Observatorio de Coyuntura Económica Internacional

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Foreign Trade 2006

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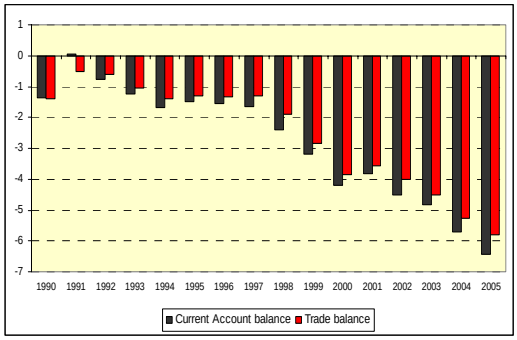
1.- U.S.A.

Foreign Trade: Unlimited Imbalance...till when?

a) Ever Increasing Current Account Deficit

It is our obligation to remind everybody of the growing US current account deficit, 90% of which stems from the foreign trade deficit (Figure 1). Negative figures have increased continuously for a decade, barely stabilising during the brief recession in 2001 (in contrast to the remarkable deficit corrections in previous economic crises).

Figure 1: (Goods and Services) Trade Balance and Current Account Balance (% of GDP)

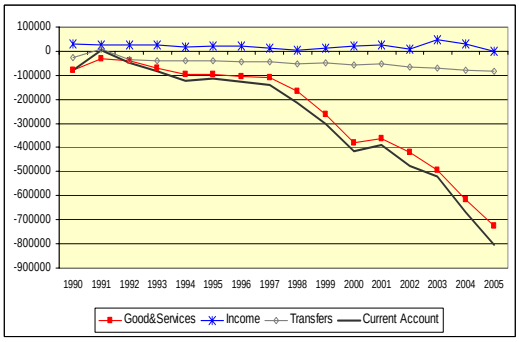


Source: own elaboration with data from the Bureau of Economic Analysis (BEA)

Despite other countries of wide ranging characteristics (Iceland, New Zealand, Hungary, Bulgaria and Spain) displaying in some cases much larger deficits in terms of GDP (6.5% in the US in 2005), the size of the US deficit in absolute terms (800 billion dollars) is unprecedented, and much more so in the world's number one superpower.

Completing the excess of imports over exports (Figure 2), the US economy systematically records a (growing) deficit in current transfers, due to a great extent to aid programmes for strategic trading partners in the developing world.

Figure 2: Current Account Balance and Components (millions of dollars)



Source: own elaboration with data from the BEA

More interestingly, the traditional surplus in the income account decreases rapidly as the net international investor position of the United States becomes more negative. Courtesy of the rapid accumulation of liabilities in recent years, that negative net position now stands at 2.5 billion dollars. Nevertheless, the favourable yield gap of foreign assets acquired by the United States with regard to US assets purchased by foreign countries saw the income account remain favourable to the value of seven billion dollars[1].

In the near future, the higher average yield (partly due to taking on greater risk) of foreign investments with respect to those obtained by foreigners investing in the United States will no longer be enough to offset the growing difference between international liabilities and assets maintained by the country. Yet another factor, therefore, to add to the deterioration of the current account balance.

[1] This figure drops to 1.5 billion after incorporating net payments to workers.

b) Trade Deficit: Reasons, Half Truths and Distribution

Meanwhile, the goods balance (it is worth remembering that the United States maintains modest surpluses in the services balance) is the centre of not only economic but also political attention. The government has repeatedly condemned the attitude of other countries (see page 6 of the US report) and Congress has threatened to take protectionist action, the best known in recent months being the S.295 bill to sanction Chinese imports if a rapid and sizeable revaluation of the yuan does not occur.

However, some of the factors that are blamed for the nonsensical deficit are either exaggerated or directly do not correspond to the truth: for example, **the role of oil imports** (detailed information in Table 1 at the end of this report). There is no doubt that the oil bill and the trade balance are directly and significantly related and its growth has been explosive in recent years, due to the spectacular hike in prices, while the increase in the amount of imports has actually been quite modest.

However, the oil bill only accounts for an average of 27% of the growth in the deficit over the past five years[2]. It is also true that this percentage is close to 50% in the first quarter of 2006.

Similarly, if we focus on the contribution to the overall balance instead of its evolution, the oil and oil derivatives deficit accounted for around a third of the overall deficit in goods and services in 2005. While this figure is high, it is lower than the contribution of consumer goods other than cars and food which amounted to almost 40%. It is also worth highlighting that car and motor vehicle parts trade on its own explains 18% of the trade deficit. Even capital goods register a negative balance, albeit minimal[3].

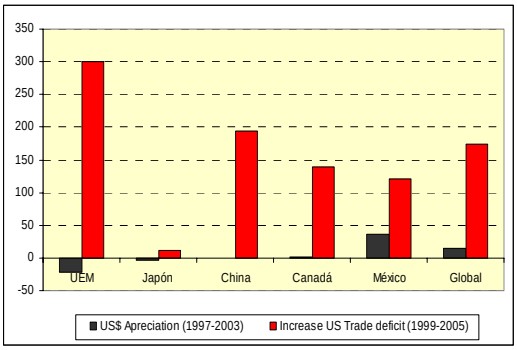
On more than a few occasions the OCEI has repeated that neither do **exchange rate patterns** justify the US trade deficit, nor will changes therein (unless we are talking of scandalous depreciations that trading partners are unable to come to terms with) be enough to correct the imbalance.

Figure 3 shows how there is no connection whatsoever between the evolution of exchange rates and the trade deficit in recent years. A summary of the data corresponding to the United States' trading partners as a whole and the most important countries is provided. The two-year lag between one variable and another would allow the well-known "J effect" in the depreciations/devaluations of a currency to act: the balance must first worsen (due to the increase in import prices while exports are cheaper) to later improve as quantities begin to correspond to the change in relative prices.

[2] Curiously, as can be appreciated in Table 2, oil imports do account for practically the entire decrease in the deficit observed in 2001.

[3] In view of the size of the overall deficit, the 18 billion dollar deficit in capital goods is almost minor.

Figure 3: Exchange Rate (% change, positive score = appreciation of the dollar) and Trade Balance (% change, positive score = increase in the deficit)



Source: own elaboration with data from the BEA

There is no sign of improvement in the trade balance with those regions where the dollar depreciated with respect to the local currency. In fact the largest percentage deterioration occurred precisely in the region with the strongest currency over the period in question, the euro.

Partial figures by country with shorter periods, different time lags and other estimations have been omitted so as not to bore the reader. The results are the same: little correlation between the decrease/increase in the value of the dollar and the improvement/deterioration of the trade balance[4]. At the end of this report, there is a series of graphs that display the annual evolution of exchange rates and the goods and services balance for the regions considered.

