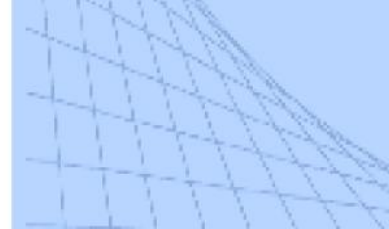




May 2008

Foreign Trade



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1. USA

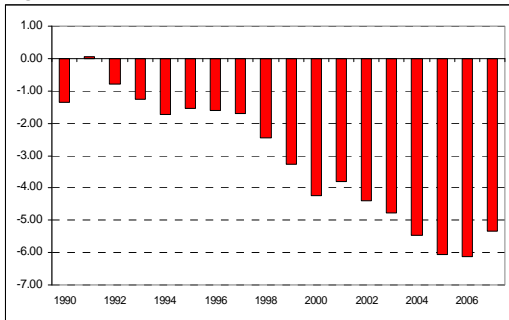
Foreign Trade: Every Cloud has a Silver Lining

a) Current Account Deficit Begins to Decrease

The US current account, having risen uninterruptedly for a decade and a half, (see Figure 1) began to decrease in 2007, a trend that will undoubtedly become more pronounced over forthcoming quarters. In fact, the 5.3% deficit for the year as a whole shrank to below 5% (for the first time since 2004) in the last quarter.

There are two factors that explain this anticipated improvement: in the first place, the slowdown in economic growth in the US, while 2007 was a particularly prosperous year for the country's main trading Partners. In the second place, the progress weakening of the dollar, which has enhanced the competitiveness of US exports.

Figure 1: US Current Account (% of GDP)



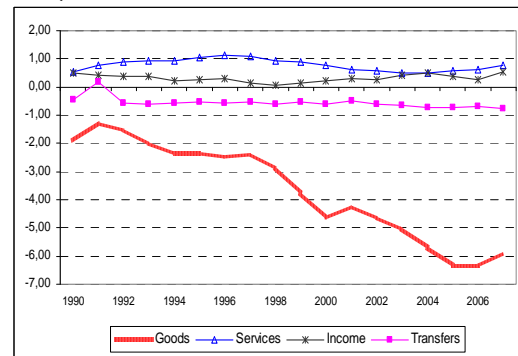
Source: own elaboration with data from BEA

It is worth underlining that these two factors have been dealt with in order of importance. That is, the income effect, stemming from the growth gap, is considerably larger than the price effect, caused by the depreciation of the "greenback". The latter will be addressed later in this report.

The current account deficit decreased by around eight decimal points between 2006 and 2007, mainly (90%) due to the simultaneous improvement (Figure 2) in the enormous deficit in trade in goods (which still exceeded 100 billion dollars).

Parallel to this, the situation in the income account also improved with respect to previous years, despite the net financial deficit in the US at the end of 2006 amounting to 2,539 billion dollars. Once again, US-owned foreign assets are confirmed to be much more profitable than US assets in foreign hands. Even still, the increasingly negative financial situation of the country appears unavoidably bound to convert the income account balance into a deficit.

Figure 2: Current Account Sub Items (% of GDP)



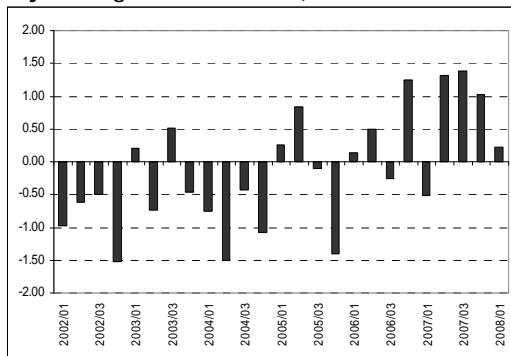
Source: own elaboration with data from BEA

Nevertheless, 2007 once again demonstrated the United States' unique ability to obtain financing at singularly low cost thanks to the confidence in its public debt issues, the size, depth and variety of its financial markets and the willingness of many governments, particularly in Asia and the Middle East, to maintain their currencies on level par with the US dollar. In other words, no other country would be capable of obtaining financing with moderate interest rates (with a downward trend

towards the end of the year) and a continuously depreciating currency.

Finally, as can also be observed in Figure 2, net US unilateral transfers recorded a new high (105 billion dollars - 0.75% of GDP), most of which (apart from those made to international organisations) involved countries in the Middle East, Asia and the Pacific.

Figure 3: Net Exports – Contribution to GDP Growth (quarterly annually and seasonally adjusted growth rate - %)



Source: own elaboration with data from BEA

In this first overall look at the situation, it is worth highlighting that, while the fact that growth in the US has been outpaced by that its main trading partners has seen the country's foreign account improve, this trend has at the same time become a mainstay of the weak growth registered over the last few quarters. As a result, the external sector's tradition role as a detractor from GDP growth throughout practically the whole of the latest expansion has reverted (Figure 3). Indeed, without the contribution of net exports the US economy would have already suffered a quarter with negative GDP growth by now.

b) The Trade Deficit: Oil Decisive

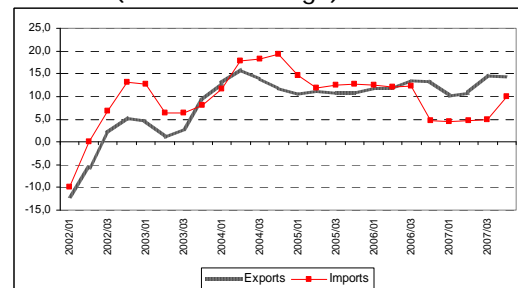
In our previous review of the US external sector only two years ago (see May 2006 report), we suggested that **oil imports** were contributing to the

deterioration of the trade balance, but were by no means decisive. When analysing this situation (see Table 1 at the end of that report and the updated table at the end of this report), we estimated that oil imports were approximately responsible for 25% of the deficit over the four-year period dating from 2002 to 2005.

The situation has not changed dramatically following the continuous and, more recently, sharp increase in oil prices. In 2006, growth in the trade deficit slowed down with respect to previous years, amounting to 48.5 billion dollars. No less than 83% of this figure was due to the increase in the cost of oil imports, despite the physical amount of oil imported decreasing.

The figure referring to 2007 is even larger. Due to the US economy growing less (and, in turn, imports) and the favourable trend in exports (Figure 12), the trade deficit shrank by 57 billion dollars, but the oil bill increased by more than 21 billion, despite less barrels being bought from abroad for the second year in a row.

Figure 4: Exports & Imports of Goods and Services (annual % change)

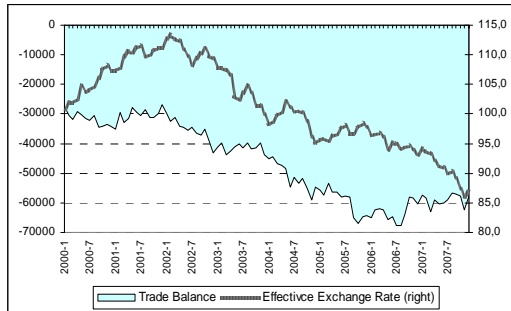


Source: own elaboration with data from BEA

And in the first quarter of 2008 the situation has become extreme. In such a short space of time, the cost of oil imports has risen by nearly 30 billion dollars in relation to the same period in 2007, while the total trade deficit

remained practically unchanged (+30 million dollars).

Figure 5: Trade Balance (millions of dollars) and Effective Exchange Rate of the Dollar (broad group of trading partners; 1999:1 = 100)



Source: own elaboration with data from BEA
Note: a decrease in the effective exchange rate index denotes a depreciation of the dollar

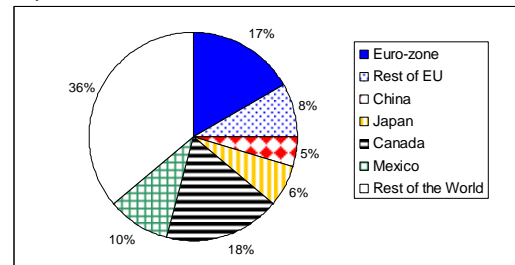
Nevertheless, despite the damaging impact of the energy bill, the trade deficit has slowly begun to recover (Figure 5) since the last quarter of 2006. Without denying that the depreciation of the dollar has played a role in this trend, the idea of this being the fundamental cause of the improvement remains difficult to defend. Figure 5 above reveals that there is no correlation between the two variables. Interested readers can verify this overall sensation by observing the fourth and eighth columns in Table 2 (at the end of this report), where data disaggregated by period and trading partner are presented.

In contrast, the enormous difference between the economic cycle in the US and its Trading Partners (which leads to an income effect on exports and imports) explains a great deal more. On the one hand, expenditure has moderated (firstly in residential investment, later in non residential investment, private consumption and government spending), which has curbed imports – except those involving

raw materials, due to the upturn in prices. On the other hand, Canada and Mexico continued to record remarkable growth rates, together with the exception economic growth in China. What is more, 2006 and 2007 were the two years in which GDP has risen the most this decade in the Euro-zone and Japan. All these situations have boosted US exports considerably, outpacing imports in 2006 and 2007 by more than four percentage points¹.

One aspect that has not changed significantly with respect to our analysis two years ago is the geographical distribution of exports and imports. The former (Figure 6) are still mainly bound for the European Union and its two neighbours, Mexico and Canada (approximately 25% in each case), while little more than 10% are bound for China and Japan.

Figure 6: US Exports by Destination (2007; %)



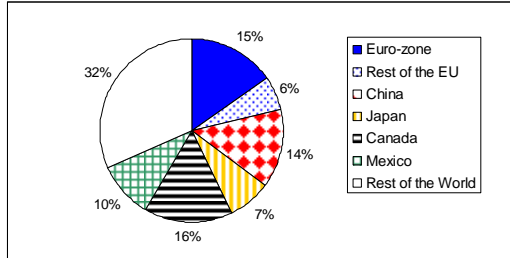
Source: own elaboration with data from BEA

In contrast, US imports (Figure 7) come in the same proportion from the two Asian superpowers as from the EU as a whole, while a slightly larger proportion come from the two NAFTA Partners². Data disaggregated further than in this report reveal how oil exporters have increased their share of total US imports, as was to be expected.

¹ On average over the eight quarters in 2006 and 2007, exports rose by 12.6%, compared to an 8.2% increase in imports.

² North American Free Trade Agreement.

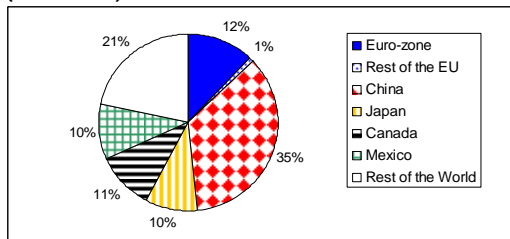
Figure 7: US Imports by Origin (2007; %)



Source: own elaboration with data from BEA

However, the most striking trend in the US trade balance is undoubtedly the unstoppable increase in the deficit with China, not only in absolute terms (exceeding a quarter of a billion dollars in 2007 for the first time), but also as a percentage of the total (Figure 8).

Figure 8: US Trade Deficit by Country (2007; %)



Source: own elaboration with data from BEA

More than 35% of the total US deficit is due to its trade with China, almost six percentage points more than in 2005. The figure more than trebles the deficits with the other four regions highlighted here, which have either stabilised (Japan, Mexico, Canada) or shrunk (European Union) as a percentage of the total.

Therefore, at least to date, the progressive and administered floatation of the Yuan has not helped to decrease the deficit which is hanging over US and Chinese relations like Damocles' Sword.

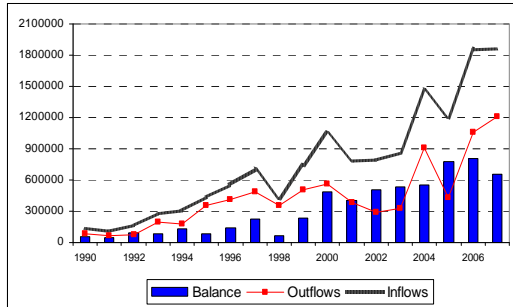
In light of this situation, we must insist that reducing imports from China would tend to increase imports purchased from other emerging nations, not to

raise national product, which has a different structure of activities and costs to the normal structure in the Chinese products bought by the US. In fact, it is largely US companies that are chalking up juicy benefits in the Asian country by exporting back to their country of origin. Finally, China continues unmistakably willing to finance the US foreign deficit, despite the economic losses this entails with regard to other investment alternatives, by purchasing US Treasury Bonds.

c) Financial Account Surplus: No Matter What Happens, the US Absorbs Worldwide Saving

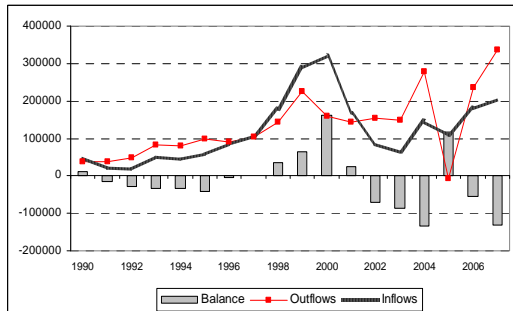
Let's imagine an economy where the currency has depreciated dramatically, the interest rate gap with respect to its main trading partners has decreased (and even changed sign), partially dismantled financial markets that have triggered a worldwide crisis and a real sector that is clearly slowing down and has accumulated large deficits. What chance would you give such a country of attracting investment flows? Certainly not much. However, this is not the case with the United States. As can be observed in Figure 9, net financial inflows amounted to almost one and a half trillion dollars over 2006 and 2007, maintaining therefore a rate of two billion a day. This has occurred even when financial outflows shot up over this period, as US investors themselves went in search of more attractive destinations to invest in. That is, inflows have boomed in adverse circumstances.

Figure 9: Financial Account (millions of dollars net)



Source: own elaboration with data from the BEA

Figure 10: Foreign Direct Investment (millions of dollars net)



Source: own elaboration with data from the BEA

How can we explain the apparent paradox between the mediocre conditions that the United States appears to offer for investment and the massive influx of funds? In the first place, beyond circumstances related to the current economic environment, we are still talking about the largest economy in the world, which is uniquely flexible and capable of adapting. This can be appreciated when, in the midst of the crisis, Foreign Direct Investment inflows also rose (Figure 10).

In the second place, the credibility of the US Treasury as an issuer of assets is, at least so far, safe from the difficulties of the economy. Furthermore, with willingness of Asian countries, led by China, and Persian Gulf Exporters to avoid their currencies from appreciating against the dollar, for trade reasons or to maintain a foreign

peg, guarantees a continuous flow of government funds from these countries. And one thing that none of the countries above lack is a surplus of resources to invest³.

Thirdly, US financial markets, apart from those that are collapsing, still boast a categorical comparative advantage, due to their diversity, depth and size with respect to those in any other economic region.

In the fourth place, the dollar as a deposit value is certainly not very attractive at the moment. However, due its unquestionable position as an international currency (that is, the currency used to carry out most of the trade and financial transactions worldwide) the dollar enjoys a privilege that is unequalled. Both the public and private sector have enormous amounts of dollars to operate in markets and raw materials are also abundant.

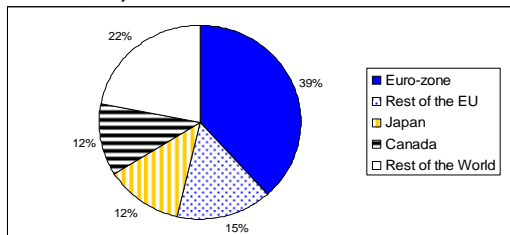
Having resolved this paradox, we will now devote a few lines to breaking down the latest trends in capital flows involving the United States.

As mentioned previous, FDI inflows have increased. Nevertheless, following an unusual year in 2005 when net outflows were even negative, US direct investment abroad has normalised and now exceeds inflows. This is the normal trend in the world's largest economy, only bucked in the second half of the 1990s (Figure 10) by the record influx of capital due to investors from all over the world being attracted to the New Economy. More than half the FDI in the US came from the European Union, led

³ Defending the stability of their currencies certainly entails a cost for these countries: first, excessive inflation. Second, low yields (depreciating currency + low interest rate received)

by the Euro-zone in 2007, which is also normal (Figure 11).

