore, state-run companies have been forced to compete with a growing private sector that superseded all those that were not competitive.

The Chinese government has employed various measures to sell off state-run companies:

- Selling shares on the stock market
- Selling shares to company directors
- Transferring central government assets to local governments

Most of the privatisations have had a common denominator, corruption. There declared bankruptcy, workers were made redundant and assets were sold off poorly in order to create similar private companies and hire workers under more favourable conditions for the employer.

However, the main state-run companies increased their profits by almost 35% in the first quarter of 2007. More than 74% of these companies belong to the petrochemical, electrical, metallurgy, coal and telecommunications sectors.

¹⁰ Report by the International Confederation of Free Trade Unions, 2005

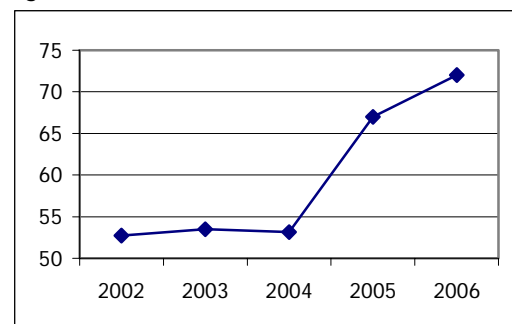
What is more, the growth of private companies is unstoppable. More than 680,000 companies were founded in 2006 alone, which represents an increase of 15.8% with respect to the previous year. Furthermore, the workforce in these companies amounted to 120 million employees, 10% more than the previous year. This figure is the equivalent of 15% of total national employment.

FDI in China's Corporate Make-up

The inflow of foreign investment has significantly boosted industrialisation, providing access to new technologies. However, the government initially adopted a series of protection measures (at the end of the 1970s) focused on the following¹¹:

- Reinforcing the initial development of new industries
- Developing export sectors
- Promoting international production competitiveness
- Diversifying industry towards sectors more intense in capital and technology.

Figure 2: FDI (in millions of dollars)



Source: Asian Development Bank

¹¹ Sancho and Manchón (2007): Éxito y perspectivas de las economías China e India. *Economía Industrial*, 362, pp. 39-70

The measures adopted during the first stage of opening up to foreign trade made enabled the government to channel a great deal of investment to sectors that were less intensive in labour and with greater added value, such as the electronics and car industries. As a result, tens of thousands of foreign companies installed their operations in China.

Since the beginning of the 1990s, important multinational enterprises have concentrated a great deal of their production in China. Some have opened new companies and others have closed their factories in their home countries and moved to China seeking better conditions. The main reasons that have led these companies to invest in China are as follows¹²:

- Enormous consumer potential due to being the largest market in the world in terms of population
- China is a very new market
- Labour costs are low
- High availability of human resources
- Labour is flexible and with a great capacity for learning
- China is a safe and stable country
- China has a strong and advanced network of infrastructures

Initially, in 2001, only large multinationals decided to channel their investment to China. Currently, a completely different trend can be observed. Companies are setting up their factories in China, regardless of their size.

¹² Rodríguez, I. (2005): "China, inversión directa y economía catalana", Carta de Asia-Economía, Nº 104

There are various ways of entering the Chinese market:

1. Representation Office: this is the quickest way of legally entering the country. It is normally the first step taken by foreign companies and it is highly restricted, as they are prohibited from sealing trade contracts and they are not granted judicial status.
2. Equity Joint Ventures created with local partners. Initially this was the only way of opening operations in China.
3. Wholly Foreign-Owned Enterprises. The presence of this type of company has increased considerable in recent years due to a greater deregulation of industry

All these multinationals are attributed around a third of China's output in sectors such as chemical products, pharmaceuticals and machinery and electronics.

Furthermore, if we concentrate on the flip side of the coin, that is, the globalisation of Chinese companies, the following formulas were used to gain access to the world market:

- Large export companies. These companies have mainly be concerned with the quality of their products and low cost manufacturing. However, they are highly deficient in terms of sales techniques, distribution and post-sale services due to a lack of experience.
- Competitive networks. These companies have a highly flexible structure and produce goods at a very low price. They are developing in markets that require a quick response to changes in demand.

- Technological operators. The five-year plans fostering the development of infrastructure for research by facilitating the creation of companies with state-of-the-art technology.
- Leading national companies create global brand names and this enables them to compete on the international stage.

However, the number of obstacles these companies must face is obvious. The following are the most significant:

- Lack of qualified personnel
- Absence of an acceptable corporate code of behaviour
- Lack of coherent competition policy in the domestic market

Chinese multinationals are not very strong due to the high degree of intervention on behalf of the State. In contrast, in the most deregulated sectors, competition has stimulated the development of companies such as TCL (the largest manufacturer of televisions in the world), Lenovo (personal computers), Bird (mobile telephones), Hauwei (telecommunications); all of which are deemed strong in their respective sectors. As a result, emerging Chinese multinationals need to be backed by an appropriate institutional framework that stimulates competition, enabling companies to grown on their own.