In short, in an increasingly competitive environment where companies offset exchange rate developments by means of margins to protect their share of the market; where the differences in production costs no more than a few sectors are too high to be compensated by changes in the exchange rate; and where in some spheres of activity the outsourcing of production makes it simply impossible to replace foreign suppliers, the origin and solution of the US foreign trade deficit have nothing to do with the international value of the dollar.

In that case, what are the **basic reasons for the imbalance**? Well, those that have been repeated ad nauseum in this and other forums. The main reason is *excessive domestic spending*. Consumers have broken all the existing records of low saving and a high level of borrowing. In addition, the public sector deficit remains unjustifiably equivalent to nearly 3% of GDP following five and a half years of expansion and the fastest budget deterioration (between 2002 and 2004) ever witnessed in times of peace. Basic macroeconomics reminds us that excessive expenditure (or its balancing entry, a lack of saving) leads to a large current account deficit.

Certainly (and here is the argument maintained by the government) the problem has been made worse by the *poor economic growth* in two of the United States' most important customers in the world, the *European Union and Japan*.

Finally, two factors make the possibility of balancing the situation considerably difficult. On the one hand, US *import income elasticity* is noticeably higher than the country's *export income elasticity* (consequently, if economic growth in the US were the same as that of its trading partners, the balance would continue to deteriorate).

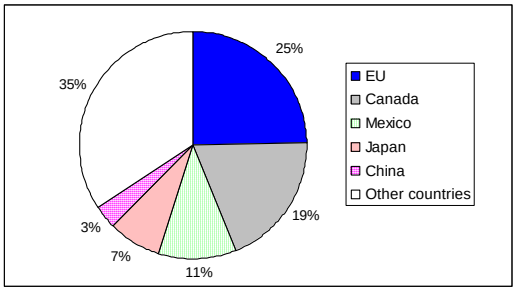
[4] Logically, a complete econometric analysis, which falls outside the objectives of this report, would enable us to provide much more accurate conclusions.

On the other hand, the arithmetic is also unfavourable: *the difference between the absolute value of imports and exports* is so large that the latter would have to increase by 60% more than the former in order to stabilise the deficit.

Figures 4, 5 and 6 display the geographical distribution of US (goods and services) trade through exports, imports and the deficit.

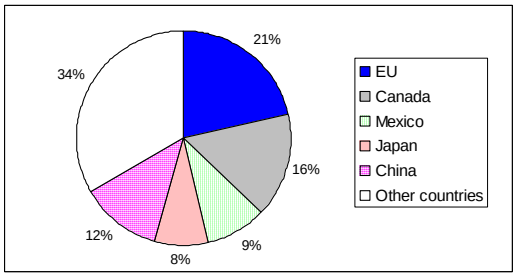
The most striking figure is undoubtedly the enormous difference between China's role as a marginal buyer of US products and its third place ranking as a supplier, only behind the European Union and Canada (which are also the two top purchasers) and well ahead of Mexico and Japan. As a result, the US trade deficit with the emerging Asian superpower accounts for almost 28% of the total, nearly double the share of the European Union and trebling the percentage corresponding to Japan or Canada.

Figure 4: Geographical Distribution of Exports (2005; %)



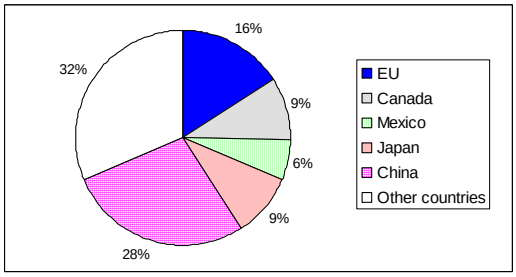
Source: own elaboration with data from the BEA

Figure 5: Geographical Distribution of Imports (2005; %)



Source: own elaboration with data from the BEA

Figure 6: Geographical Distribution of the Trade Deficit (2005; %)



Source: own elaboration with data from the BEA

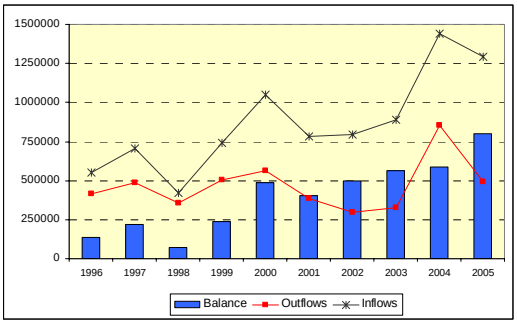
In view of these data, it is not surprising that lawmakers and the government are so keen to blame China for the deterioration of the trade deficit and, in turn, the current account deficit. However, it is worth reminding our readers the following points: once again, the main reason for the deficit should be sought out within the United States, not in unfair advantages caused by others. In the second place, a decrease in imports from China would result in a shift to other Asian or South American countries, not in greater domestic output, owing to the difference in production costs. Thirdly, the fact that Chinese imports are cheap has been a vital help in terms of keeping inflation in check, thus allowing for more accommodating monetary policy. In the fourth place, US companies based in China are responsible for more than two thirds of

China's trade flows, reaping large profits in the process. In the fifth place, despite how annoying this appears to be to the Treasury Department, China has financed a far from negligible part of the public sector deficit generated by the Bush government. Perhaps it is not necessary for the United States to thank the Chinese, as Stephen Roach stated, but both criticism and the US's overall analysis of the situation should be more moderate.

c) Financial Account Surplus: How Two Billion Dollars a Day are Obtained

In order to offset the excessive current account deficit, the US economy logically has a financial account surplus, which is as large as indicated in the title of this section. As can be appreciated in Figure 7, over the last decade this surplus has been due to a steady increase in net capital inflows that has well and truly outpaced net capital outflows. Nonetheless, the increase in the surplus last year was due to a decrease in outflows, as was also the case in 1998 and 2001. As the strongest trend is the increase in inflows, it must be concluded that the United States is *a highly appealing destination for world savings*.

Figure 7: Financial Account (2005; net values; millions of dollars)



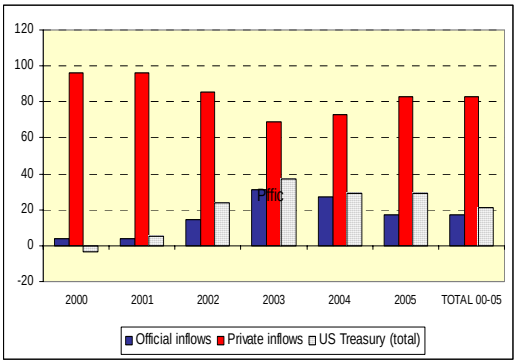
Source: own elaboration with data from the BEA

The following points explain this situation:

- Sound economic growth and productivity, particularly in comparison to other large developed regions
- The exceptional depth, size, efficiency and diversity of US financial markets. This clear comparative advantage is reinforced by a considerable excess of international savings (that some authors label an investment deficit)
- The dollar is a "safe bet" in times of uncertainty, which have been frequent over the last decade.
- The low yields offered by interest rate indexed investments in recent years in both Europe and Japan.
- Asian monetary policymakers have been purchasing assets designated in dollars in order to stop the currency from falling, which would damage their countries' competitiveness.