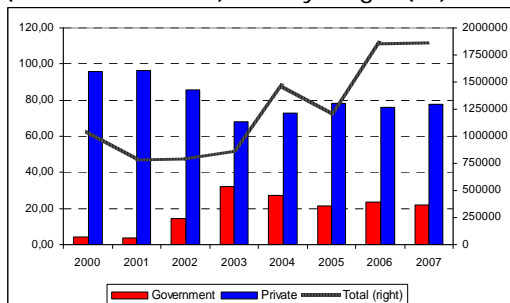
Figure 11: FDI Inflows by Origin (2007; net values; %)



Source: own elaboration with data from the BEA

Focusing on these financial flows, which are funding the massive US current account deficit, Figure 12 reveals that government investment remains unusually high in comparison to the past in the medium and the long term. Indeed, government-based FDI in the US still accounts for between 20% and 25% of the total. As mentioned previously, the policy of Asian and Persian Gulf central banks explains this regularity. Simplifying, in light of the fact that the Federal Government deficit remains responsible for a great deal of the country's borrowing requirements, these countries are continuing to sustain (at a low cost) the deficits of the Bush government.

Figure 12: Net Financial Inflows; Totals (millions of dollars) and by Origin (%)



Source: own elaboration with data from the BEA

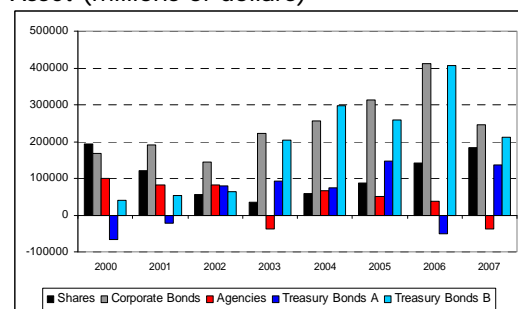
Finally, a breakdown of where funds were invested (Figure 13) shows that investment in shares has recovered, after hitting rock bottom in 2003. The

figure exceeded 180 billion dollars last year.

Even still, 2006 and 2007 confirmed that most foreign capital over the last decade has been invested in corporate bonds, although the figure of 212 billion dollars recorded in 2007 was the lowest in the last four years.

We have already described and analysed how strong investment in US treasury bonds is on behalf of government agencies from other countries. In contrast, investment in Treasury Bonds or agencies backed by the Federal Government on behalf of foreign investors from the private sector has fluctuated considerably. In fact, over the five-year period dating from 2003 to 2007, this sector only purchased the equivalent of a third of the total net acquisitions on behalf of the public sector. Bearing in mind the current scenario in which interest rates are low and the dollar is weak, private sector investment in government securities could be particularly weak in 2008. However, there are central banks for that, particularly China's.

Figure 13: Net Financial Inflows by Type of Asset (millions of dollars)



Source: own elaboration with data from the BEA
 Note: Agencies = agencies backed by the Federal Government; Treasury Bonds A = Bonds acquired by private investors; Treasury Bonds B = Treasury Bonds and other Federal securities purchased by the public sector

d) Geographical Breakdown

Table 2 at the end of this report provides data for Readers interested in a geographical breakdown of the results of the US external sector. In order to do so, we compare the trends over the last two four-year periods (2000-2003 and 2004-2007) in the trade balance, the income account, current transfers, the current account and both net inflows and outflows of direct investment, together with the pattern of the dollar compared to each respective currency. All this is related to the United States' main trading partners: the Euro-zone, the rest of the EU, Canada, Mexico, Japan and China.

Without aiming to go into too much detail, the main conclusions are as follows:

1) The US trade deficit grew over the first and second four-year period in all cases, regardless of whether the dollar appreciated markedly (Europe and Canada) or slightly (China) or appreciated (Mexico). Of course, the largest increase occurred in the case of China. The US has accumulated a bilateral trade deficit with the Asian giant of almost 850 billion dollars over the last four years.

2) The US income account balance remains positive (and displays a slightly upward trend) with respect to the Euro-zone and Canada. It is practically balanced in the case of Mexico and a deficit is observed with respect to the European Union excluding the Euro-zone (the United Kingdom is an intermediary for third party country investment and, as a result, receives – statistically speaking – the income made on this capital). The income account also displays a rising deficit with Japan and China. In the case of

the latter, the deficit is due to the growing amount of investment on behalf of the central bank in US treasury bills and bonds.

3) Current transfers recorded a deficit, which is normal for a developed nation and which was minimal with respect to the regions selected in this analysis, with the exception of Mexico, where the US registers a markedly negative balance due to immigrant remittances.

4) The FDI received by the US, as mentioned previously, essentially comes from the European Union, to a total net value of more than 700 billion dollars over the eight-year sample period. The increase in FDI from Japan and Canada between the two four-year periods is, however, striking. China, in contrast, invests practically nothing (50 million dollars on average a year).

5) In net terms, US FDI abroad largely offsets incoming FDI from the developed regions under consideration, but only compensated for that from the Euro-zone over the period dating from 2004-2007 (US interest in investing in companies in this region appears to be growing⁴). In contrast, US FDI in China and Mexico greatly outweighs the FDI flows in the opposite direction.

e) Perpetual Deficit?

The United States has recorded a current account deficit for 16 years in a row, revealing a perennial lack of savings or excessive domestic spending. In terms of GDP, the deficit has remained above 5% since the second quarter of 2004.

⁴ The recent and almost acclaimed visit to Europe by Warren Buffet, who had recognised his intention to move into this region, can be included in this general tendency.

While weak economic growth and a weak US dollar are helping to partially correct the deficit, which will decrease in 2008 and 2009 with respect to the all-time high, most people generally appear to be convinced that the world's number one economy will live with a continuous deficit in the future. This would steadily erode the country's net financial balance, which, as mentioned previously in this report, is already negative in net terms to the tune of more than 2.5 trillion dollars. Regardless of how much less the United States pays its creditors than what is received as a lender, the income account will end up inverting and will add to the current account deficit.

In our opinion, this trend is simply unsustainable. The reason is that element economic laws say so. Maybe the United States can ignore them for a while, but not forever.

Therefore, the only way to finance a growing deficit is to raise interest rates considerably, which would seriously hinder economic growth, reducing imports... and thus tending to eliminate the foreign deficit. Likewise, this permanent deficit will continue to push down the value of the dollar, generating inflation, which would also force monetary policymakers to take more restrictive measures. In addition, the weakness of the dollar would stimulate exports... and tend to eliminate the foreign deficit. However, a structurally weak US dollar would seriously compromise the economic leadership of the United States and the advantages this has for the country.

In these circumstances, there are only two alternatives left for the US public and private sector: firstly, to make the most of the current crisis to restore the equilibrium between savings and

investment, between spending and production and in foreign trade.

Secondly, to continue in the same direction as the last few years. The result: rising interest rates, a falling dollar, a declining economy and the end of worldwide economic leadership.

Time will tell.

Vicente J. Pallardó.
OCEI Director

Valencia, 30 de mayo de 2008

Table 1

Oil Imports and their Impact on the Trade Balance

Year	Oil Imports (in millions of barrels)	Annual Growth Rate (%)	Price per Barrel (\$)	Annual Growth Rate (%)	Value of Imports (in millions of \$)	Annual Growth Rate (%)
2000	3399	5.3	26.4	67.8	89876	76.6
2001	3471	2.1	21.4	-19.1	74293	-17.3
2002	3418	-1.5	22.6	5.7	77283	4.0
2003	3676	7.5	27.0	19.3	99167	28.3
2004	3821	3.9	34.5	27.8	131743	32.8
2005	3753	-1.8	46.8	35.7	175563	33.3
2006	3734	-0.5	57.8	23.5	215825	22.9
2007	3691	-1.2	64.2	11.1	236962	9.7
<i>2007 (Jan Mar)</i>	<i>- 897</i>	<i>-1.1</i>	<i>52.1</i>	<i>-1.1</i>	<i>46730</i>	<i>-2.2</i>
<i>2008 (Jan Mar)</i>	<i>- 887</i>	<i>-1.1</i>	<i>86.1</i>	<i>53.6</i>	<i>76406</i>	<i>52.5</i>

Year	Change in Trade Deficit (in millions of \$) <i>[the minus sign denotes an improvement in the trade balance]</i>	Change in cost of Oil Imports (in millions of \$)	% Change in Trade Balance due to Oil Imports
2000	115092	38976	33.9
2001	-15652	-15583	99.6
2002	59043	2990	5.1
2003	74773	21884	29.3
2004	121072	32576	26.9
2005	106036	43820	41.3
2006	48537	40289	83.0
2007	-56752	21137	-
<i>2007 (Jan – Mar)</i>	<i>-10924</i>	<i>-42</i>	0.4
<i>2008 (Jan - Mar)</i>	<i>83</i>	<i>29676</i>	35754.2

Source: own elaboration with data from the US Census Bureau

Table 2

Breakdown of US Foreign Trade Balance by Main Trading Partner

		Current Account	Trade Balance	Income Account	Current Transfers	Net FDI *	Exchange Rate **
Euro Area	2000-2003	-164.5	-230.8	73.6	-7.3	77.4	20.6
	2004-2007	-276.8	-345.1	88.6	-20.4	-42.7	15.9
Rest of EU	2000-2003	-105.0	-34.5	-85.8	15.3	107.7	6.3 ***
	2004-2007	-108.3	-62.6	-52.7	7.0	130.0	11.1 ***
Japan	2000-2003	-324.1	-242.4	-82.4	0.7	19.7	-1.7
	2004-2007	-395.7	-271.7	-129.1	5.1	79.4	-5.6
China	2000-2003	-418.4	-387.1	-25.8	-5.6	0.06	0
	2004-2007	-941.6	-841.3	-92.5	-7.8	0.3	10.3
Canada	2000-2003	-114.0	-187.9	76.2	-2.3	48.1	9.4
	2004-2007	-158.4	-306.0	79.9	-0.9	93.0	25.5
Mexico	2000-2003	-163.1	-122.1	-5.9	-35.2	8.9	-19.1
	2004-2007	-259.3	-218.7	3.3	-44.0	2.7	1.3

Notes: Data in millions of dollars in the first five columns.

A negative sign in the first four columns indicates a deficit for the United States.

* Balance of net US FDI inflows and outflows by destination.

** Bilateral exchange rate of the dollar with respect to the currency of the destination region in question (a positive sign denotes a depreciation of the dollar). Change in the average exchange rate in the first and last quarter of the period.

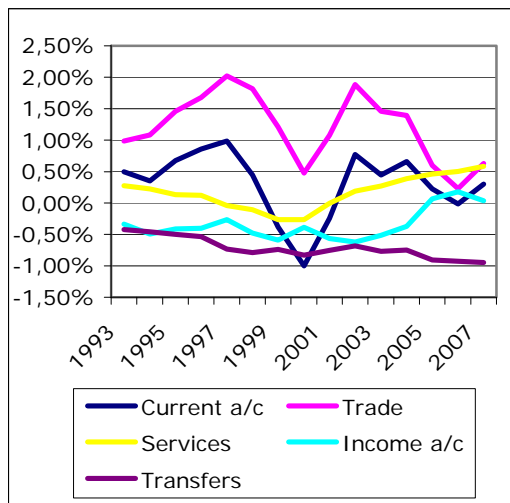
*** Trend with respect to the pound sterling.

2.-EUROZONA

1 Current Account Almost Always Displays a Surplus

The Euro-zone almost always records a current account surplus. Over the period dating from 1993 to 2007, the trend was favourable in most years with an average surplus over the entire period of 0.3% of GDP. There have been three consecutive years in which deficits were recorded – 1999, 2000 and 2001 – while the last deficit was recorded in 2006 and estimated at 0.02% of GDP.

Figure 1: Current Account Balance (% of GDP) and Items



Source: ECB

When analysing the relationship between the current account balance and its sub-items, foreign trade, trade in services, income and transfers, the trend in the former is seen to be intimately linked to foreign trade. In fact, the correlation between the two stands at 0.7, far from the rest of components that make up the current account.

In addition, not only does the trade balance explain the trend in the current account quite accurately, but also on

average it has the greatest weight in relation to the rest of components (1.2% of GDP) and has always registered a surplus. Transfers have always displayed a deficit which has almost doubled since 1993, but remain the least volatile of all the current account sub-balances. The income account has, on average, recorded deficits, although this trend has been bucked since 2005. Finally, trade in services, which on average has recorded a surplus over the period, has improved a great deal since 2004 and now displays a surplus of 0.58% of GDP.

Table 1: Correlation between Current Account and its Components

Trade	0.7
Services	0.37
Income	-0.02
Transfers	0.4

Source: own elaboration

The current account may in theory have been influenced negatively by the existence of a budget deficit, investment and above average interest rates and also by a tendency towards consumption in the present and positively by global and above average economic growth. Empirically, the variables that appear to have had the greatest impact on the result of the current account in the United States are excess investment and excess budget deficit.⁵

In the Euro-zone, the variables that have affected the current account favourably include growth in world trade and negatively, the price of oil

⁵ CDC-Ixis Flash 40-2006 "Factors that determine current account balances: A theory based on an analysis of external solvency ratios. P. Artus

(Brent) and growth in domestic demand.

Table 2: Current Account Balance and Components (% of GDP)

CURRENT ACCOUNT BALANCE		
	1993	2007
Trade	0.98%	0.63%
Services	0.27%	0.58%
Income	-0.34%	0.03%
Transfers	-0.42%	-0.95%
Current a/c Balance	0.5%	0.30%

Source: ECB and own elaboration

2 Euro-zone Still a Trade Super Power

Developed countries on the whole have lost ground in international trade in favour of emerging economies over the period dating from 1999 to 2006. While total exports from the Euro-zone, United States, Japan and Canada represented 57.9% of international trade in 1999, the figure dropped to 45.3% in 2006. Meanwhile, China (excluding Hong Kong) has more than doubled its share of the market following a more than six-point rise over the same period. Nevertheless, the Euro-zone is still the world's largest trade super power.

The Euro-zone, despite losing ground over this period (two points), is still clearly the world's largest exporter with a share of 20.7%, after maintaining a quota of around 22% over the period dating from 1993 to 1999. In contrast, US exports suffered the greatest setback over this period.

This loss of share cannot be attributed to an unfavourable trend in exports throughout the period, but rather to the emerging nations bursting onto the international scene. The weight of exports in relation to GDP has risen remarkably over the last few years.

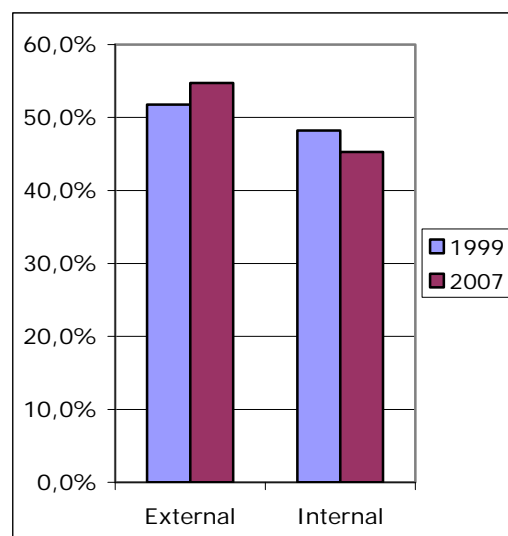
While in 1993 the figure stood at 9.7%, in 2007 it was nearly double that, at 17%. Euro-zone openness, that is, the sum of exports and imports over GDP, has also almost doubled, reaching 33.6% in 2007.

Table 3: World Export and Import Shares

% OF WORLD EXPORTS		
	1999	2006
Euro-zone	22,8	20,7
USA	18	12,3
Canada	6,2	4,6
China	5,1	11,5
Japan	10,9	7,7
% OF WORLD IMPORTS		
	1999	2006
Euro-zone	20,7	19,6
USA	26	21,5
Canada	5,3	3,9
China	4,1	8,9
Japan	7,6	6,5

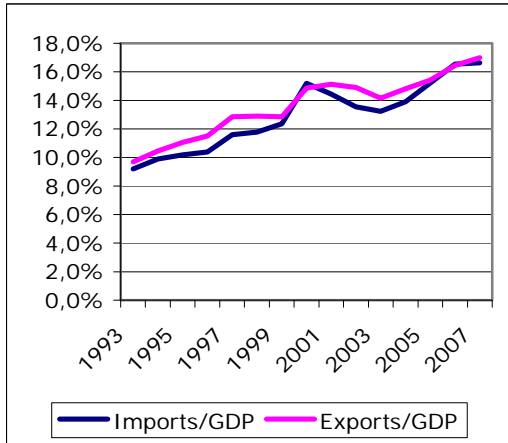
Source: Eurostat and own elaboration

Figure 2: External and Internal Euro-zone Trade



Source: ECB and own elaboration

Figure 3: Euro-zone Exports and Imports over GDP (external transactions)



Source: ECB and own elaboration

As regards exports of goods and services, the Euro-zone has exported less internally than abroad. However, despite internal exports increasing, the gap between these two variables has broadened and is now estimated at nearly 9% - 54.7% external and 45.3% internal. The reason for this is that the weight of Euro-zone exports abroad in terms of GDP has almost doubled over the period under consideration.