In addition to this, small and medium-sized enterprises represent more than 99% of all Chinese companies and generate more than 60% of GDP. Therefore, they are an important source of economic growth and job creation. Moreover, the fact that they are enormously flexible when faced with changes in the economy makes

them even more important bearing in mind the reform, development and process of external opening in the country. But we must take into account difficulty these companies have to obtain financing. For this reason, the government has promoted micro loans in certain areas of the country in recent years. These loans are granted not taking into account mortgage capacity, but the borrower's ability to pay off the loan.

In 2006 the main trading banks granted a total of 1.79 billion yuan in loans to 684,300 small companies, that is, 9.87% more than the previous year. Furthermore, statistics show that 26.33% of this amount has entered default, which is 3.33% less.

The number of SMEs is growing at a dizzying rate and they are one of the best alternatives to relieve the pressure generated by unemployment. However, many Chinese banks have serious doubts when it comes to lending them money, due to the uncertainty of gaining profits.

M^a Luisa Martí Selva &
Rosa Puertas Medina
Valencia, May 31 2007

6.- Mexico

Mexico released its Monthly Services Survey (MSS) for the first time in April with data from February onwards. As the MSS is new, at least in that its results had never been published before, it is worth indicating the background of this survey.

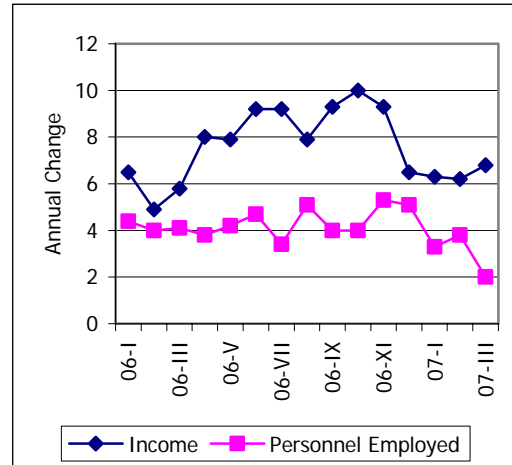
The survey refers to Private Non Financial Services. It dates back to 1993 and is aimed, according to INEGI, at generating information on the private non financial services sector by using a sample of around 2,500 economic units covering 79 different activities. The sample was increased to 4,726 economic units in 2004. Today the survey includes a sample of 7,792 economic units and 57 branches of economic activity.

The information released shows that the survey produces indexes on income for providing services and on people in employment for nine sectors of economic activity.

The survey currently generates indicators for the main private non financial services, transports and messaging activities. Indicators refer to the people employed, wages, expenses and income.

In the same publication, INEGI also released monthly figures dating back to 2005, which makes it possible to calculate the monthly change in annually adjusted figures since 2006. The results are presented in the graph below.

Figure 1: Income and Employment in Private Non Financial Services (2006-2007)



Source: elaborated with data from INEGI

The graph above shows how growth in income has outpaced that in employment over the period under study. It is also striking that between January 2006 and March 2007 both indicators recorded positive growth rates every month.

The information from the second report released by INEGI with figures for March this year gave the following results:

Income for Providing Private Non Financial Services

This indicator shows how much the total equity of these companies has grown. In real terms, total equity rose by an annual 6.8% in March.

At sector level, the most striking results were recorded in recreational, cultural, other recreational services, sports and leisure services with an increase of 13.2%, due to the improvement in recreational facilities and amusement parlours.

Professional, scientific and technical services recorded the next largest increase with an 11.7% surge from management, scientific and technical,

architectural and engineering consulting services and related activities.

The sectors related to mass information media recorded a rise of 9.8%, real estate agents and companies that lease out furniture and intangibles rose by 9.6%, health and social aid by 9.1%, temporary accommodation and food and beverage preparation by 6.9%, transport, postage and warehousing by 5.2%, business support services and waste management and remediation services by 3.8% and finally, educational services by 3.6%.

Employment Growth

The number of people employed by the private non financial services sector rose in March by 2% in relation to the same month in 2006.

At sector level, the highest rate was observed in transport, postage and warehousing services, which recorded a rise of 4.4% due to favourable results in maritime transport and intermediation for freight.

Educational services recorded the second highest rate, which rose by an annual 3% in March due to the good work done by non university post high school services and higher education centres.

The sectors to register rises of less than 3% were temporary accommodation and preparation of food and beverages, with a 2.7% rise, mass media 2.2%, health and social aid 1.8%, recreational, cultural, sports and other leisure services 1.3%, professional, scientific and technical services 1% and real estate agents and companies that lease furniture and intangibles 0.3%, while business support and waste management and remediation services recorded a decrease of 0.8%.

In the first quarter of the year, income rose by 6.5% in March 2007 in relation to the same month the previous year, while employment only rose by 3%.

A very new survey, as mentioned previously, that only has detailed information for two months, but which will undoubtedly be extremely useful in forthcoming months when it comes to analysing the economic scenario.

Héctor Ruiz Ramírez
Toluca, Mexico May 29 2007