This last point has sparked a controversy over just how much the sustainability of the foreign deficit (and in turn, domestic spending and growth) has depended on the purchase of paper (mostly Treasury Bonds) on behalf of Asian central banks. In view of the fact that these central banks' reserves may be excessively biased towards assets in dollars, some analysts warn against the possibility of portfolio diversification towards other currencies making it difficult for the United States to finance its current account deficit. Let's take things step by step.

Figure 8: Net Financial Inflow Distribution (millions of dollars)



Source: own elaboration with data from the BEA

Figure 8 shows the unusually high level of official financial inflows to the United States in recent years. This share shrank to a more normal level in historical terms throughout 2005. While the official inflows were led mainly by Asian central banks up to 2004 (China, Japan[5], Southeast Asia), the share of petroleum exporters increased has increased over the last year, following the large surpluses achieved through cancelling part of the foreign debt they had accumulated. However, the investments made by these countries are largely channelled anonymously through financial intermediaries in London, which somewhat distorts the analysis of the geographical origin and ownership of these capital inflows to the United States.

In any case, the increase in Treasury bond purchases has obviously been parallel to the increase in the share of official flows, which are clearly biased towards this type of paper. Of course, even at their lowest point (2003-04), private flows accounted for 70% of the total, but it would be no less realistic to recognise that without the public sector contribution from Asia, the US would not have been able to fund its current account deficit (or budget deficit).

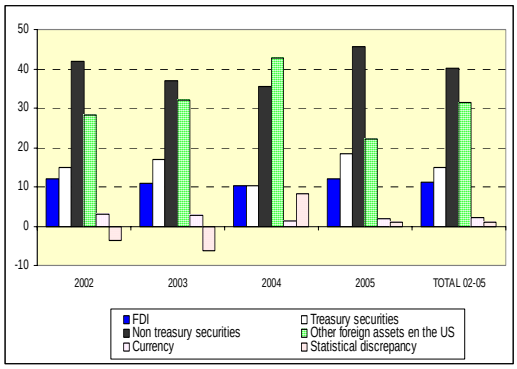
The second issue is the risk of Asian central banks diversifying their portfolios, which are overloaded with US dollars[6]. It is highly unlikely in the case such a diversification occurred, it would be significant. In the first place, any movement in this direction would cause the dollar to collapse, which Asian economies cannot afford. In the second place, although the depreciation of the dollar reduces the value of those reserves, interest rates in the United States are higher than the main alternatives in the rest of the developed world. Thirdly, if central banks decide to diversify their assets instead of in terms of foreign exchange, US financial markets offer the widest range of alternatives.

Therefore, from our point of view, the main risk in terms of financing come more from a loss of confidence in the US economy among private investors (fruit of its deficits) – including United States citizens themselves, rather than from official bondholders diversifying their portfolios.

[5] The Bank of Japan has not intervened to prop up the dollar since the first quarter of 2004.

[6] The Bank of China, for example, 70% of its 875 billion dollars in reserves, now the largest in the world.

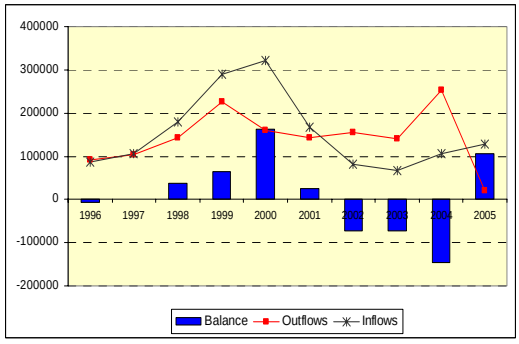
Figure 9: Net Financial Inflows by Type of Asset (millions of dollars)



Source: own elaboration with data from the BEA

Figure 9 displays the composition of private capital flows to the US in recent years. While this period is marked by considerable stability, it is worth paying attention to the pattern of Foreign Direct Investment (FDI) going a back a bit further in the past (Figure 10).

Figure 10: FDI (millions of dollars)



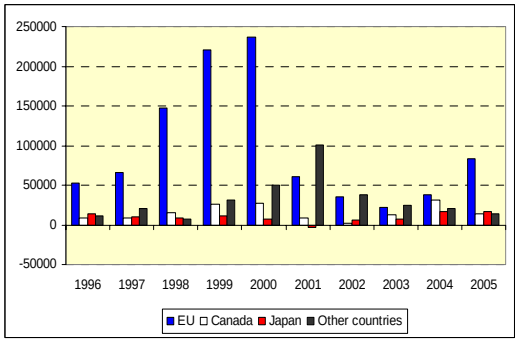
Source: own elaboration with data from the BEA

Following a period during which the US attracted an enormous amount of FDI, largely mergers and takeovers (more than 600 billion dollars between 1999 and 2000), the economic crisis in the European Union and a loss of confidence in the US economy sparked a severe decrease. With US investments stabilised at around 150 billion euros (growing in 2004), the balance dropped into the red.

This trend changed in 2005, abeit due more to the unusually weak US FDI than to an increase in inflows, which remain sluggish.

In any case, the economic recovery in Europe, which finally appears to have consolidated (particularly in Germany), should result in FDI flows recovering at least partially the level of inflows recorded in the second half of the last decade, in light of the leading role played by the EU in this type of investment, as can be appreciated in Figure 11. This effect began to emerge, albeit timidly, in 2005, when the European FDI figure more than doubled with respect to 2004.

Figure 11: Geographical Distribution of FDI in the United States (%)



Source: own elaboration with data from the BEA

However, it is worth remembering that this type of investment, particularly beneficial and yearned for by all countries, has been made considerable more difficult in the United States due to geopolitical and security issues, which have blocked the possible acquisition of US businesses behalf of Chinese or Arab companies. The Foreign Investment and National Security Act 2006, created to restrict the foreign acquisition of “strategic assets” is not good news in this respect.

Combining protectionist measures in both trade and investment is a dangerous strategy on behalf of the world's largest superpower; if other countries imitate the United States, a worrying return to protectionism would be guaranteed.