Notwithstanding, intra-European trade still enjoys a greater share than the rest of regions – Europe 66%, United States 55% and Asia and Australasia 49%⁶.

3 Constant Trade Surplus, but Fluctuating

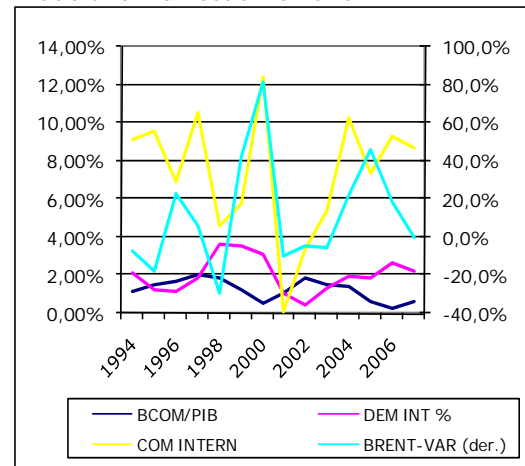
As indicated above, the current account balance has been greatly influenced by the trend in trade. While the trade balance has recorded surpluses throughout the entire period, there have been many ebbs and flows. On average, the trade balance has recorded a surplus equivalent to 1.2% of GDP. The variables that have primarily worked against this trend include the upturn in domestic demand

⁶ Flash 483-2007 Natixis. Patrick Artus

and the price of oil – imports. On the positive side, the surplus has been boosted by growth in international trade.

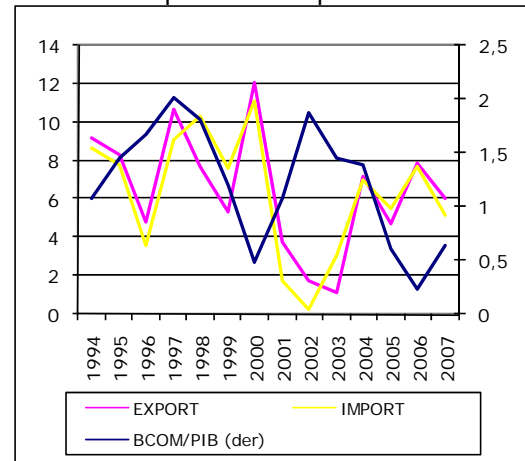
The two most significant falls over the period occurred in 2000, following a marked rise in oil prices (81.3%) and strong growth in domestic demand (3.1%) and in 2005 and 2006, when the trade surplus was cut in half due to another increase in oil prices (42.7% and 18.6%) and in domestic demand in 2006.

Figure 4: Trade Balance (%), Change in Brent and Real Growth in International Trade and Domestic Demand



Source: ECB and Reuters

Figure 5: Trade Balance (% GDP), Real Growth in Exports and Imports



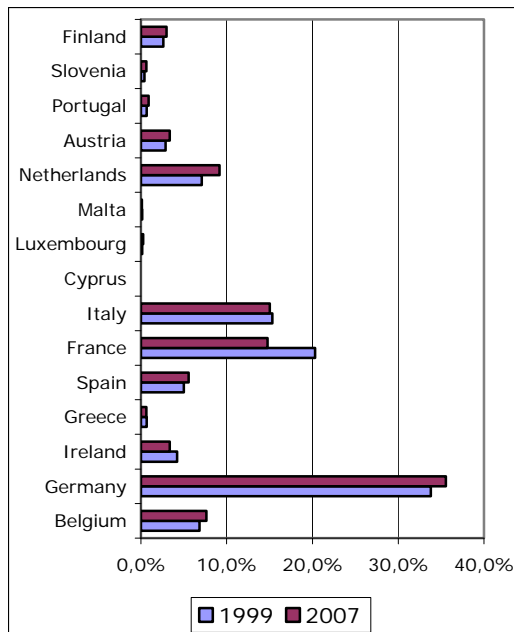
Source: ECB and Eurostat

Exports and imports have both recorded favourable trends over the last two years, in relation to the period dating from 2000 to 2003. Exports and imports have grown in real terms over the last four years by an average of 6.5% and 6.4% respectively.

4 Euro-zone Foreign Trade not Uniform

If foreign trade data for the Euro-zone is broken down to country level, the region's largest exporter is Germany (35.6%) followed some distance back by Italy (15%) and France (14.9%). Germany has increased its overall share of exports by two points over the period dating from 1999 to 2007, while France has lost five points.

Figure 6: Country by Country Share of Euro-zone Exports



Source: Eurostat and own elaboration

In general, exports and imports rose strongly over the period under study and both gained ground in terms of GDP, rising by approximately eight points in both cases to around 41.1%

of GDP in the case of exports and 39.7% in the case of imports.

Within the Euro-zone, exports have risen most in Germany, Slovenia, Luxembourg, Austria and Ireland.

When comparing exports to GDP, the size of the economy in question also comes into play. Exports from small countries such as Luxembourg, Malta, Slovenia, the Netherlands and Belgium register high percentages of GDP in relation to other Euro-zone countries.

As regards intra and extra-European exports by country, over the 1999-2007 period, the former have lost approximately one point (68.1% of the total) in favour of extra-EU exports and two points in intra-European Union imports (64.3%). As regards intra-European exports, almost all countries have seen their share drop, with the exception of Cyprus, where a marked rise was observed (13%) and Malta and Luxembourg, with small increases of less than 1%.

Some countries in the Euro-zone tend to trade much more within the Union than others where the opposite occurs. Belgium, Luxembourg and Portugal export around 80% of their goods and services to the Union, while Malta and Finland export only 50%. In terms of imports, Austria and Portugal receive around 80% from Europe, while Italy and the Netherlands purchase between 50% and 60%.

Table 4: Euro-zone Exports to the EU by Country

% of TOTAL EXPORTS TO THE EU		
	1999	2007
Belgium	78,7	76,6
Germany	65,5	64,8
Ireland	67,3	63,6
Greece	66,5	64
Spain	73,6	69,9
France	65,3	65
Italy	64	60,1
Cyprus	58,4	71,8
Luxembourg	87,7	88,6
Malta	49,1	49,6
Netherlands	82	78
Austria	76,3	72,5
Portugal	84,2	76,7
Slovenia	73,7	69,3
Finland	65,4	56,8
EU27	69,1	68,1

Source: Eurostat and own elaboration

As regards the trade balance, apart from the surplus recorded in 2007 (28,500 million Euro), the Euro-zone also registered an average surplus of 36,100 million Euro over the period from 1999 to 2007. Five out of the 15 countries that make up the Euro-zone contributed to this surplus (Germany, Belgium, the Netherlands, Finland and Ireland) while Italy was more or less in equilibrium.

5: Geographical Distribution of Euro-zone Exports and Imports by Type of Good

The Euro-zone as a whole has recorded constant trade surpluses. Exports are mainly bound for the United Kingdom (15.2%) and the United States (12.9%), although the latter have lost more than eight points with respect to total exports over the period in favour of Eastern European nations, which together would undoubtedly constitute Europe's main customers, and China.

Figure 7.1: Destination of Euro-zone Exports (%)

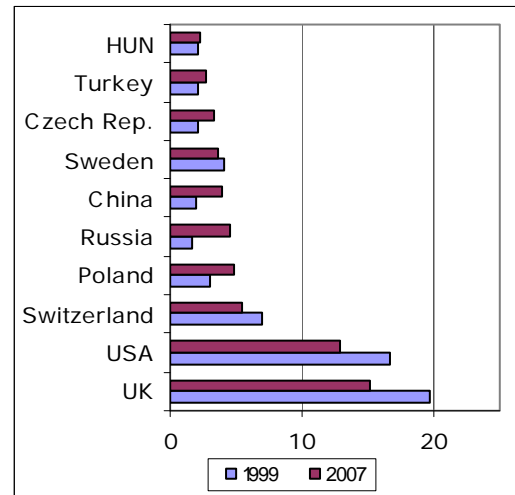
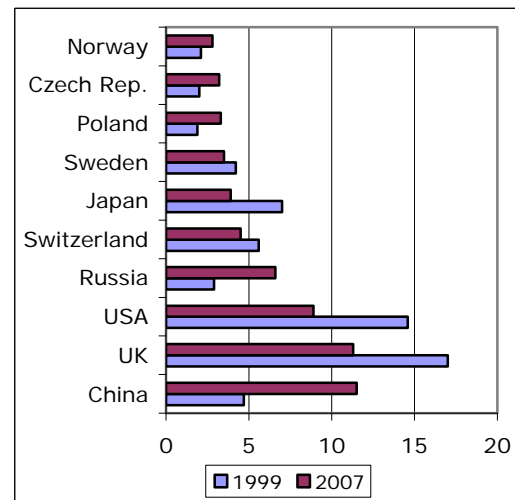


Figure 7.2: Origin of Euro-zone Imports



Source: Eurostat

On the import side, the Euro-zone's primary supplier is China (11.5%), which has increased its share of total imports by nearly 7%, followed by the United Kingdom (11.3%) and the USA (8.9%), both of which have lost nearly six points of their share at the beginning of the period. It is worth highlighting imports from Russia (6.6%), with a nearly four-point increase in market share.

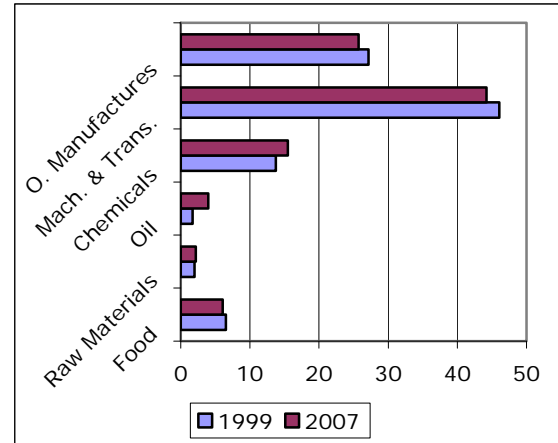
As regards the trade balance by country in relation to the Euro-zone, we can underline that large surpluses are observed with both the United States and the rest of European countries, particularly the United Kingdom, while deficits are recorded with China, Russia and Japan.

By type of good, the Euro-zone mainly exported machinery and transport equipment (44.21%), other manufactured goods (25.7%) and chemical products (15.5%). As regards imports, once again machinery and transport equipment (32.8%) and other manufactured goods (26.5%) figured prominently, but it is worth highlighting that oil products represented 19.7% of total imports, almost 10 percentage points more than in 1999.

If we analyse the trade balance by type of good in the European Union, whether a surplus or a deficit is registered depends on the sub sector in question.

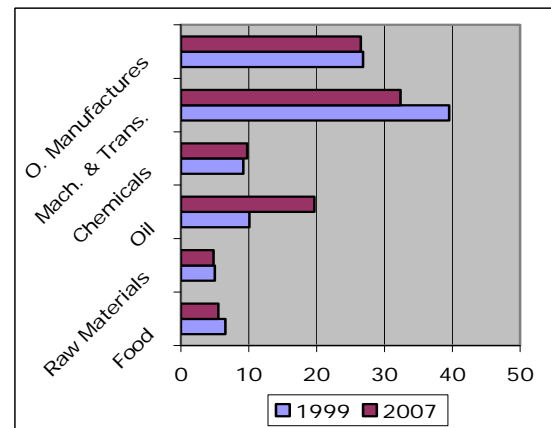
In the case of food, beverages and tobacco, a deficit is recorded (13,390 million Euro). Surpluses are observed in grain, fruit and vegetables, tobacco and beverages, while meat products among others display deficits. The primary producers in the Euro-zone are the Netherlands, Germany, France, Spain and Italy, while a large amount of imports are required from Brazil and Argentina.

Figure 8.1: Euro-zone Exports by Type of Good



Source: Eurostat

Figure 8.2: Euro-zone Imports by Type of Good



Source: Eurostat

As regards non energy raw materials, the trade balance is also negative. The largest deficits are registered with the United States, Brazil and Canada.

In the sub sector of oil products the Union also displays a clear deficit. Energy is the main sector in which Europe has an increasingly significant deficit. This sector has almost doubled its share of imports between 1999 and 2007. Europe's primary importers are Russia, Norway and Libya.

In the chemicals sector, the EU enjoys a trade surplus. Despite the strong

competition, particularly from Asia, European companies, mainly in Germany, Austria, the Netherlands, Belgium and France, and more recently Ireland and Finland are faring well. The largest surpluses are recorded in the case of the United States, Russia and Turkey.

The EU also registers a marked trade surplus in machinery and transport equipment. As regards machinery, Europe mainly exports engines, computers, aeronautics and equipment for construction and other public works. The strongest countries in this sector are France, Germany, Italy and Spain. The largest surpluses are recorded with the United States, Russia and Norway, while the EU strikes up a significant deficit with China and Japan. Finally, other manufactured goods also displays a significant deficit. Firstly, textiles, a sector where competition from Asian countries has resulted in Europe's share of the market dropped to around 50%. The main European exporters are Germany, France and Italy.

As regards Electronic goods, Asian countries generally dominate the market, while Europeans concentrate on precision instruments, Computers and telecommunications equipment.

The largest deficit in other manufactured goods is with China, followed well back by Turkey and India. However, the largest surplus is registered in trade with the USA.

6 Trade in Services and Income

The surplus in trade in services in 2007 was double that recorded in 1993 and now represents 0.58% of GDP, having improved constantly since 2002.

Cuadro 5 Balanza de servicios en miles de millones de euros

	1996	2007
Royalties	-7,7	-15,7
Transport	0	13,4
Travel	4,7	11,6
Business	-0,7	12,2
Recreation & Culture	-3,5	-3,3
Governmental	4,7	6,1
Communications	0,1	-0,3
Construction	4,6	8
Insurance	0,5	0,2
Financial Services	0,5	9
Computers	0	13,8
TOTAL	3,2	55

Source: Eurostat

By type of service, the sectors that most contributed to the overall surplus were computer services (13,800 million Euro), business (12,200 million), travel (11,600 million) and financial services (9,000 million), all of which have improved substantially since 1996. In contrast, royalties and licence fees are the most negative sector, detracting 15,700 million Euro from the overall surplus.

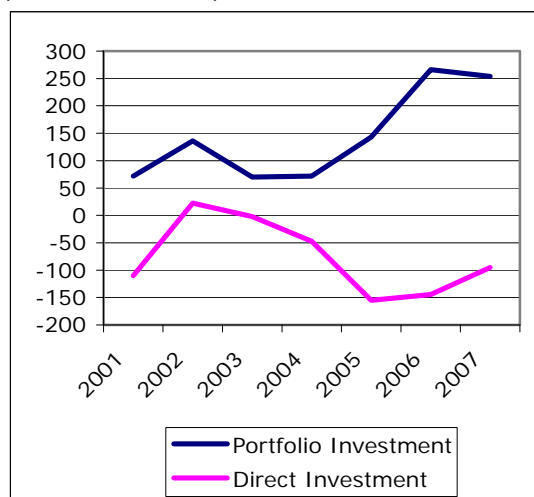
As regards the income account, a surplus has been recorded since 2005, albeit relatively small in comparison to other sub items. On the direct investment side, in both shares and debt, net profits have been achieved. However, on the side of income generated through portfolio assets, there is an outflow of income due to shares and net inflows on the debt side. As far as wages are concerned, the net result is also positive.

7 Euro-zone Financial Account

Over the period dating from 1997 to 2007, except for 2000 and 2001, the sum of the current account balance and the capital account has always been positive, which means that the Euro-

zone is a net moneylender to the rest of the world. Over the past year, the surplus in this account amounted to 40,500 million Euro.

Figure 9: Direct and Portfolio Investment (in billions of Euro)



Source: ECB

However, the financial account has boasted a surplus since 2005, which means more capital has entered the Euro-zone than has been invested abroad, which contradicts the Euro-zone's status as a net moneylender to the rest of the world. This anomaly is offset statistically by the section devoted to errors and omissions.