Table 1

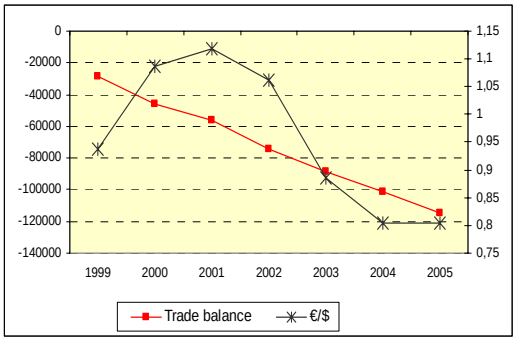
Oil Imports and their Impact on the Trade Balance

Year	Millions of Barrels of Oil	Annual % Change	Price per Barrel ($)	Annual % Change	Value of Imports ($mn)	Annual % Change
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
2005 (Jan-Mar)	*946*	*1.9*	*37.8*	*28.2*	*35763*	*30.6*
2006 (Jan-Mar)	*906*	*-4.2*	*52.6*	*39.1*	*47691*	*33.4*

Year	Change in Trade Deficit ($mn) *[" –" denotes an improvement in the trade balance]*	Change in the Costo f Oil Impots ($mn)	% of Trade Balance Change 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**
2005 (enero-marzo)	*33273*	*8378*	**25.2**
2006 (enero- marzo)	*24105*	*11932*	**49.5**

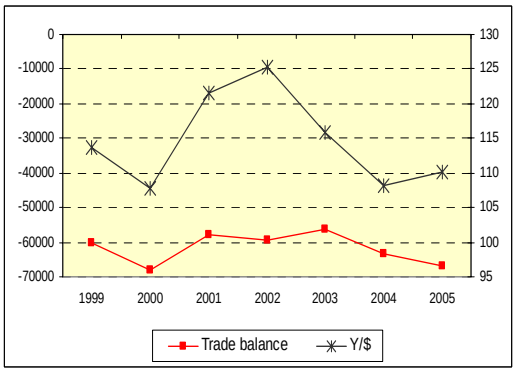
Source: own elaboration with data from the US Census Bureau

Figure 12: Trade Balance ($mn) and Bilateral Exchange Rate with the EMU



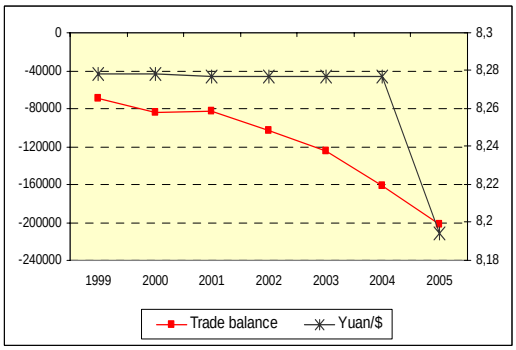
Source: own elaboration with data from the BEA

Figure 13: Trade Balance ($mn) and Bilateral Exchange Rate with Japan



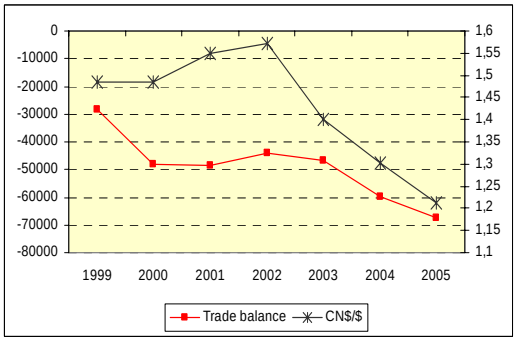
Source: own elaboration with data from the BEA

Figure 14: Trade Balance ($mn) and Bilateral Exchange Rate with China



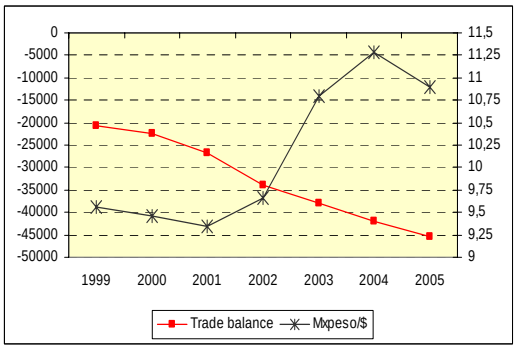
Source: own elaboration with data from the BEA

Figure 15: Trade Balance ($mn) and Bilateral Exchange Rate with Canada



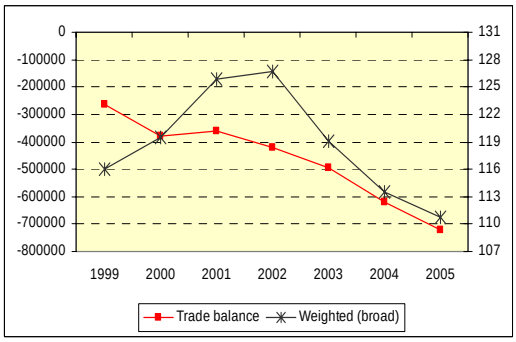
Source: own elaboration with data from the BEA

Figure 16: Trade Balance ($mn) and Bilateral Exchange Rate with Mexico



Source: own elaboration with data from the BEA

Figure 17: Global Trade Balance ($mn) and Effective Exchange Rate (broad group of trading partners)



Source: own elaboration with data from the BEA

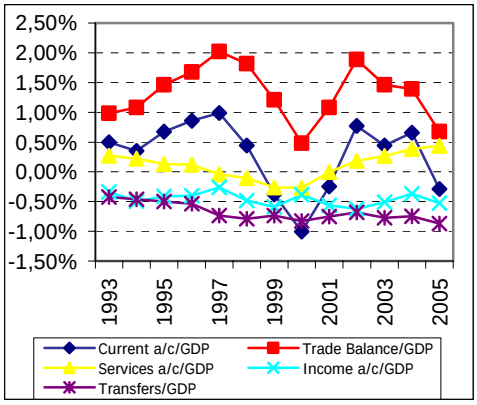
Vicente J. Pallardó
Valencia, May 31, 2006

2.- Euro-zone

1. Current Account History and Structure:

Generally speaking, the Euro-zone current account balance has displayed a surplus. Over the period dating from 1993 to 2005, the Euro-zone has recorded surpluses most years that overall average 0.29% of GDP. During the same period, the Euro-zone chained together three years with a deficit, 1999, 2000 and 2001, as well as last year with the equivalent of -0.29% of GDP.

Figure 1: Current A/C Balance and Components



Source: ECB

If the relationship between the current account and the various sub-accounts it comprises (trade in goods, services, income and transfers) is analysed, we can see how the former is closely linked to the trade balance. In fact, the correlation between the two is 0.79, well above the degree of influence of the rest of accounts.

Table 1: Correlations between the Current Account and Components

Trade	0.79
Services	0.40
Income	0.27
Transfers	0.37

Source: own elaboration

Furthermore, the trade balance not only accurately explains the historical evolution of the current account, but is also on average the most important of all the components (1.32% of GDP) and has always ended the year with a surplus. The income and transfers accounts have always recorded deficits, particularly in the case of transfers, where the deficit has almost doubled since 1993. The services account, however, is not very important in relation to the rest of accounts and on average has recorded surpluses. Royalties, business services, recreation and culture and communications have always displayed a deficit and have therefore generated foreign payments for such services.