Table 6: Financial Account (outstanding amounts in billions of Euro)

FINANCIAL ACCOUNT	2007
Investment by Residents	-4730,9
Shares	-2049,6
Fixed Income	-2681,3
Long Term Fixed Income	-2277,6
Monetary Assets	-403,7
Investment by Non Residents	6705,1
Euro-zone Shares	3232
Fixed Income	3473,1
Long Term Euro-zone Fixed Income	3129,7
Euro-zone Monetary Assets	343,4
Portfolio Investment	1974,2
<i>Summary of Instruments</i>	
Shares	1182,4
Fixed Income	791,8
Bonds	852,1
Monetary Assets	-60,3
Direct Investment	-440,5
Shares	-3428,3
Liabilities	2987,8
Other Investment (Loans)	203,8
Assets	-5156,3
Liabilities	5360,1
DERIVADOS FINANCIEROS	45,1
Reserve Assets	347,3
Gold	201
Deposits and Currencies	29,6
Shares	0,4
Bonds	87,7
Money Market	20,4
IMF & GED	8,2

Source: ECB

Direct investment, which has been channelled more to capital shares than to inter-company loans has practically always recorded a net deficit (94,000 million Euro in 2007), which is the same as saying that residents are always investing more abroad than foreign direct investment in the Euro-zone. The balance has risen quite significantly since 2003. Albeit exceptional, in 2000 direct investment on behalf of non

residents in the Euro-zone did jump up due to the large number of mergers and takeovers that appeared on the scene.

In contrast, regarding portfolio investment, there has been more foreign investment in the Euro-zone than local investment abroad and this imbalance has grown markedly since 2004 (253,900 million Euro in 2007). The net positive balance in portfolio investment has almost always exceeded the negative balance in direct investment. Within portfolio investment, the most important item has been investment in fixed income and the Money market.

Table 7: Breakdown of Reserves (%)

Reserves	2007
Gold	57,88%
Deposits and Currency	8,52%
Shares	0,12%
Bonds	25,25%
Money Market	5,87%
DEG & IMF	2,36%

Source: ECB

In theory, emerging nations with low capital per capita should have received a large amount of transfers from developed countries. However, the exact opposite has occurred. Excess saving over investment in emerging countries such as China, Russia, the OPEC and Latin America has flowed to advanced nations, largely bound for the bond market. This is mainly due to the former enjoying less technology and human capital and their prudence in order to generate a foreign surplus following their experience of the crises suffered between 1998-2001⁷.

⁷ CDC-Ixis Flash 2006-183 "An anomaly: The opening of trade of goods and capital between advanced countries and emerging countries should lead to a rise in real interest rate in advanced countries, instead of fall" P. Artus

The appeal of the Euro to non residents, reflected by the massive acquisition of Bonds and shares in this currency, due to its quality and a lack of imbalances, is resulting in the European currency increasing assuming the role as the international reserve currency. At the end of the second quarter in 2007, 25.6% of official central bank reserves were in Euros, a full seven percentage points more than in 1999 which now make it the second most important currency in the world.

As regards other investments (loans), a the balance is also positive (58,900 million Euro in 2007). However, the deficit in financial derivatives is strikingly about 10 times larger than in the last few years (110,100 million Euros in 2007).

If we take into account outstanding assets and liabilities at the end of 2007, direct investment abroad registers a net surplus of 440,500 million Euro, foreign portfolio investment in the Euro-zone a net surplus of 1.97 trillion Euro, mainly in bonds and Money market assets, and foreign loans to the Euro-zone a net surplus of 203,800 million Euro.

In relation to reserves, total value has risen constantly over the last few years to 347,300 million Euro at the end of 2007. Gold accounts for 57.9% of reserves, despite this share dropping in recent years, while bonds are increasing their share which currently amounts to 25.3% of total reserves.

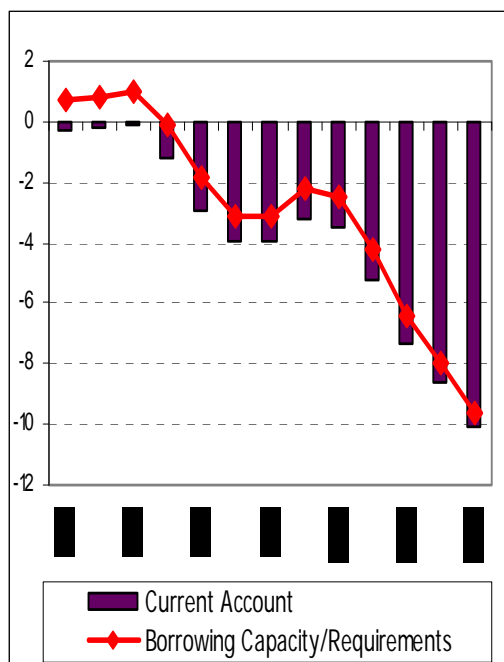
Valencia, 4 de junio de 2008
Nicolás Jannone

3.-ESPAÑA

Foreign Trade – Dramatic External Indebtedness

One of the features of the expansion that is currently drawing to a close has been the drastic downturn in the external sector in recent years. Figure 1 shows how the current account deficit has increased above and beyond 10% of GDP, while borrowing requirements (the overall balance of the current and capital accounts) rose to 9.6% of GDP, slightly more than 101,000 million Euros in 2007.

Figure 1: Current Account and Borrowing Capacity/Requirements over GDP



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

Net external indebtedness has grown dramatically since 2003, when this variable represented only 2.5% of GDP.

Spain has borrowed from abroad due to the inability of domestic savings (relatively high in aggregate terms) to finance investment in Spain over the

last few years, which has exceeded 30% of GDP.

In this special report on foreign trade, we are going to analyse two issues. In the first place, the origin of the deficit, by examining the various items in the current account. In the second place, we will analyse how this borrowing is financed, which is particularly important during the current financial crisis with restricted liquidity which could effectively curb economic growth.

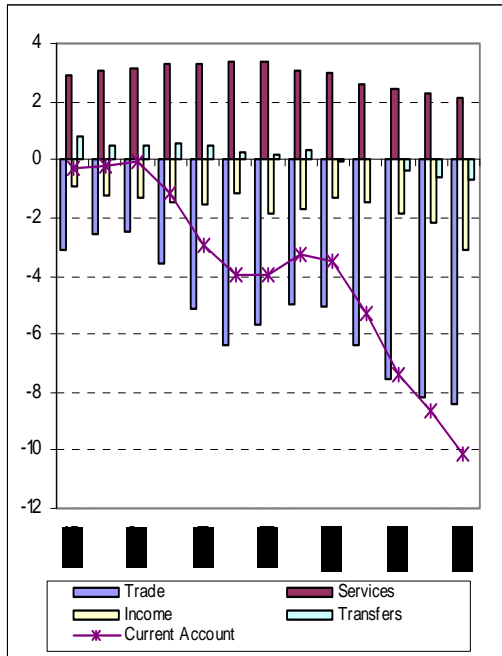
In order to tackle these two issues, we will analyse the balance of payments and the various items therein (current account, capital account and financial account).

a) Current Account – Marked Increase in Deficit since 2003

Since the Spanish economy began to internationalize and become increasingly integrated in the worldwide economy, a mounting foreign trade deficit (that is, payments for imports exceed income through exports) has been one of the characteristics that has marked this process (Figures 2 and 3). Furthermore, during expansions, the trade deficit has increased due to Spain depending on capital goods from abroad in order to sustain economic growth and also to meet strong domestic consumption. During the period in which raw material prices, particularly oil, soared the trade deficit also increased due to the upturn in (energy) imports as a result of Spain being highly energy dependent.

Over the last few years of rapid economic growth, the trade deficit has expanded remarkably, evidencing that Spain has a serious problem of competitiveness.

Figure 2: Current Account Balance and Items (% of GDP)



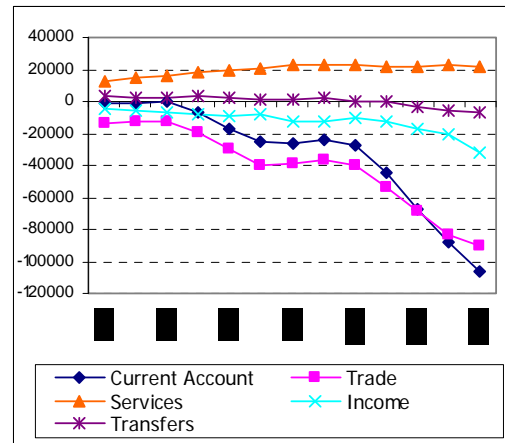
Source: own elaboration with data from INE and Banco de España

Spain's perennial trade deficit has traditionally been offset by income through tourism and current transfers (together with capital inflows). As a result, the current account deficit had always been smaller than the trade deficit. However, this trend has been bucked in recent years due all the other sub items in the current account deteriorating. While the surplus in trade in services has stagnated, the balances in income and transfers have worsened (Figures 2 and 3). Consequently, the current account deficit exceeded the trade deficit in both 2006 and 2007.

The trend observed in the income account can be almost entirely attributed to income from investment (rather than from labour). The income account has registered a deficit throughout the sample period that has grown over the last few years as Spain has become less of an international net

investor due to the increasingly high current account deficits. As a result, the income account deficit amounted to some 24,300 million Euros in 2007.

Figure 3: Current Account Balance and Items (in millions of €)



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

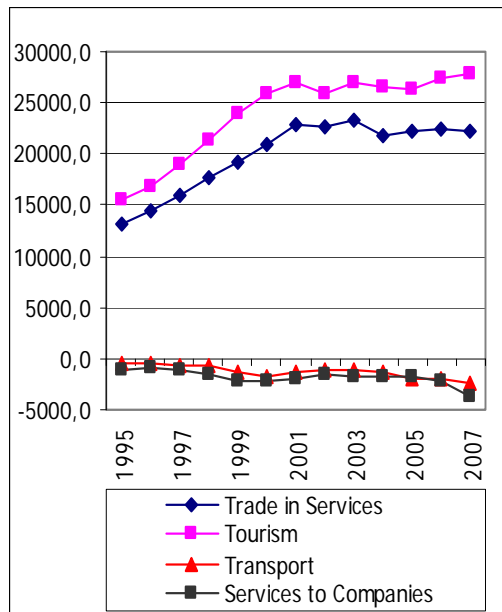
Furthermore, the balance in current transfers has deteriorated over the period and has been "in the red" since 2003. The situation in this account has worsened as a result of the weak increase in income, which has doubled, while payments have increased by 4.5 times due to the increase in immigrant remittances, which se from 361 to 8130 million Euros over the period dating from 1995 to 2007⁸. It is also worth highlighting the moderate rise in income from the EU (FEOGA-Guarantee and European Social Funds), which was outpaced by payments to the EU.

Growth in Services Surplus Stagnates

As can be appreciated in Figure 4 below, the surplus in trade in services rose strongly up to 2001 to later stabilise and even decrease.

⁸ Over the same period, income stemming from migrant remittances rose from 1,946 to 5,305 million Euros.

Figure 4: Trade in Services and Main Items (in millions of €)



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

The graph above shows how the trend in services resembles that in tourism, which has recovered some buoyancy over the last two years. Over the period under consideration, growth in tourism income has dropped substantially in the last few years (from an average growth rate of 10.4% between 1996 and 2001 to 3.6% between 2002 and 2007), while payments have increased markedly (by around 12-13% over 1996-2007). The increase in the overall surplus in 2006 and 2007 was due to the increase in payments slowing down. The other two items that make up trade in services in the graph (transport and services to companies) both display a downward trend.

Análisis de la balanza comercial

In the next section, we will analyse the trade balance (by region and product), which, as can be observed in Figures 2 and 3), is a highly important component of the current account.

1. By Region

Table 1 displays the geographical distribution of Spanish trade in goods in terms of both exports and imports, as well as the export/import ratio and the deficit in 2007.

Table 1: Trade Balance by Geographical Region in 2007

	Imports	Exports	[1]	[2]
Total	100.0%	100.0%	64.7%	100.0%
Euro-zone	49.3%	55.9%	73.4%	37.1%
- Germany	15.2%	10.8%	46.0%	23.2%
- France	12.2%	18.6%	98.7%	0.4%
- Italy	8.7%	8.5%	63.3%	9.0%
United Kingdom	4.7%	7.5%	103.4%	-0.5%
OECD	70.4%	80.2%	73.6%	52.6%
- USA	3.5%	4.2%	76.2%	2.4%
- Japan	2.2%	0.7%	22.0%	4.8%
OPEC	7.5%	2.9%	25.1%	16.0%
China	6.7%	1.1%	11.1%	16.8%

Source: own elaboration with data from Customs Statistics and Banco de España

[1] Export/import ratio

[2] Distribution of Trade Balance by region (%)

The global export/import ratio stands at 64.7%, that is, income derived from goods exports only represents 64.7% of payments through imports of goods. As a result, Spain has a substantial trade deficit. In addition, the import-export ratio has declined steadily over the last few years (in 1995, for example, it was 79.8%).

Another aspect that is worthy of mention is how a high percentage of trade is carried out with a small group of countries, particularly where exports are concerned. In this sense, 60% of exports are bound for Euro-zone countries, 38% of which went to Germany, France and Italy. If we add the United Kingdom, these four countries account for 45% of total exports. Finally, 80% of exports are bound for the OECD.

Moving on, Spanish imports are slightly more diversified than exports. OECD countries are the origin of 70% of total imports. Within imports, the significant

share that correspond to oil exporters stands out (OPEC), together with the increasingly important role as a supplier of goods played by China (China's share of total Spanish imports has trebled since 2002), even surpassing the United States and the United Kingdom. In the Euro-zone, it is worth highlighting Germany's importance as a supplier of goods.

The export/import ratio by country/region is generally below 100 (except in the case of the United Kingdom). It is worth highlighting that the export/import ratio with the Euro-zone is only 73.4%, bearing in mind how deregulated trade flows are among these countries, together with the fact that exchange rates cannot explain any fluctuations in the trade balance. Moreover, the export/import ratio with the Euro-zone has fallen by 17% since 1995, a clear reflection of how Spain has become less competitive.

Finally, the last column in Table 1 displays each region/country's share of the trade deficit. More than half of the trade deficit can be attributed to trade with OECD countries (although this percentage has decreased over the last few years), while the Euro-zone is responsible for 37.1% (and rising in recent years). It is particularly striking that Spain's trade deficit with China represents 16.2% of the total, exceeding the share of OPEC countries. Meanwhile, the trade deficit with Germany represents 23.2% of the overall deficit.

2. By Good

Table 2 illustrates how Spain clearly tends to trade in traditional consumer goods (which represent 35.7% of exports) such as food (and also leather, footwear, furniture, etc.) and other

consumer goods such as motor vehicles.

Table 2: Trade Balance by Good (%)

	Imports		Exports		[1]		[2]	
	1995	2007	1995	2007	1995	2007	1995	2007
Total	100	100	100	100	79.8	64.7		
Consumer	24.6	27.4	42.5	35.7	137.8	84.2	-46.0	12.3
- Food	7.7	5.6	13.3	11.6	136.9	133.1	-14.1	-5.3
- Cars	5.2	7.5	16.8	11.3	256.3	97.9	-40.5	0.4
Intermediate	56.6	47.1	46.8	50.7	65.9	69.7	95.5	40.4
Capital	11.2	10.6	9.4	9.2	67.3	56.4	18.1	13.1
- Machinery	7.3	6.8	5.3	4.1	57.7	39.5	15.3	11.7
- Transport equipment	1.9	2.2	3.3	4.4	138.1	129.4	-3.6	-1.8
Non energy	91.6	85.1	98.4	95.6	85.7	72.7	64.9	65.8
Energy	8.4	14.9	1.6	4.4	15.1	18.9	35.1	34.2

Source: own elaboration with data from Customs Statistics and Banco de España

[1] Export/Import Ratio

[2] Trade Balance by Region (%).

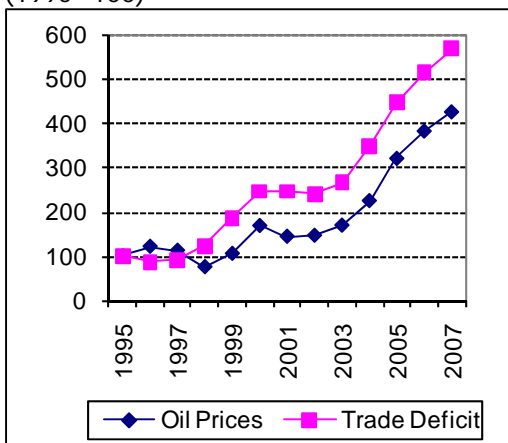
However, the share of traditional consumer goods has gradually diminished over the last few years in favour of intermediate goods, while the share of capital goods has remained unchanged. It is worth highlighting the remarkable decrease in the export/import ratio in consumer goods and the even more spectacular fall in cars, which is probably related to Spain losing cost competitiveness and also echoes the offshoring of production in Spain to other countries where costs are lower (for example, in Eastern Europe) in the last few years. In contrast, Spain is becoming increasingly specialised in intra-industry trade, although the export/import ratio is quite low (69.7% in 2007). This variable explains 40% of the trade deficit. Over the last few years, changes are occurring in Spain's specialisation pattern, shifting from sectors that a more factor-endowed (natural/labour factors) to sectors in which technology plays a more important role (economies of scale, product differentiation).

Spain is also highly dependent on intermediate goods from abroad,

particularly equipment, where exports only represent 60% of imports. The export/import ratio for capital goods has decreased in recent years to 56.4% in 2007. Spain is extremely dependent on foreign machinery and this situation appears to have accentuated over the last few years in which economic growth has boomed in Spain.

The two last rows in Table 2 illustrate Spain's enormous dependence on energy products, which are responsible for a third of the overall trade deficit. Consequently, if oil prices remain high, bearing in mind that they appear to be directly related to the trade deficit, as Figure 5 suggests, the trade (and current account) deficit could continue to grow over the next few months. Nevertheless, the marked slowdown in domestic demand will undoubtedly mitigate the effect of oil on the trade deficit.

Figure 5: Trade Deficit and Oil Prices (1990=100)



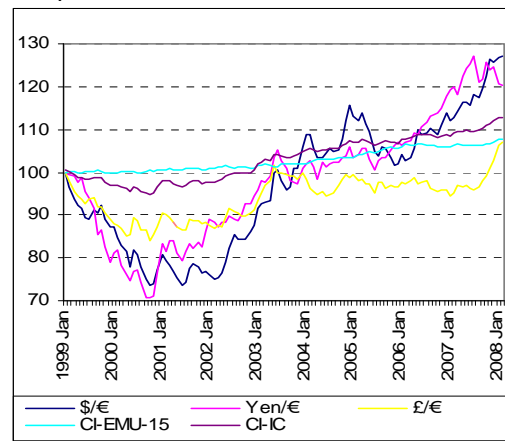
Source: own elaboration. Oil prices: \$/Barrel of Brent (Financial Times). Trade deficit in millions of Euros and Euro/\$ exchange rate (Banco de España)

The Euro has registered an upward trend since the beginning of 2002 (particularly against the US dollar and the yen) as can be observed in Figure 6, which despite curbing the deterioration of the energy account

(above all in recent months) may have contributed (at least initially) to the foreign trade deficit.

However, despite the recent appreciation of the Euro, the exchange rate cannot be attributed a great deal of blame for the trade deficit in light of Spain's trade exchanges becoming increasingly concentrated in the Euro-zone. In this sense, Figure 6 shows how Spain has lost competitiveness in relation to other Euro-zone countries.

Figure 6: Exchange Rate Trends with respect to the Euro (Jan-99=100) and Competitiveness (Q1-99=100)



Source: own elaboration with data from Banco de España

CI: Competitiveness Index with respect to the Economic and Monetary Union-15 (CI-EMU-15) and Industrialised Countries (CI-IC). Competitiveness indexes calculated with manufacturing producer prices. An increase denotes a loss of competitiveness

Obviously, the continuous loss of competitiveness is one of the most serious problems faced by the Spanish economy.

The mounting foreign deficit is largely as a result of the loss of competitiveness mentioned previously rather than oil prices or the exchange rate. As indicated in previous reports, modest growth in productivity, the rigidities in factor and product markets

and the marked rise in prices explain this situation. Notwithstanding, the marked slowdown in domestic demand can be expected to level out the increase the foreign trade deficit.

From a macroeconomic perspective, the current account deficit stems from domestic demand not being met by national production or from domestic savings not being able to finance investment.

The Spanish economy has recorded high growth rates over the last few years, considerably outpacing other countries in the region. Growth has been based on the upturn in domestic demand, which boosts imports. Furthermore, the low growth in nearby countries has not helped to increase exports.

Having a current account deficit implies that part of (the level of) domestic current expenditure is financed by means of foreign savings (loans or investments from the rest of the world), which will have to be offset in the future. That is, the Spanish economy is capturing resources (savings) from abroad.

One issue that having a current account deficit entails is that related to the use of resources from the rest of the world. As regards the efficient inter-temporal assignment of resources at international level, one could argue that the Spanish economy may be an attractive destination for excess world savings. As a result, current profitable investment can provide high yields for paying international investors while also, at least potentially, allowing Spain to increase its productive capacity, productivity and competitiveness in the long term. However, the high rate of investment in Spain (largely residential

investment) has not as yet substantially boosted productivity.

Another important issue that arises as a result of having a large and persistent current account deficit is whether or not this situation can be sustained in the long term. This issue is particularly important bearing in mind the current scenario of financial turmoil and limited liquidity on the international scene that could effectively restrict economic growth.

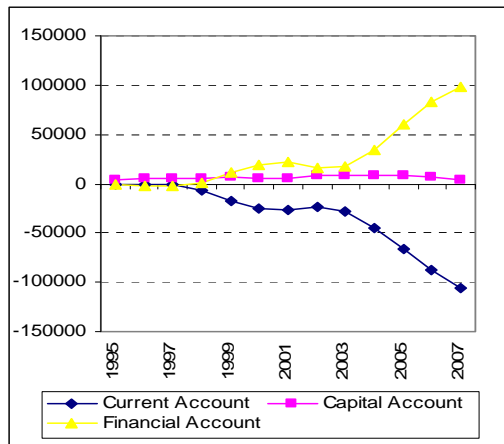
Finally, in relation to the issue of sustainability, it is necessary to examine whether the growing debt is to be financed with short or long term investments. In order to do so, we must analyse the composition of the financial account to see how foreign borrowing is financed.

b) Financial Account – How can the Current Account Deficit be Financed

The unavoidable balancing entry of the enormous (and mounting) current account deficit is an increasingly large financial surplus (net capital inflows). The minimal and stable size of the surplus in the capital account result in the balances of the current and financial accounts in Figure 7 offering a practically symmetrical graph. Both balances have swelled since 2003.

The financial account is the difference between the net change in liabilities (NCL) and the net change in assets (NCA) of transactions that consist in acquiring tradables (shares, Bonds, debentures), loans and deposits and change in reserves and assets compared to the Euro system. An increasingly large surplus indicates net capital inflows, which amounted to 98,000 million Euros in 2007.

Figure 7: Net Balances of the Current, Capital and Financial Accounts^a (in millions of Euros)

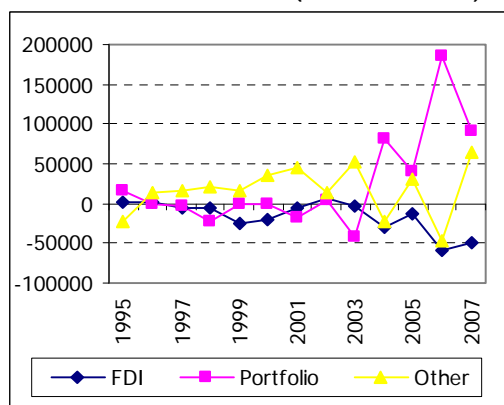


Source: own elaboration with data from Banco de España

^a A positive sign denotes capital inflows and a negative sign outflows

Figure 8 shows the evolution of the main components of the financial account and, therefore, the progress in the sources of foreign financing of the Spanish economy. Up to 2003, precisely when the current account deficit began to bloom, "other investments" were the main source of financing (see Figure 8). Since 2003, portfolio investment has emerged as the main source of financing for Spain's foreign deficit, mainly through bonds and debentures.

Figure 8: Main Components of the Financial Account^a – Net Balances (in millions of €)



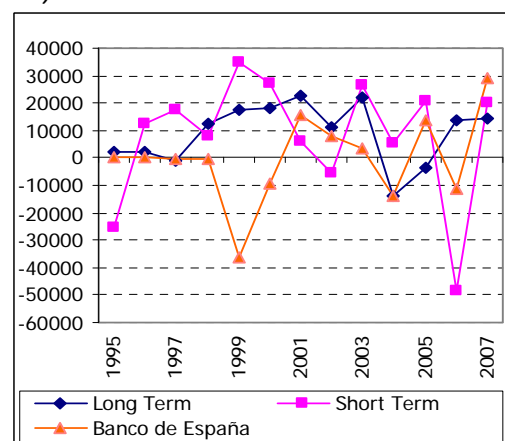
Source: own elaboration with data from Banco de España

^a Balance=NCL-NCA. Positive (negative) sign indicates capital inflows (outflows)

Other investments include changes in financial assets and liabilities on behalf of non residents that are not accounted for as direct or portfolio investment, such as loans and deposits between residents and non residents, direct commercial loans between suppliers and purchasers, deposits (including possession of foreign notes) by the various institutional sectors (public administration, other resident sectors and monetary and financial institutions, including the Banco de España).

As can be observed in Figure 9 below, short term inflows, despite being volatile from one year to the next, have become more important in recent years, coinciding with the period in which Spain's borrowing needs (that is, the current account deficit) increased drastically.

Figure 9: Other Investments (millions of € net)



Source: own elaboration with data from Banco de España

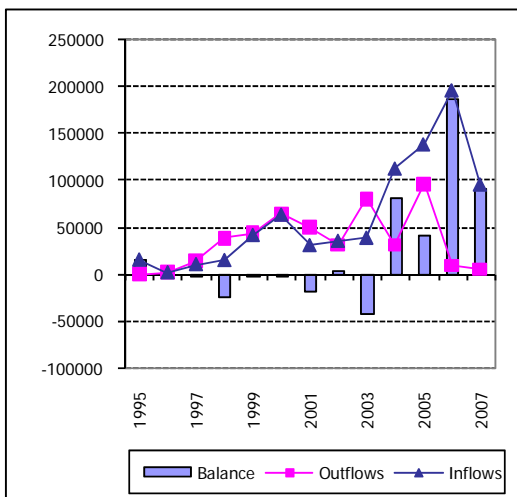
^a Balance=NCL-NCA. A positive (negative) sign indicates capital inflows (outflows)

The second item that helps to finance the economy is portfolio investment (see Figures 8 and 10). Furthermore, this item has become proportionally much more important over the last few

years parallel to the increase in the foreign deficit. This increase is mainly due to bonds and debentures (Figure 11).

Finally, Figures 8 and 12 show how capital outflows have picked up over the last few years (since 2003), increasingly outpacing FDI inflows. This trend reflects how strong investment on behalf of Spanish multinational companies abroad has been, particularly since the beginning of this decade. Spanish investment abroad has largely been in shares and also, albeit to a lesser extent, in other types of participations and reinvested profits (Figure 13). This graph also illustrates how net investment in real estate has decreased in relative terms in recent years (since 2004), as a result of a decline in foreign investment in property and the increasing investment in real estate abroad on behalf of Spanish residents.

Figure 10: Portfolio Investment (in millions of €)



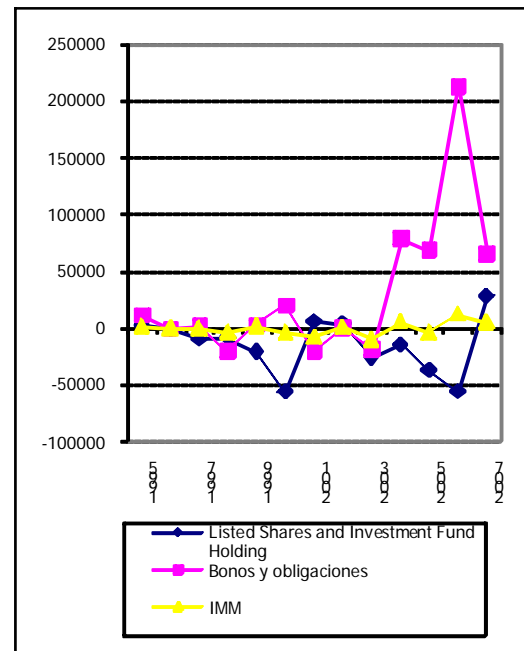
Source: own elaboration with data from Banco de España

^a Balance=NCL-NCA. A positive (negative) sign indicates capital inflows (outflows)

Therefore, considering the recent trend in terms of financing, portfolio

investment and other investments, such as loans and deposits have increased while FDI has shrunk significantly, particularly that devoted to production, which is associated to more stable longer term investment. As a result, the situation in terms of foreign financing does not look very promising, particularly bearing in the mind the current financial crisis and international credit crunch.

Figure 11: Portfolio Investment Breakdown (balance in millions of €)



Source: own elaboration with data from Banco de España

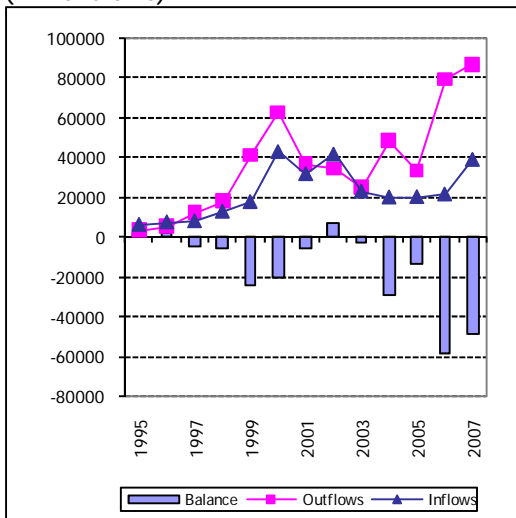
- Listed shares and holdings in investment funds
- MMI: Money market instruments
Balance=NCL-NCA. A positive (negative) sign indicates capital inflows (outflows)

In the current situation in which growth is slowing down and it is more difficult to obtain financing, the sizeable foreign deficit and the problems to attract international capital could further dampen economic growth in Spain.

Resources have been obtained over the last few months from the liquidity supplied by the European Central Bank

in several interventions. However, in the short-medium term it might be difficult to gain access to the external financing the Spanish economy requires due to the credit restrictions in force at present.

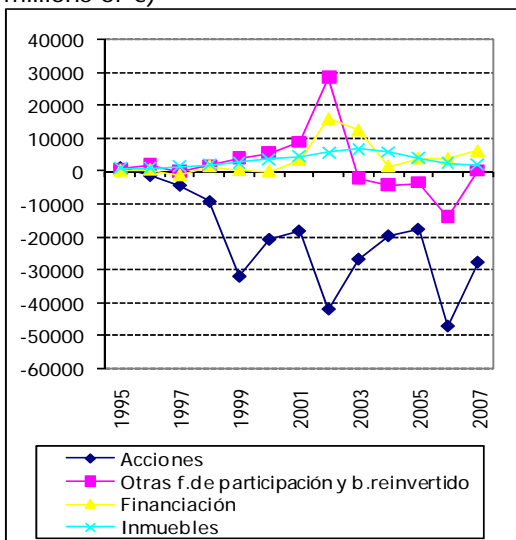
Figure 12: Foreign Direct Investment (millions of €)



Source: own elaboration with data from Banco de España

^a Balance=NCL-NCA. A positive (negative) sign indicates capital inflows (outflows)

Figure 13: Direct Investment (balance in millions of €)



Source: own elaboration with data from Banco de España

- Other types of shares and reinvested profits

- Financing related companies

Balance=NCL-NCA. A positive (negative) sign indicates capital inflows (outflows)

Conclusion

The current account deficit has soared since 2003 and now stands at 9.6% of GDP. This sizeable and growing deficit could initially be the result of foreign market sluggishness (particularly in the Euro-zone) and a loss of competitiveness on behalf of the Spanish economy. Internal causes could be behind this loss of competitiveness, due to Spain having a higher inflation rate together with slow growth in productivity, or external causes, such as the appreciation of the Euro against other currencies (particularly the US dollar) and the disproportionately larger impact of the upturn in energy prices.

The bullish trend of the Euro since the beginning of 2002 (particularly against the US dollar), despite somewhat mitigating the deterioration of the energy account due to prices rising, has also contributed to the growing foreign deficit. Both energy prices and the appreciation of the Euro have fuelled the external imbalance.