The positive or negative balance of the current account may have been negatively affected by the presence of a public sector deficit, above average investment and interest rates and by a strong preference towards consuming in the present and positively affected by above average economic growth. Empirically speaking, the only variable that has a significant influence on the current account balance for the Euro-zone is excess investment. In the United States, excessive public deficit is also significant.[7]

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

Table 2: Current Account Balance and Components (s/GDP)

	1993	2005
Trade	1,0%	0,7%
Services	0,3%	0,4%
Income	-0,3%	-0,5%
Transfers	-0,4%	-0,9%
Current Account	0,5%	-0,3%

Source: ECB and own elaboration

2. The Euro-zone as a World Trading Power:

The Euro-zone remains the world's number one trading power. The region boasts a share of world exports of around 22% that has remained more or less constant since 1993, two points more than its share of imports. However, the United States, Japan and China have suffered significant changes. The US share of total world exports has dropped over the period under consideration to 14%, while imports maintain a share of around 23%. Japan has lost ground on the international scene, in contrast to China, which has almost doubled its share of both exports and imports with a current market share of around 10%.

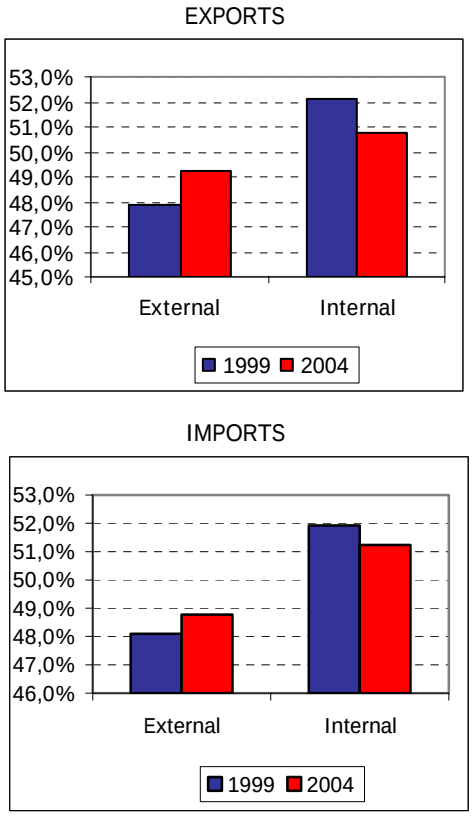
Table 3: World Export and Import Market Shares

% WORLD IMPORTS	1999	2004
Euro-zone	20.6	20.0
USA	25.9	22.7
Japan	7.6	6.8
China	4.1	8.4
% WORLD EXPORTS	**1999**	**2004**
Euro-zone	22.6	22.8
USA	17.9	14.4
Japan	10.8	9
China	5.1	9.4

Source: Eurostat

However, despite not losing its market share in terms of global exports and imports, a more detailed analysis does reveal differences. Textile and electronic goods from the EMU have lost ground in favour of China, among others.

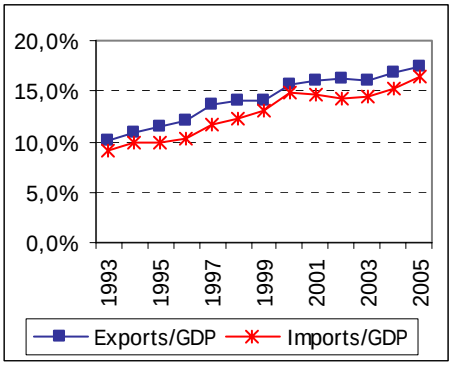
Figure 2: Euro-zone Internal and External Trade



Source: Eurostat and own elaboration

While Euro-zone external trade is important, trade within the Euro-zone is even more so. Notwithstanding, Euro-zone external trade has gained ground on internal trade when we compare the situation in 1999 to 2004. If we take the European Union into account, more than 65% of transactions are internal.

Figure 3: Exports & Imports over GDP



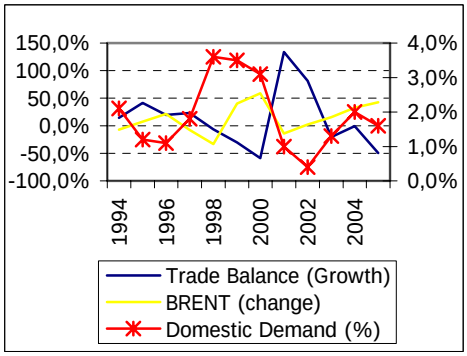
Source: ECB and own elaboration

In addition to this, we can deduce from Figure 3 that the degree of external openness of the Euro-zone economy has gradually increased over the years. While in 1993 exports and imports represented 10% and 9.1% of GDP respectively, in 2005 they amount to the equivalent of 17.3% and 16.5% respectively.

3. Trade Balance Always Favourable but with Ebbs and Flows:

As mentioned earlier in this report, the trade balance has a great influence on the current account balance. Despite remaining favourable over the period under study, the trade balance has fluctuated frequently. The trade balance has averaged a surplus equivalent to 1.4% of GDP. The fluctuations have been clearly related to domestic demand shifts and the price of oil. Both these factors are negative, that is, the trade surplus shrinks when the price of oil rises or when domestic demand increases. Both variables are significant if all three variables are estimated econometrically.

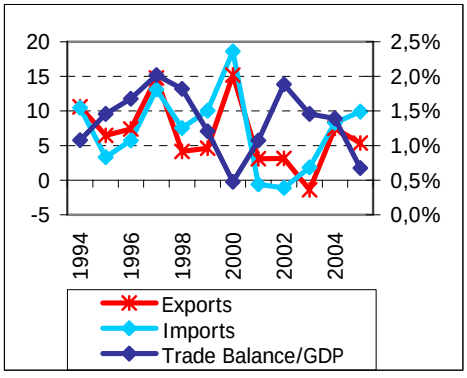
Figure 4: Trade Balance, Brent and Domestic Demand (Real Growth Rates)



Source: ECB and Reuters

The two largest falls recorded in the period occurred in 2000, following a strong rise in oil prices (58.9%) and strong growth in domestic demand (3.1%), and last year when the trade balance was halved due to the marked increase in the price of oil (42.7%). The situation continues to deteriorate in 2006, in light of the figures published by Eurostat on the external sector. In fact, the trade balance from January to March recorded a deficit of 11.6 billion compared to the 5.8 billion surplus registered over the same period the previous year. The strong growth in both energy and non-energy imports is entirely to blame for this highly negative trend.

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



Source: ECB and Eurostat

On breaking down the trade balance into exports and imports, positive growth is observed in both variables over the last two years, in comparison to the period dating from 2000 to 2003. Exports grew by 7.5% and 5.3% in real terms in 2004 and 2005 respectively, while imports rose by 8.3% and 9.9% respectively. However, if we compare 2005 to 2004, growth in imports has picked up speed whereas export growth has slowed down. As a result, import growth almost doubles export growth.