However, due to Spain's trade relations being concentrated in Euro-zone countries, there are two basic factors behind the growing current account deficit. In the first place, the fact that growth in Spain has outpaced that in the Euro-zone in recent years and the country's marked dependence on intermediate goods, particularly equipment (machinery). The weak recovery of the main economies in the Euro-zone has negatively affected exports, while imports have risen on the back of strong domestic demand. In the second place, undoubtedly the most important factor is the constant decline

in competitiveness, which is the most serious problem current faced by the Spanish economy. The current account deficit is, therefore, mainly a problem of competitiveness.

Another important aspect is that the situation in the current account reflects a lack of domestic saving (the savings rate has remained relatively stable, despite the decrease in household savings) to finance the strong investment in Spain. However, investment does not appear to have sufficiently improved the country's productive capacity.

Finally, the composition of external financing is also worrying. On analysing the sources of funding, portfolio and other investments stand out, with short term capital figuring prominently. This capital is much more volatile than its long term counterpart. In addition, only a small share of financing is obtained through foreign direct investment.

Therefore, the foreign deficit is particularly worrying in light of how difficult it may be to obtain international financing in the near future due to liquidity restrictions and this could seriously put the brakes on economic growth.

Silviano Esteve

Valencia, 1 June 2008

4.-FRANCIA Y ALEMANIA

It is a well known fact that Germany has a tremendously strong external sector that has been the cornerstone of economic growth in the country over the last few years. The strength of the external sector, as is also well known, is based on the current account. Germany's large current account surplus in all the years for which data are available has increased remarkably since halfway through 2006, recording an outstanding figure of more than 53,000 million euro in 2007. This exceptional performance is based on trade in goods, with a surplus of almost 51,000 million euro. Trade in services displays a deficit, but not normally higher than 10,000 million euro. Almost certainly, most of the deficit in trade services reflects the fact that tourism is a negative item in the German current account. Nevertheless, the deficit in trade in services is much smaller than the surplus in trade in goods.

The other two sub items in the current account are the income account and current transfers. The surplus in the former has witnessed an increase recently, amounting to more than 14,500 million euro in the fourth quarter of 2007, while the latter registered a relatively small deficit normally below 10,000 million euro.

Table 1: Current Account Balance - Germany

	Balance	Goods	Services	Income	Current Transfers
Q1-05	30405	42535	-7428	6690	-11392
Q2-05	28408	40112	-8030	2586	-6260
Q3-05	25081	40150	-14479	7007	-7597
Q4-05	32712	32786	-6141	9404	-3337
Q1-06	30284	39096	-8162	9538	-10188
Q2-06	30345	35609	-4996	4645	-4913
Q3-06	29418	39146	-12788	11201	-8141
Q4-06	51443	45966	-3101	12231	-3653
Q1-07	46455	50355	-5980	13007	-10927
Q2-07	41805	50522	-5316	1473	-4873
Q3-07	42634	51595	-12890	12969	-9040
Q4-07	53328	50844	-6194	14518	-5840

Source: Eurostat

In comparison to the situation in the German current account, the French current account displays an entirely different picture. The overall balance is negative and amounted to nearly 10,000 million euro in the fourth quarter of 2007. This figure reflects that fact that, unlike Germany, France has registered a deficit throughout the entire period under analysis, as our readers are well aware of. This negative trend is mainly due to persistent deficit in trade in goods, which totalled slightly less than -13,000 million euro in the fourth quarter of 2007, and in current transfers, with an equally persistent deficit that amounted to close to 7,100 million euro in the same quarter. Trade in services and the income account both display surpluses (1,381 and 8,974 million euro respectively in the fourth quarter of 2007), but which are unable to offset the foregoing deficits.

Table 2: Current Account Balance - France

	Balance	Goods	Services	Income	Current Transfers
Q1-05	-3251	-5463	1466	3963	-3219
Q2-05	-4826	-4673	2693	2750	-5594
Q3-05	-1233	-5616	5384	5046	-6246
Q4-05	-6393	-7191	897	6958	-7058
Q1-06	-3341	-7754	71	6190	-1847
Q2-06	-8826	-7243	3328	959	-5871
Q3-06	-3715	-7732	4958	6065	-7005
Q4-06	-6574	-7299	-91	7826	-7011
Q1-07	527	-6419	-212	8364	-1208
Q2-07	-9859	-8467	2248	2953	-6593
Q3-07	-2609	-10586	5513	9781	-7317
Q4-07	-9954	-13126	1381	8974	-7182

Source: Eurostat

Germany has an extremely negative financial account balance, with a deficit that, apart from often being large, amounted to almost -34,000 million euro at the end of last year. This situation reflects the fact that Germany is a keen investor abroad. On breaking down the financial account, some interesting conclusions can be drawn. In the first place, all three items in this account played an important part in the overall deficit in the fourth quarter of 2007. Direct investment recorded a deficit of 13,500 million euro, while financial derivatives and portfolio investment registered a deficit of almost 13,000 million euro. Other investment also displayed a deficit, albeit slightly smaller, of -7,627.2 million euro. Furthermore, direct investment has recorded a deficit in all the periods for which data are available, while the other two items, particularly financial derivatives and portfolio investment have registered both surpluses and deficits.

Nevertheless, as indicated above, these deficits are a clear symptom of Germany's tendency to invest abroad and, bearing in mind that the current account surplus almost doubles the financial account deficit, the country is perfectly capable of coping with this situation.

Table 3: Financial Account - Germany

	Balance
2007-1	-2,802.6
2007-2	-26,790.6
2007-3	-26,065.9
2007-4	-18,970.2
2007-5	-29,995.2
2007-6	-36,121.7
2007-7	-3,706.5
2007-8	5,434.4
2007-9	-15,659.4
2007-10	-27,933.7
2007-11	-23,042.8
2007-12	-15,205.2
2008-1	-4,110.1
2008-2	-31,946.0
2008-3	-33,928.6

Source: Bundesbank

Table 4: Breakdown of the German Financial Account

	Direct Investment	Financial Derivatives & Portfolio Investment	Other Investment
Jan-07	-60253.5	-6156.9	10066.9
Feb-07	-3035.6	-14677.4	-9643.7
Mar-07	-1268.0	-7083.2	-17706.5
Apr-07	-7091.6	-16657.4	5993.6
May-07	-14511.9	-9299.4	-5527.2
Jun-07	-84.94	38660.6	-75210.21
Jul-07	-8251.4	1216.7	3207.0
Aug-07	-5593.4	18198.9	-7149.7
Sep-07	-3019.8	1322.7	-13515.6
Oct-07	-13987.2	10008.6	-24263.6
Nov-07	-9729.6	38733.1	-52385.4
Dec-07	-12291.5	9176.8	-11995.3
Jan-08	-14403.9	602.5	10002.6
Feb-08	-17367.8	-28020.6	13791.6
Mar-08	-13500.2	-12296.8	-7627.2

Source: Bundesbank

As regards the French financial account balance, it has historically been negative, as can be observed in Table 19, until a significant surplus was

recorded in 2005, a surplus that, albeit slightly smaller, was maintained in 2007. As a result, there appears to have been a change in trend in this sector of France's external sector in the last two years, which has seen the country change from being a net investor abroad to a net receiver of foreign investment. On breaking down the financial account, the reason for this change in trend becomes clear. Direct investment and financial derivatives and portfolio investment are not responsible for this change and normally register deficits, although the latter has recorded a positive balance on some occasions. The change is the result of the spectacular increase in other investment over the last two years. We must remember that this item includes loans and deposits, which means that the increase echoes an enormous hike in the amount of money France owes the rest of the world.

Table 5: Financial Account - France

	Balance
1995	-6,157
1996	-17,664
1997	-38,291
1998	-45,508
1999	-37,474
2000	-32,603
2001	-31,429
2002	-17,268
2003	9,708
2004	-7,842
2005	-10,503
2006	63,912
2007	47,323

Source: Banque de France

Table 6: Breakdown of the French Financial Account

	Direct Investment	Financial Derivatives & Portfolio Investment	Other Investment
1995	6025	4009	-16380
1996	-6598	-48151	36227
1997	-11043	-23037	-2565
1998	-15856	-41901	30243
1999	-75381	-7132	45270
2000	-145659	40019	65319
2001	-40556	24004	-23421
2002	-1494	-11151	-14331
2003	-9435	5770	21606
2004	-19469	-52354	62488
2005	-32091	-13671	22997
2006	-27071	-59522	155946
2007	-49816	-16505	115687

Source: Banque de France

The capital account is residual, as it includes unilateral capital transfers and asset transactions that were not carried out or which are intangible. In both countries, surpluses and deficits are recorded throughout the period, with no clear trend being observed. In addition, the balance has traditionally been very low in comparison to the rest of items in the Balance of Payments. In the case of France, the amount is even smaller, although surpluses appear to outnumber deficits.

Table 7: Capital Account Balance - Germany

	Balance
Q1-2005	-1491
Q2-2005	107
Q3-2005	81
Q4-2005	56
Q1-2006	152
Q2-2006	11
Q3-2006	-236
Q4-2006	-102
Q1-2007	157
Q2-2007	419
Q3-2007	317
Q4-2007	-669

Source: Eurostat

Table 8: Capital Account Balance - France

	Saldo
Q1-2005	132
Q2-2005	386
Q3-2005	376
Q4-2005	-388
Q1-2006	-200
Q2-2006	-246
Q3-2006	181
Q4-2006	76
Q1-2007	330
Q2-2007	1140
Q3-2007	127
Q4-2007	259

Source: Eurostat

The trend in the euro has resulted in exports becoming considerably more expensive and imports substantially cheaper since the fourth quarter of 2007. However, this does not appear to have damaged the trade balance to date, particularly in the case of Germany. Nevertheless, this is one of the issues in the current economic scenario that needs to be monitored closely in light of just how much the exchange rate of the euro has risen recently.

Table 9: Euro/Dollar Exchange Rate

	nominal	Real
2007-1	1.29	104.42
2007-2	1.30	104.75
2007-3	1.32	105.44
2007-4	1.35	106.32
2007-5	1.35	106.08
2007-6	1.34	105.58
2007-7	1.37	106.23
2007-8	1.36	106.01
2007-9	1.38	107.02
2007-10	1.42	107.94
2007-11	1.46	109.60
2007-12	1.45	109.38
2008-1	1.47	109.91
2008-2	1.47	109.51
2008-3	1.55	112.90
2008-4	1.57	114.38

Source: Bundesbank

The tables below display the trade relations between France and Germany and their main trading partners. The main conclusion is that most of the

transactions the two countries carry out are with fellow European nations, which has logically helped to protect the Balance of Payments from the upturn in the Euro.

Table 10: France's Top 20 Suppliers (data in billions of euros)

	2007
Germany	74.4
Italy	38.3
Belgium	37.1
Spain	31.3
China	28.3
United States	25.8
United Kingdom	24.4
Netherlands	18.4
Russia	11.1
Japan	10.2
Switzerland	10.0
Ireland	6.5
Norway	6.3
Sweden	5.8
Poland	5.4
Turkey	4.8
Czech Republic	4.5
Portugal	4.1
South Korea	4.0
Austria	3.9

Source: INSEE

Table 11: France's Top 20 Customers (data in billions of euros)

	2007
Germany	56.8
Spain	37.7
Italy	36.1
United Kingdom	33.1
Belgium	29.7
United States	25.0
Netherlands	16.7
Switzerland	10.5
China	9.1
Poland	6.3
Japan	5.8
Russia	5.7
Sweden	5.4
Turkey	5.2
Portugal	5.0
Algeria	4.2
Greece	3.8
United Arab Emirates	3.7
Austria	3.7
Singapore	3.6

Source: INSEE

Table 12: Germany's Top 20 Suppliers (data in billions of euros)

	2007
France	64.9
Netherlands	64.3
China	54.6
United States	45.6
Italy	44.3
United Kingdom	43.4
Belgium	38.8
Austria	32.7
Switzerland	29.7
Russia	28.7
Czech Republic	26.2
Poland	24.1
Japan	24.0
Spain	21.1
Hungary	18.1
Ireland	17.8
Norway	17.6
Sweden	14.1
Denmark	10.9
Turkey	9.7

Source: DESTATIS

Table 13: Germany's Top 20 Customers (data in billions of euros)

	2007
France	93.8
United States	73.3
United Kingdom	70.9
Italy	65.1
Netherlands	62.3
Austria	52.7
Belgium	51.4
Spain	48.1
Switzerland	36.3
Poland	36.0
China	29.9
Russia	28.1
Czech Republic	26.0
Sweden	21.6
Hungary	17.3
Denmark	15.3
Turkey	15.0
Japan	13.0
Finland	10.2
South Korea	8.7

Source: DESTATIS

Antonio Cutanda

Valencia, 30 May 2008

5.-CHINA

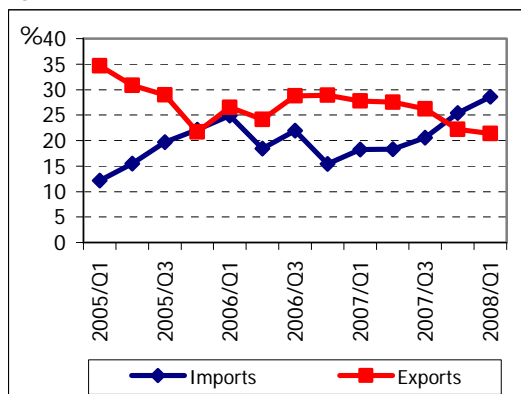
The external sector is one of the most important enclaves of the Chinese economy. The growth and influence this sector has on the main world superpowers has led numerous studies and analyses to be carried out by economists.

The current scenario in China where international trade is concerned is changing (Figure 3) and foreign sales are dropping due to:

- An increase in the price of raw materials, wages and transport
- New laws defending worker rights
- Western consumers controlling their expenditure

Imports have outpaced exports in terms of growth since the second quarter of 2007, as can be appreciated in Figure 1. However, GDP growth remains in double figures due to domestic demand picking up where exports have left off.

Figure 1 Annual Growth in Trade



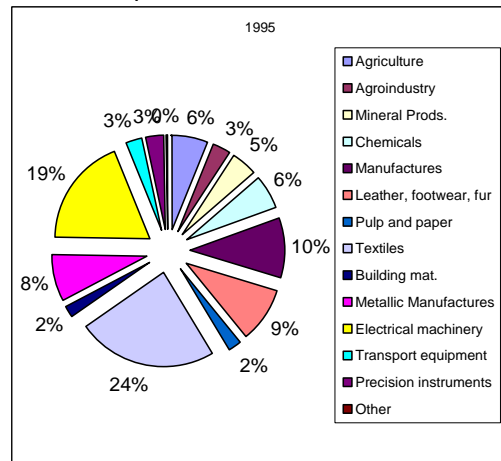
Source: OECD

What Goods does China Export?

Chinese exports are undergoing a significant transformation. It can now be said that the country not only sells

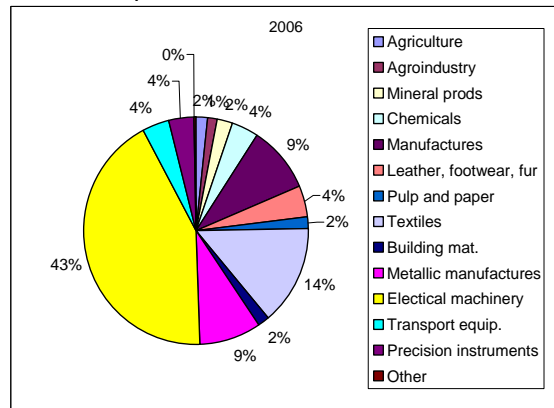
goods in enormous quantities, but also an attractive variety of them.

Figure 2 Sector-by-sector Breakdown of Chinese Exports (1995)



Source: own elaboration with data from Comtrade

Figure 3 Sector-by-sector Breakdown of Chinese Exports (2006)



Source: own elaboration based on data from Comtrade

If we concentrate on the differences between 1995 and 2006, Figures 2 and 3 reveal that electrical machinery has gained importance to the point of accounting for 43% of Chinese exports in 2006, to the detriment of textiles which have dropped from 24% to 14%. These figures indicate that China is committed to sectors involving technology and skilled labour, giving less importance to more traditional

sectors. Nonetheless, half of Chinese exports are imports at the destination country which are reprocessed.

The literature on international trade includes indicators that measure the foreign trade advantages of each country under analysis. One of these indicators is the Index of Revealed Comparative Advantage (IRCA) presented by Balassa (1965), which indicates that a country has an advantage if the value of the index is greater than one and a disadvantage if the opposite applies. The index is as follows:

$$IVCR = \frac{X_i^a / X_i}{X_w^a / X_w}$$

whereby,

- X_i^a : sector "a" exports from country "i"
- X_i : total exports from country "i"
- X_w^a : World sector "a" exports
- X_w : Total world exports

According to the IRCA, the competitive advantage of the "electrical machinery" sector stood out ahead of other more traditional sectors such as "textiles", "leather and footwear" and "manufactured goods". While remaining competitive, the latter have scored less on the index in the recent past.

Furthermore, China's incorporation into the World Trade Organisation in 2001 has not resulted in a substantial change in the country's sector-by-sector competitiveness on a global scale, as index scores have not varied a great deal.

Table 1 Average IRCA Scores for Chinese Foreign Demand

	1995-2000	2001-2006
Agricultural Products	0.904	0.575
Agroindustry	0.819	0.607

Mineral Products	0.556	0.266
Chemicals	0.668	0.488
Manufactures	1.350	1.231
Leather, Footwear & Fur	4.775	3.777
Pulp & paper	0.483	0.529
Textiles	3.584	3.031
Building Materials	1.426	1.467
Metallic Manufactures	1.029	0.985
Electrical Machinery	0.799	1.400
Transport Equipment	0.256	0.299
Precision Instruments	0.989	0.944
Other	0.074	0.084

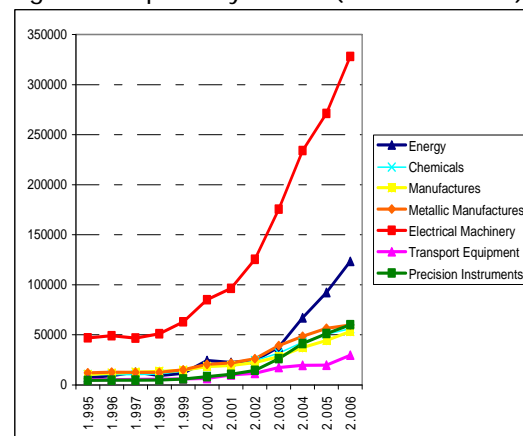
Source: own elaboration

What does China Import?

As regards imports, China has typically purchased raw materials from its trading partners to later transform and export them as final products. Chinese consumption of iron, zinc, copper and nickel accounts in some cases for more than 30% of the global total, which makes the Asian giant a net importer.

As a result, and as can be appreciated in Figure 4 below, China mostly imports "electrical machinery", which has recorded exponential growth over the last ten years.

Figure 4 Imports by Sector (in millions of \$)



Source: own elaboration based on Comtrade data

As far as China's demand for energy is concerned, it is worth highlighting the enormous growth in the consumption

of primary energy, coal and oil due to the robust economic development the country is experiencing. According to the *BP Statistical Review of World Energy 2007*, China is responsible for the structural change in world energy demand. More specifically, the Asian giant accounts for more than 46% of energy growth between 2001 and 2006, almost a third of which was coal. Table 2 illustrates the increase in China's energy consumption with respect to the rest of the world over little more than 15 years.

Table 2 Chinese Weight in World Energy Consumption

	1990 (%)	2006 (%)
Primary Energy	8.4	15.6
Coal	23.7	38.6
Oil	3.5	8.6

Source: BP

It is also important to highlight the change that is occurring in agricultural trade. A deficit of 3,660 million dollars was recorded in the first quarter of the year, compared to a surplus of 460 million dollars in the same period in 2007. More specifically, exports rose by 9.6% over the first three months of 2008, while imports shot up by 61%.

Who are China's Trading Partners?

China and Japan are each other's most important trading partners. China is Japan's fastest growing export market and Japan is China's main source of foreign investment and the country's main supplier of imports (14.01% of total Chinese imports in 2007). Both countries are currently trying to establish trade agreements to continue to reinforce their bilateral relations.

Table 3 Distribution of Chinese Exports and Imports in 2007

Export Destination		Import Origin	
USA	19.14%	Japan	14.01%
EU-15	18.19%	EU-15	11.08%
Hong Kong	15.15%	Korea	10.85%
Japan	8.38%	Other Asian nations	10.57%
Korea	4.61%	USA	7.27%
Singapore	2.43%	Malaysia	3%
Russia	2.34%	Australia	2.7%
India	1.97%	Philippines	2.42%

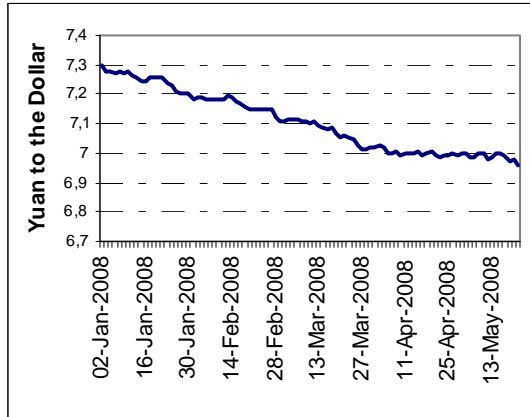
Source: own elaboration based on data from Comtrade

How does the Yuan Affect Foreign Trade?

The constant appreciation of the Yuan is the most significant factor when it comes to reducing the trade deficit gap. The central Yuan rate stood at 7 Yuan to the dollar more than a month ago, which implies an increase of 4.26% so far this year.

With the dollar falling even more quickly with respect to the Yuan, numerous Chinese companies have suffered losses and are now trying to find ways to raise the international price of their products. Faced with the double threat of a decrease in the dollar and weaker US demand, some Chinese exporters are beginning to ask their customers to pay in Euros. Others try to reduce the amount they sell abroad to increase their domestic market share.

Figure 5 Yuan/Dollar Exchange Rate



Source: IMF

According to the WTO, if China had a more flexible exchange rate, the country could employ more independent monetary policy, better designed to guarantee a low and stable inflation rate.

Other Important Foreign Trade Issues

China opened a research centre in May devoted to studying the mechanism used by the WTO to solve disputes, the first of its type in the country, which will offer suggestions and Solutions to trade disputes the government and companies must face. The opening of this institute is closely related to the numerous trade controversies the China has been involved in over the last seven years it has been a member of the WTO.

At present, there are several conflicts that are still to be solved, such as that with the USA and the EU over how Beijing regulates foreign supplies of financial information. China demands data suppliers such as Thomson Reuters Corp, Bloomberg and Dow Jones, part of the company News Corp owned by magnate Rupert Murdoch, operate through the State news agency Xinhua, which is also their competitor,

instead of dealing directly with customers.

Likewise, Chinese export security is also shrouded in doubt, as customs officers account for barely 10% of the contents of the 10,000 containers that leave the Chinese Port of Yantian on a daily basis. According to the criteria of customs workers, their job is to monitor, but also to foster exports, arguing that opening each container would damage companies due to the delay involved.

Foreign Direct Investment

Chinese growth is concentrated in four regions in the east (Guangdong, Jiangsu, Fujian and Zhejiang), where foreign investment boosted development years ago thanks to the combination of port proximity and tax benefits, but above all due to the presence of very cheap labour. Many US and European moved their factories to these regions in order to take full advantage of this situation.

Nowadays, the appreciation of the yuan against the dollar and higher labour costs have made the Eastern region less profitable and companies have decided to move their factories inland. Foreign companies invested 11,600 million dollars in the west and centre of China last year, 30% more than in 2003.

According to a report by the Chinese Ministry of Trade, low labour costs have resulted in 70% of FDI being channelled to the manufacturing industry, followed by real estate and public services (nearly 15%), while the rest of sectors received less foreign investment due to the restrictions

imposed by the government⁹. The factors that make China appealing to foreign investors include the following:

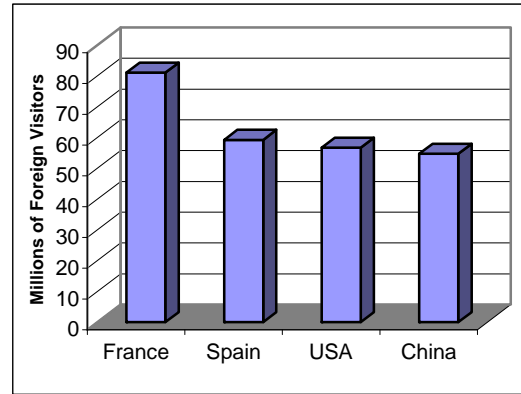
- The enormous potential of the Chinese market: a growing middle class that helps all types of companies to grow.
- Low labour costs.
- Investment incentives promoted by the government, including significant tax advantages for high technology companies.

Tourism

The tourist sector is consolidating in China and is now the fourth most popular destination in the World (Figure 6). The Asian giant is highly attractive due to uncountable riches and treasures, unknown culture, customs and history, all of which is captivating millions of travellers eager to explore countries that are very different to the western world.

Tourist services have increased by more than an annual 10% over the last five years due to economic reform and China's opening up to foreign visitors. The tourist industry contributed 12.2% of GDP in 2007 and employed 90 million people. However, tourist income amounted to 33,949 million dollars, while the US recorded a figure of 122,700 million. The scenario described above means China is a country where the level of spending is well below that in the largest countries.

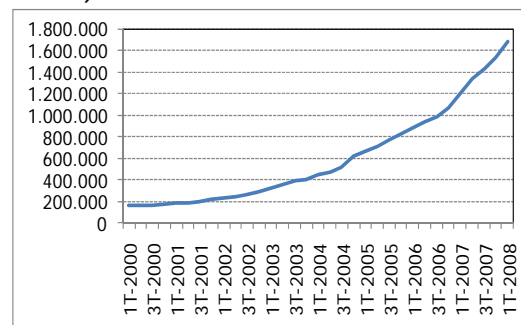
Figure 6 Main Tourist Destinations in the World (2007)



Source: National Tourism Administration

One of the results of this last decade is that China has accumulated enormous reserves. As can be appreciated in Figure 7 reserves have increased from 156,000 million dollars to more than a trillion in only slight more than a decade. The increase cannot only be attributed to the current account surplus and net foreign capital inflows, but also to both being sterilised by means of purchasing currencies to be able to control the possible appreciation of the national currency caused by the upturn in national demand.

Figure 7 Currency Reserves (trillions of dollars)



Source: State Administration of Foreign State

In conclusion, Table 4 displays the latest available Balance of Payments for China published by the State

⁹ Transport and communication 2.1%, energy supplies 1.8%, agriculture 1.8%, distribution and catering 1.4% and construction 1.3%

Administration of Foreign Exchange¹⁰. It is worth highlighting the enormous rise in both the Current Account, boosted mainly by goods and services, and the financial account, in this case due to the remarkable contribution of direct investment.

Table 4: Balance of Payments (millions of dollars), First Half of 2005, 2006 and 2007

	2007	2006	2005
I Current Account	162.858	90.807	67.264
<i>Goods & Services</i>	132.549	72.758	50.302
<i>Income</i>	12.904	4.426	4.873
<i>Current Transfers</i>	17.405	13.623	12.088
II Financial & Capital Account	90.164	30.871	38.298
<i>Capital Account</i>	1.465	1.948	2.154
<i>Financial Account</i>	88.700	28.923	36.144
1. Direct Investment	50.919	26.569	22.475

Source: State Administration of Foreign Exchange

M^a Luisa Martí Selva and Rosa Puertas Medina

Valencia, 30 May 2008

6.-MEXICO

According to information from the Secretariat of Economic Affairs, Mexico has signed 12 trade agreements with 42 countries in three different continents. This gives the country preferential access to 1,057 million consumers, to countries that account for two thirds of total world imports and which are responsible for 75% of world GDP.

However, regarding the countries that Mexico has not signed agreements with, there is still great potential for trade, as these countries represent 5,185 million consumers (four fifths of the world population); 35% of the value of world imports and 22% of world GDP.

Mexico's share of these countries' imports is less than 1%. In 2006, only 4.5% of total Mexican exports were bound for these countries.

In 1985, when Mexico began to open its doors to foreign trade, exports totalled 26.7 billion dollars. In 2007, the figure amounted to 272 billion dollars, more than 10 times the previous figure. Exports represent 41% of Mexico's GDP.

Current Account

The current account registered a deficit of 7,370 million dollars in 2007, which is the equivalent of 0.8% of GDP.

This situation was due to the deficits in the trade balance (11,189 million dollars), in factor services (13,895 million) and non factor services (6,638). Meanwhile, current transfers chalked up a surplus of 24,352 million dollars.

In the first quarter of 2008, as can be observed in the table below, the current account registered a deficit of

¹⁰ As full data for 2006 and 2007 were not available, data from the first half of each year are provided

1,485 million dollars, due to the deficits in trade (1,630 million), factor services (4,196 million), non factor services (1,107 million), while transfers (mainly through remittances from Mexican workers in the US) recorded a surplus of 5,448 million dollars.

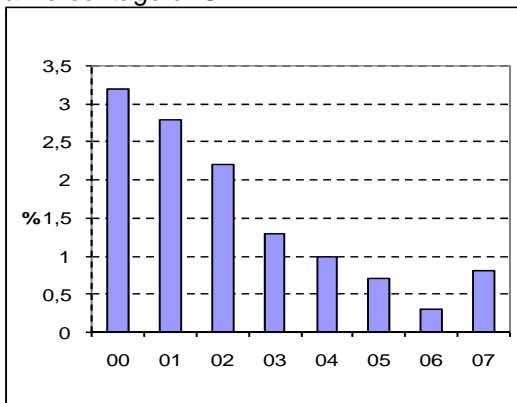
Table 1: Current Account Balance – Q1 (in millions of dollars)

	2007	2008
Current Account	-2,236	-1,485
Trade Balance	-2,454	-1,630
Non Factor Services	-525	-1,107
Factor Services	-4,869	-4,196
Transfers	5,611	5,448

Source: elaborated with information from Banco de Mexico

The current account deficit in the first quarter is the equivalent of 0.6% of GDP. This figure will probably rise to around 1% by the end of the year.

Figure 1: Annual Current Account Deficit as a Percentage of GDP

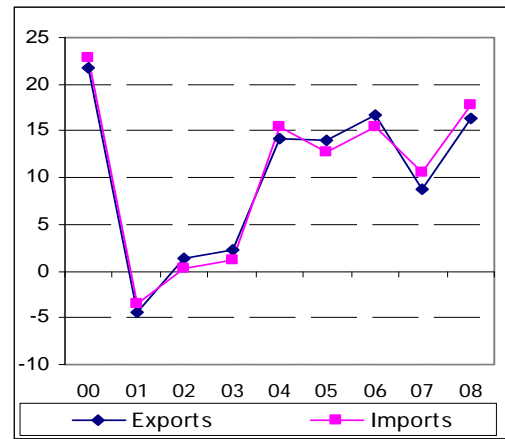


Source: elaborated with information from Banco de Mexico

Exports

Mexico exported goods and services to the value of 272,044 million dollars in 2007. This figure represented an increase of 8.9%, practically half that recorded last year, which was 16.7%. The slowdown in export growth reflects the difficult economic scenario in the United States.

Figure 2: Annual Growth in Exports and Imports (2000-2008)*



* 2008 figure refers to the first quarter

Source: elaborated with data from Banco de Mexico

In the first quarter of 2008, exports totalled 70,128 million dollars, an increase of 16.4% with regard to the same period last year. This increase was mainly due to soaring export oil prices (82.98 dollars/barrel in the first quarter), as the value of these exports was up by 50.3%, while the value of non-oil exports rose by 10.7%.

The increase in non oil exports is largely due to the favourable results recorded by the car industry, which registered an increase of 12.75% in foreign sales that saw the sector represent three quarters of total non oil exports.

In the first quarter, exports of consumer goods amounted to 18,144 million dollars. Mexico exported intermediate goods to a value of 37,919 million and capital goods worth 14,065.

Intermediate goods represented slightly more than half the total, while consumer goods accounted for around a quarter; capital goods represented a fifth as can be appreciated in the table below.

Table 2: Exports – Share by Good (January-March)

	2006	2007	2008
Total Exports	100.0	100.0	100.0
Consumer Goods	24.7	26.1	25.9
Intermediate Goods	53.7	52.6	54.1
Capital Goods	21.5	21.3	20.1

Source: elaborated with information from INEGI

Consumer goods exports rose by 15.3% in the first quarter of the year, intermediate goods by 19.6% and capital goods by 9.7%, a huge improvement on the figures recorded the previous year (8.2%, 0.2% and 1.2%, respectively).