Over the period dating from 1993 to 2005, real export growth was boosted by the upturn in international trade (0.71 elasticity) and hampered by the real effective exchange rate (-0.47 elasticity). However, real imports were have risen on the back of growth in domestic demand (3.2) and the price of oil (0.06) – particularly if nominal imports are considered (0.15) – and restricted by the real effective exchange rate pattern (-0.39).

The visible deterioration of the trade balance due to the recovery in domestic demand and real activity is the result of:

a) The Euro-zone becoming increasingly less competitive in terms of both cost and non-cost, thus losing market share, except in the case of Germany. For example, labour costs per hour in 2003 in the European Union amounted to $US24.95, whereas in newly industrialising countries in Asia the average was $US7.57.

b) A persistently high public-sector deficit that is deteriorating savings/investment equilibrium.

c) Strong growth in bank loans to households.[8]

Productive specialisation and the geographical structure of exports, together with German industry off shoring also negative affect the trade balance.

4. Heterogeneity in Euro-zone Foreign Trade:

The marked heterogeneity observed across Euro-zone countries in the analysis of other aspects of the economy is also present in the external sector.

The Euro-zone export/import ratio – including goods and services – has performed very favourably in recent years, reaching 108.2 in 2004. However, this ratio is not uniform across Euro-zone countries. The export/import ratio in four out of the 12 countries (Spain, Italy, Greece and Finland) is below 100, meaning that their exports do not cover their imports. The highest ratios in the Euro-zone are observed in Ireland, Luxembourg and Germany.

[8] CDC-Ixis Flash 184-2006. "If Euro-zone growth is to continue, the euro Hill have to become an international currency". P. Artus

Table 4: Export/Import Ratio (%) 2004

Euro-zone	108.2
Belgium	102.7
Germany	111
Greece	88.4
Spain	99.3
France	100.7
Ireland	118.9
Italy	94.5
Luxembourg	121.3
Netherlands	107.4
Australia	108.3
Portugal	108.6
Finland	94

Source: Eurostat

The country most externally oriented (not including small economies) is Germany. Exports in this country equate to 40.2% of GDP, in contrast to other large countries such France and Italy (26.3%), or Spain (25.4%). Other countries that due to their reduced size are highly export oriented include Luxembourg (158.3%), Belgium (87.1%) and the Netherlands (71.2%).

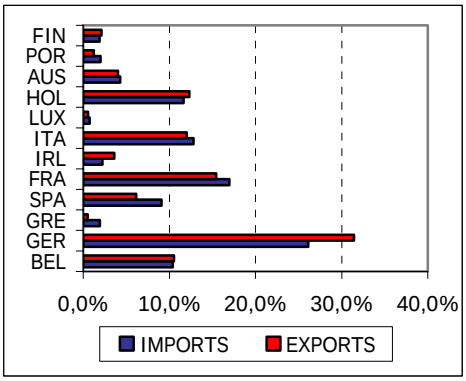
Due to the size of its economy and export vocation, Germany is also the main exporter and importer in the Euro-zone, well ahead of France, Italy and Spain. Likewise, Germany is also the country that in terms of volume most exports and imports outside of the European Union, more than doubling French and Italian exports.

Table 5: Export Share by Euro-zone Country (%)

	EXPORTS/GDP
Belgium	87,1
Germany	40,2
Greece	20,8
Spain	25,4
France	26,3
Ireland	79,4
Italy	26,3
Luxembourg	158,3
The Netherlands	71,2
Austria	51,7
Portugal	28,6
Finland	38,7
Euro-zone	37,3

Source: European Commission

Figure 6: % Share of Euro-zone Exports and Imports



Source: Eurostat

By geographical area, Germany displays a trade surplus with all regions, whereas Spain, on the other hand, has a trade deficit with the whole world. France and Italy record a deficit with the Euro-zone and a surplus with the rest – except for Italy with OPEC. However, the Netherlands records a large surplus with the Euro-zone and a significant deficit with the rest of the world.

As regards the share of exports to emerging nations, Germany (17%) and Italy (16%) are the countries that sell

the highest proportion of goods and services to these countries with respect to total exports. Moreover, Germany enjoys a competitive advantage over the rest of Euro-zone countries in that it is a specialist in capital goods and equipment.

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

The most exported products are machinery and transport material (47%), other manufactured products (26.8%) and chemical products (15.6%). The most imported goods, apart from machinery and transport material (37.3%) and other manufactured products (26.2%), include oil products, which account for 15% of total imports.

The Euro-zone displays a surplus in machinery and transport material, chemical products, other manufactured products and food, beverages and tobacco and a deficit in oil and derivatives and raw materials.

Table 6: Imports and Exports by Product 2004

	IMPORTS
Food, Beverges, Tobacco	5,8%
Raw Materials	4,6%
Oil	15,9%
Chemical Products	10,1%
Machinery and Transport	37,3%
Other Manufactures	26,2%
	EXPORTS
Food, Beverages, Tobacco	6,0%
Raw Materials	2,0%
Oil	2,5%
Chemical Products	15,6%
Machinery and Transport	47,0%
Other Manufactures	26,8%

Source: Eurostat

On the other hand, regarding the origin and destination of Euro-zone imports/exports within and outside the community the following is observed:

a) The most increasingly significant surpluses are with the United Kingdom and the United States, both similarly weighted at around 80% of the total result. However, over the 1993-2004 period, the relative surplus with the USA has increased five times more than that corresponding to the United Kingdom.

b) The largest trade deficits are with China in the first place followed quite a way back by Japan and Russia, which are similarly weighted. However, while the deficit with China and Russia has increased significantly over the period under study, the deficit with Japan has shrunk noticeably.

c) As regards exports, the main destinations are the United Kingdom and the United States, which are both increasing their market share. It is worth mentioning the increase in the share of exports to the Eastern European countries that have recently joined the European Union, which is a logical part of the integration of these countries in the union.

d) Imports mainly come from the United Kingdom and the United States, although both countries are losing ground over time. The third largest importer is China, which over this period of time has trebled its share of the Euro-zone market. China increasingly leads the manufacturing and other

sectors, but what makes the country fearsome for other segments of the economy is that Chinese industry could quickly and easily apply patents to industry if they decided to look for industrial uses for patents from the German patent register for example.

Table 7: Euro-zone Imports and Exports: Main Origins and Destinations

IMPORTS	1993	2004
Czech Republic	1.1%	2.6%
Hungary	1.0%	2.3%
Poland	1.6%	2.7%
Sweden	3.9%	3.7%
United Kingdom	16.1%	13.2%
Switzerland	6.7%	5.0%
Russia	3.5%	5.2%
United States	13.8%	10.5%
China	3.5%	8.6%
Japan	8.4%	5.0%
Other	40.3%	41.1%
EXPORTS	1993	2004
Czech Republic	1.3%	2.7%
Hungary	1.2%	2.2%
Poland	1.9%	3.3%
Sweden	3.5%	3.7%
United Kingdom	17.9%	17.8%
Switzerland	7.9%	5.8%
Russia	2.5%	3.1%
United States	13.6%	15.1%
China	2.2%	3.5%
Japan	3.9%	2.9%
Other	44.2%	39.9%

Source: Eurostat

6. Euro-zone Financial Account:

Theoretically speaking, emerging nations, which have low levels of capital per capita, should have received strong capital transfers from advanced countries. However, quite the opposite has occurred. Excessive savings to the detriment of investment in emerging countries such as China, Russia or the OPEC and South America has been channelled to advanced countries, particularly to bond markets. The reason for this is highly expansive global monetary policy, the technology and human capital deficit in emerging nations and precaution in order to obtain a foreign trade surplus, following the previous crises suffered between 1998 and 2001[9].

Table 8: Financial Account (% of GDP)

	2001	2005
Portfolio Investment	1,1%	1,8%
Direct Investment	-1,6%	-2,0%
Other Investment	0,1%	0,7%
Financial Account	-0,5%	0,5%

Source: ECB, Eurostat and own elaboration

The Euro-zone financial account displayed a deficit over the 2001-2005 period except for last year. Direct investment has practically always registered a deficit, therefore resulting in residents' net investment going abroad, a trend that became more pronounced last year. This is due to the Euro-zone not appealing enough as a place to produce. The exception occurred in 2000 when direct investment on behalf of non Euro-zone residents peaked following a larger number of mergers and takeovers in the market.

[9] 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

Table 9: Portfolio Investment by Instrument

	2001	2005
Portfolio Investment	1,1%	1,8%
Equity Securities	1,9%	1,8%
Fixed Income	-0,9%	0,0%
Bonds	-0,6%	-0,5%
Monetary Market Instruments	-0,2%	0,5%

Source: ECB, Eurostat and own elaboration

However, portfolio investment has always displayed a favourable balance and, therefore, means that there is net investment in portfolio assets in the Euro-zone on behalf of non residents.

Portfolio investment in equity securities has always favoured investment on behalf of non-residents in the Euro-zone over the 2001-2005 period, although Euro-zone investment in equity securities abroad has also increased over time. In 2005, net portfolio investment in equities almost quadrupled, which apart from the merger in July, echoes the favourable results on the stock market in 2005.

As regards fixed income, the net overall surplus has decreased over this period of time, dropping slightly into the red in 2005 (-0.01%). Consequently, the Euro-zone has gone from receiving net investment from abroad in fixed income securities, to becoming a net investor in foreign fixed income. A breakdown of fixed investment reveals a deficit in terms of bonds and a similar-sized surplus in monetary market instruments (notes and commercial bills). These shifts are due to financial asset yield differences.

Finally, as regards geographical distribution, direct investment is mainly bound for EU countries, which account for 68.3% of the total. Meanwhile, in the case of portfolio investment 40.6% of is destined to these same countries.

Table 10: International Investment Position

	TOTAL	DIRECT	PORTFOLIO
2001	-389	422.9	-834.8
2002	-703.6	184.5	-937.6
2003	-809.3	43.1	-914
2004	-946.4	33.1	-1049.4
2005	-1048.5	233.4	-1308.6

Source: ECB

Nicolás Jannone
Valencia, 5 June 2006

3.- Spain

Spanish Foreign Trade...Growing Imbalance

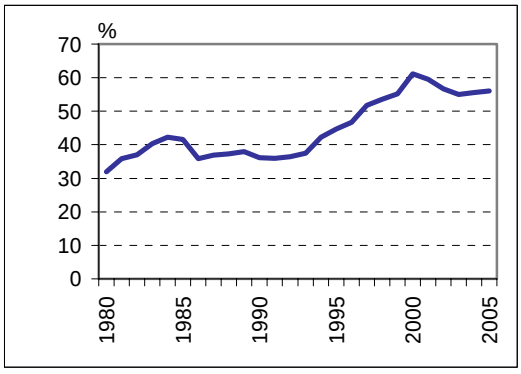
One of the main structural changes that has accompanied and boosted the outstanding economic growth in Spain since the 1960s is its increasing external openness.

Internationalisation of the Spanish Economy

Figure 1 displays the steady process of internationalisation and the Spanish economy's growing degree of interdependence with the rest of the world. As a result, the external openness ratio (percentage of exports and imports over GDP) rose from 32% in 1980 to close to 60% at the beginning of the 21st century, in line with EU countries.

Spain began to open up to foreign trade with the *"Plan de Estabilización y Liberalización"* (Stabilisation and Deregulation Plan) in 1959 and finally consolidated in 1980 when Spain joined the EEC and with the achievement of the single market and the Economic and Monetary Union in the 1990s.

Figure 1: External Openness Ratio 1980-2005



Source: own elaboration and OCEI

Economic growth has undoubtedly been boosted by the greater degree of economic openness and integration, which has played a leading role in both the improvements in productive efficiency (due among other things to increased competition and the fact that the integrated market was larger, technology imports and foreign savings to finance national investment) and also the achievement of greater macroeconomic stability (following the homologation of macroeconomic policy and higher levels of deregulation and market flexibility.

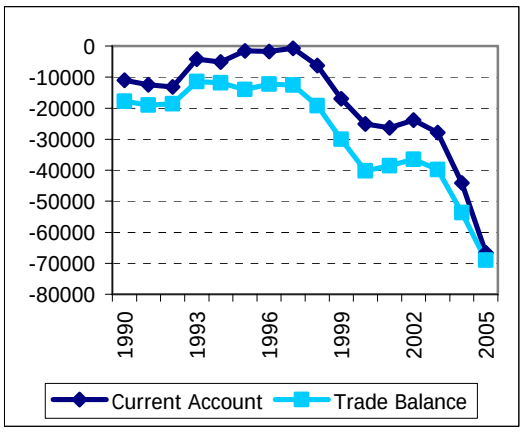
This process has not, however, been uninterrupted, as can be appreciated in the graph above. On the one hand, progress in this sense has been curbed by pressure on behalf of protectionist lobbies and on the other hand boosted by the international commitments undertaken.

In order to analyse the evolution of the external sector, we are going to examine the Balance of Payments and its various components (current account, capital account and financial account).

Increasing Trade and Current Account Deficits

When a not very competitive economy opens up to international competition, one of the direct consequences is the emergence of trade deficits (more payments than income). These deficits have marked the evolution of the Spanish economy over the past 40 years. However, the growing trade and current account deficit in recent years is progressively and alarmingly deteriorating the competitiveness of the Spanish economy (see Figure 2).