Table 3: Exports – Annual Growth by Good (January-March)

	2007/ 2006	2008/ 2007
Total Exports	2.4	16.4
Consumer Goods	8.2	15.3
Intermediate Goods	0.2	19.6
Capital Goods	1.2	9.7

Source: elaborated with information from INEGI

Imports

Imports totalled 283,233 million dollars in 2007, 10.6% more than in 2006, although the growth rate was inferior (15.4% in 2006).

The increase was influenced by higher oil product import prices. Imports of this type of product were up by 28%.

In the first quarter of 2008, imports amounted to 71,758 million dollars, an annual rise of 14.4%.

The total value of imports was affected by the purchase of oil products, mainly petrol, that have recorded a marked increase in price in international markets, and also by food prices which have also risen. There is concern over growing oil product imports, which in the first quarter of 2008 represented 27% of the value of oil exports, partly due to soaring oil prices. Oil product imports increased by an annual 54% in

the first quarter, which resulted in a surplus in trade in oil of 5,205 million dollars.

By type of good, intermediate goods accounted for 71% of imports in the first quarter, while consumer goods represented 15.2% and capital goods the remaining 13.8%.

Table 4: Imports – Share by Good (January-March)

	2006	2007	2008
Total Imports	100.0	100.0	100.0
Consumer Goods	14.2	14.6	15.2
Intermediate Goods	73.9	73.4	71.1
Capital Goods	11.9	12.0	13.8

Source: elaborated with information from INEGI

As regards growth, it is worth highlighting capital goods, which registered a 35% annual increase, while consumer goods rose by 22.1% and intermediate goods by 13.7%.

Table 5: Imports – Annual Growth Rate by Type of Good (January-March)

	2007/2006	2008/2007
Total Imports	7.9	17.6
Consumer Goods	11.0	22.1
Intermediate Goods	7.2	13.7
Capital Goods	8.6	35.0

Source: elaborated with information from INEGI

Exports by Market Sector

In reference to exports by market sector, the figures for the first quarter of 2008 indicate that the public sector was responsible for 18.3% of total exports, while the private sector accounted for the remaining 81.7%.

Oil accounted for practically all public sector exports. As a result, there is a strong correspondence with the table included in the section devoted to oil, where oil exports account for 50.3%.

As regards imports, the public sector purchased 7.4% of the total and the private sector 92.6%.

Exports by Country

In the first quarter of 2008, Mexico exported goods and services to the tune of 70,128 million dollars, of which 56,453 were bound for the United States, 1,479 for Canada and the remaining 12,197 million dollars to other countries.

As far as foreign trade is concerned, there is still a strong relationship between Mexico and the United States, as 80.5% of exports in the first quarter of 2008 were destined to Mexico's northern neighbours. Mexico's other close trading partner, Canada, received 2.1% of exports and other countries the remaining 17.4%.

Table 6: Exports by Destination Country (January-March)

	2006	2007	2008
Total Exports	100.0	100.0	100.0
United States	85.5	82.9	80.5
Canada	1.7	2.3	2.1
Other Countries	12.8	14.8	17.4

Source: elaborated with information from INEGI

In the first quarter, total exports to the United States increased by 13%, to Canada by 5.7% and to the rest of countries by 36.5%.

Table 7: Exports by Country – Annual Growth (January-March)

	2007/2006	2008/2007
Total Exports	2.4	16.4
United States	-0.8	13.1
Canada	39.4	5.7
Other Countries	18.8	36.5

Source: elaborated with information from INEGI

In the first quarter, non oil exports to the United States increased by 7.7% compared to 9.2% in the previous quarter. Non-oil exports to the rest the world grew by 25.9% in the first quarter, compared to 33.5% in the last quarter of 2007.

Despite the problems the US economy is suffering, exports at least increased

in the first quarter in relation to the previous quarter, while in the case of the rest of countries, growth decreased. However, growth in the latter still clearly outpaces the former.

In relation to the enormous market in the European Union, exports only accounted for 6.4% of the total, while exports to Spain represented 1.8%.

Table 8: Exports to the European Union and Spain – Share (January-March)

	2007	2008
Total Exports	100.0	100.0
European Union	4.8	6.4
Spain	1.1	1.8

Source: elaborated with information from INEGI

The appreciation of the peso against the US dollar explains the increase in exports to countries other than the United States. The dollar has depreciated against other currencies such as the Euro, which in turn depreciates the peso against currencies other than the dollar.

Table 9: Exports and Imports to European Union and Spain – Percentage Change (January-March)

	2008/2007
Total Exports	16.4
European Union	54.3
Spain	86.3
Total Imports	17.5
European Union	12.7
Spain	10.2

Source: elaborated with information from INEGI

Imports by Country

Trade relations with the United States are not as strong where imports are concerned, although the volume remain considerable.

Table 10: Imports by Country – Share (January-March)

	2006	2007	2008
Total Imports	100.0	100.0	100.0
United States	53.3	50.4	52.2
Canada	2.9	2.8	3.1
Other Countries	43.8	46.8	44.7

Source: elaborated with information from INEGI

Slightly more than half of Mexico's imports come from the United States (52.2%), 3.1% from Canada and 44.7% from the rest of the world.

Imports rose by an annual 17.6% in the first quarter, clearly outpacing the rate in the same period the previous year, which was 7.9%.

Imports from the United States were up by 21.7%, those from Canada by almost 30% and from other countries by 12.1%.

Table 11: Imports by Country – Annual Growth (January-March)

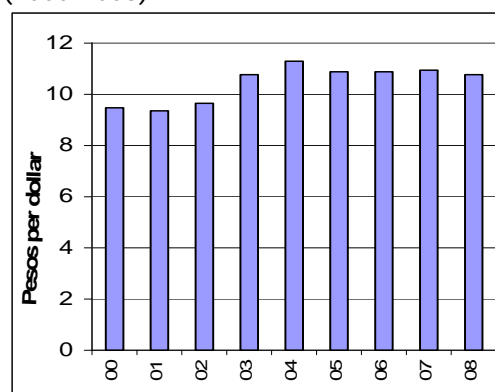
	2007/2006	2008/2007
Total Imports	7.9	17.6
United States	2.1	21.7
Canada	5.1	29.8
Other Countries	15.2	12.1

Source: elaborated with information from INEGI

Exchange Rate Appreciates against the Dollar

Taking the average exchange rate over the first quarter of the year in comparison to that recorded over the same period in 2007, the peso has appreciated by around 2%.

Figure 3: Average Annual Exchange Rate (2000-2008)



Source: elaborated with information from Banco de Mexico

If the same comparison is made between 2007 and 2006, the peso was seen to have appreciated by 2.5%.

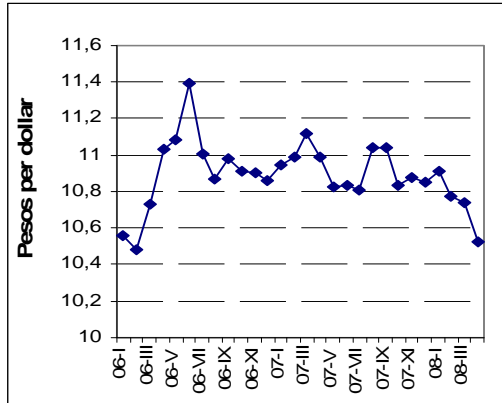
Inflows through oil sales, foreign investment, remittances and tourism represent a key source of currency that sustain the exchange rate of the Mexican peso.

Market perception that the Bank of Mexico will employ more restrictive monetary policy over the next few months, in light of the possible increase in interest rates (currently at 7.5%) to combat mounting inflation, has also influenced this situation.

A lower exchange rate would make importing food and petrol, for example, less costly and would also reduce the impact of increases on the international market on the domestic market.

A strong peso would benefit importers, but would hurt exporters, as well as those who receive remittances from abroad.

Figure 4: Average Monthly Exchange Rate



Source: elaborated with information from Banco de Mexico

Less Oil Exports

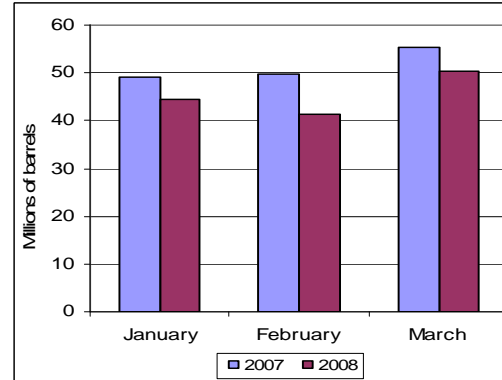
The Mexican export mix is making setting new record prices on a daily basis a habit. The price recently surpassed 100 dollars per barrel. This is very important, as approximately a third of the Mexican government's income stems from oil exports.

It is worth remembering that the average price per barrel of Mexican Mix was estimated, for Federal Budget purposes, at 49 dollars.

In the first quarter, as mentioned previously, the average price of a barrel of Mexican Mix was 82.98 dollars, well above that recorded last year, which was 47.86 dollars and the estimate used to elaborate the Budget.

As regards output, a decrease in the amount of oil exported was observed. In the first quarter, Mexico sold 1.5 million barrels a day, compared to 1.7 million in the same period in 2007.

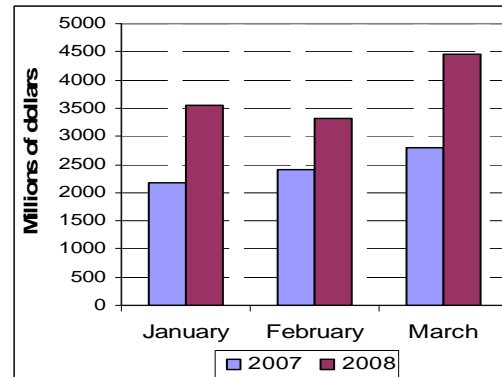
Figure 5: Oil Export Volume



Source: elaborated with information from INEGI

However, this decrease has been well and truly offset by the increase in price.

Figure 6: Value of Oil Exports



Source: elaborated with information from INEGI

Out of a total of 70,128 million dollars of total exports, 12,895 million were oil and 57,233 million other goods, accounting for 18.4% and 81.6% of the total respectively.

Table 12: Oil and Non Oil Exports – Share of Total (January-March)

	2006	2007	2008
Total Exports	100.0	100.0	100.0
Oil Exports	16.9	14.2	18.4
Non-oil Exports	83.1	85.8	81.6

Source: elaborated with information from INEGI

We can also see that oil exports rose strongly in annual terms in the first quarter of the year, by 50.3%, once again due to prices soaring.

This contrasts with non-oil exports, which only increased by 10.7% over the same period.

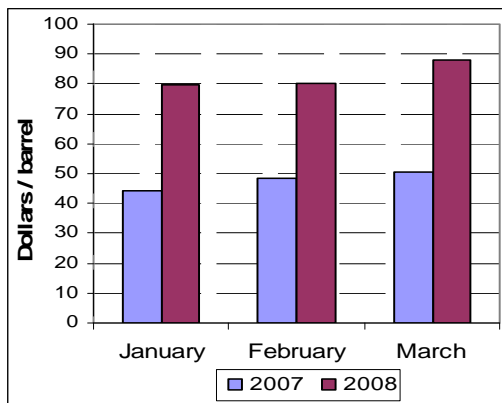
Table 13: Oil and Non-oil Exports – Annual Growth (January-March)

	2007/2006	2008/2007
Total Exports	2.4	16.4
Oil Exports	-13.8	50.3
Non-oil Exports	5.7	10.7

Source: elaborated with information from INEGI

As regards the export price per barrel, significant increases have been observed over recent months. While the Mexican Mix averaged 88.1 dollars a barrel in March this year, a year earlier the figure stood at only 50.5 dollars.

Figure 10: Average Export Price per Barrel of Oil



Source: elaborated with information from INEGI

Annual petrol imports amount to a round 9 billion dollars, which is approximately 43% of the country's total consumption. Petrol imports represented 27% of total oil exports in the first quarter of 2008.

Domestically, the subsidy awarded to petrol has opened up a wide gap between how much it costs in Mexico and the United States. This situation can be most clearly appreciated on the border, where US citizens cross to buy petrol in Mexico.

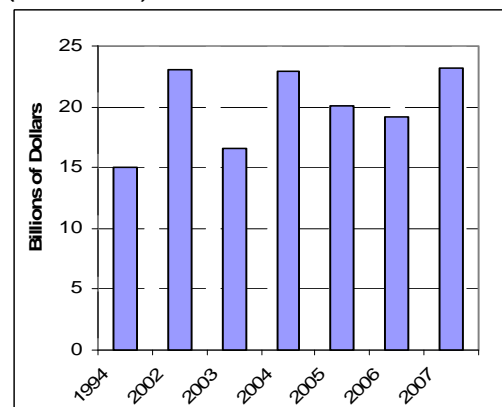
Foreign Direct Investment

In the first quarter of 2008, the capital account displayed a surplus of 8,911 million dollars. Foreign direct investment played a part in this result.

When the North American Free Trade Agreement (NAFTA) came into force in 1994, foreign direct investment totalled 15 billion dollars, while in 2007 the figure had risen to 23.23 billion.

NAFTA has brought certainty to foreign investment, which has resulted in a substantial increase since the trade agreement came into force.

Figure 11: Foreign Direct Investment (1994-2007)



Source: elaborated with information from the Secretariat of Economic Affairs

According to information from the Secretariat of Economic Affairs, foreign direct investment shrank by an annual 36% in the first quarter of 2008, recording a total of 1,195 million dollars.

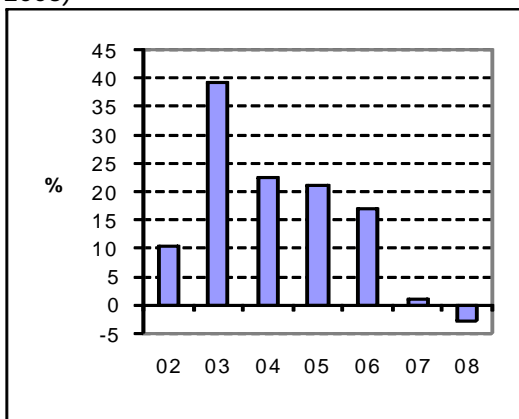
Remittances Stagnate

Transfers recorded a surplus of 5,448 million dollars in the first quarter of 2008. Family remittances from Mexicans working in the US are the most important item in this sub balance and one of the cornerstones of economic growth in Mexico, together with oil, foreign direct investment and tourism.

Remittances appear to have peaked in 2007 at 23,979 million dollars, recording a 1% growth rate in the first quarter, compared to the 17.1% rate witnessed a year earlier.

Faced with the problems of finding work in the United States due to this country's internal problems, but also as a result of tougher immigration policy, remittances appear to have bucked the upward trend and are now beginning to slide.

Figure 12: Growth in Remittances (2002-2008)



Source: elaborated with information from Banco de Mexico

This is observed in the first quarter of this year, when a figure of 5,350 million dollars was recorded, 2.9% less than in the same period a year earlier (5,508 million).

Remittances are still a very important source of foreign exchange for Mexico. In fact, it is the second most important source behind oil.

Tourism

Non factor services, which mainly includes International travellers (tourists and day-trippers) recorded a deficit of 1,107 million dollars in the first quarter of the year. The international travellers account

displayed a surplus of 2,075 million dollars.

The marked slowdown in the US economy is seemingly still to be felt by tourist flows to Mexico, as is also the case with the insecurity in some tourist destinations.

According to information from the Secretariat of Tourism, Mexico received 1,748,716 tourists, of whom 61% were American, 13.5% Canadian and 1.4% Spanish (56,053).

Tourist expenditure between January and March this year amounted 4,025 million dollars, 7% more than over the same period in 2007.

Mexican expenditure abroad amounted to 1,950 million dollars over the same period, which resulted in the tourism balance registering a surplus of 2,075 million dollars, as mentioned previously, 6.6% larger than a year earlier.

While the trade balance displayed a deficit of 1,630 million dollars in the first quarter of 2008, tourism recorded a surplus of more than 2,000 million dollars.

Factorial Services

Factor services registered a deficit of 4,196 million dollars in the first quarter of 2008. Net interest payments abroad amounted to 2,144 million dollars. The remaining items in this balance chalked up a deficit of 2,052 million dollars.

Hector Ruiz Ramírez

Toluca, Mexico 29 May, 2008