Figure 2: Trade and Current Account Deficits (millions of euros)

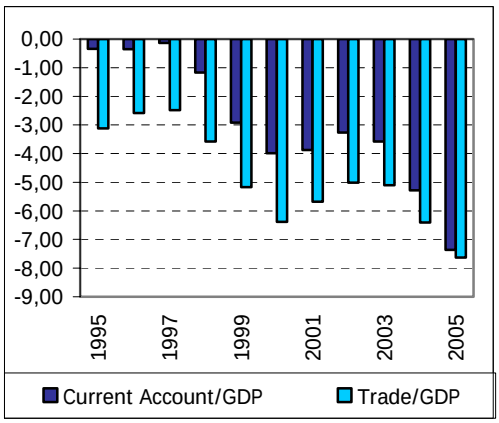


Source: own elaboration with data from Banco de España

In addition, Figure 4 clearly shows how balance entries that normally offset the trade deficit (tourism income and current transfers) and historically mitigated the size of the current account deficit have lost ground.

A current account deficit indicates that the economy needs to borrow money. That is, the country has an external debt. In 2005, this debt rose above 7.7% of GDP, doubling the current account deficit in 2003 (See Figure 3).

Figure 3: Trade and Current Account Deficit over GDP



Source: own elaboration with data from Banco de España

Spain's current account deficit traditionally rises during expansive periods due to the country's dependence on investment goods required to sustain the growth of the economy and as a result of the increase in consumption stemming from an increase in consumer purchasing power. Supply shocks (increases in the price of raw materials) have also played a part in the deterioration of the current account.

From a macroeconomic viewpoint, a current account deficit arises when domestic demand exceeds national production. The Spanish economy has boomed in recent years on the back of strong domestic demand, which partly results in an increase in imports. Moreover, the sluggish economic growth in the countries surrounding Spain is not helping to boost exports either. Wide price gaps together with remarkable corporate profit margins (in sectors protected from competition), together with the minimal progress made in terms of productivity, are deteriorating Spain's competitive position.

Alternatively, from a macroeconomic viewpoint, the deficit can be deemed as insufficient domestic savings to finance investment. In the Spanish economy, the deficit is caused by the high rate of investment, which is the equivalent of nearly 28% of GDP.

A current account deficit implies an increase in current expenditure financed by foreign savings (loans or investment from the rest of the world), which will have to be offset in the future. That is, the Spanish economy is capturing foreign resources. From the perspective of efficient resource allocation on an international scale, one could argue that the Spanish economy

could be appealing as a destination for the world's surplus savings. Consequently, profitable current investments could provide high yields to pay international investors with.

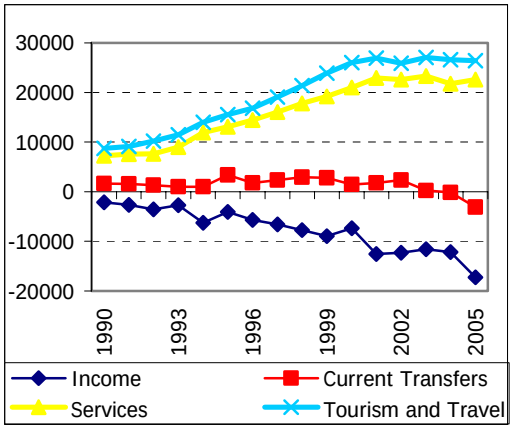
However, the following points must be taken into account. On the one hand, prolonged and sizeable current account deficits may become impossible for any economy to sustain in the long term. On the other hand, the issue of whether financed expenditure is superfluous or productive arises. Moreover, if the last case were applicable, would it boost productive capacity and growth in the economy? The investment rate in the Spanish economy is high, although it not so clear whether this investment is improving productive capacity. Finally, it is necessary to examine whether the growing debt is being financed by short or long term investments. In order to do so, we will examine the composition of the financial account later in this report. In any case, high current deficits increase the deficit of the income account, which in turn fuels the current account deficit in the future. In the next section we study the origin of the current account deficit by thoroughly examining the recent history of its components: trade in goods, trade in services, income and current transfers.

Current Account Components

Figures 2 and 3 highlight the magnitude of the trade deficit and how it is getting increasingly closer to the current account balance. This trend is the result of developments in other components of the current account balance sheet.

Figure 4 shows how the net balance of trade in services, income and current transfers has clearly declined over the last two years, despite the tremendous differences among its components. In this sense, all the current account entries have deteriorated since 2003.

Figure 4: Trade in Services, Tourism and Travel, Current Transfers and Income (balance in millions of euros)



Source: own elaboration with data from Banco de España

Apart from the surplus in tourism and travel levelling out, which have traditionally offset the trade deficits, the situation of the income account has deteriorated markedly. This almost entirely due to the pattern of investment income (rather than labour earnings) and is a result of the increasingly large current account deficits financed by foreign savings. The balance has become increasingly negative due to the accumulation of foreign net liabilities. It is also worth highlighting the slump observed in the current transfers balance in recent years. The main components of this balance are those corresponding to the European Agricultural Guidance and Guarantee Fund (EAGGF), which are current transfers to the private sector from the EU, and European Social Funds (public current transfers including financial aid for professional training and employment), as well as

remittances from Spanish citizens residing abroad.

In the next section we conduct an extensive analysis of the trade balance, which is a vital part of the current account, as can be appreciated in Figure 3.

Trade Balance Analysis

a) By Geographical and Economic Region

Table 1 shows how the trade deficit has increased over the period 1995-2005. The overall export/import ratio is clearly below 1 and has fallen by 13.5 percentage points.

Table 1: Spanish Trade by Geographical Region (%) and Export/Import Ratio (1995-2005)

	Imports		Exports		Ratio	
	1995	*2005*	*1995*	*2005*	*1995*	*2005*
Total	*100%*	*100%*	*100%*	*100%*	*79.8%*	*66.4%*
EU	65.4%	58.6%	72.3%	69.1%	88.3%	78.3%
EMU	55.5%	51.0%	62.7%	57.7%	90.2%	75.1%
OECD	*81.1%*	*72.9%*	*83.4%*	*82.7%*	*82.1%*	*75.3%*
USA	6.4%	3.4%	4.1%	4.0%	51.4%	78.0%
JAPAN	3.3%	2.5%	1.4%	0.8%	33.2%	19.7%
OPEC	5.6%	7.6%	3.0%	2.7%	42.4%	24.0%

Source: Own Elaboration. Data: Banco de España and Customs Statistics.

Furthermore, Spanish trade relations are highly concentrated in a small number of countries. In this sense, the OECD accounts for 80% of Spain's exports and imports (with an export/import ratio of less than 100 and dropping). The EMU share has increased since 1995, mainly due to the increase in imports which has considerably worsened the export/import ratio.

This aspect is very important in light of the fact that trade flows with Euro-zone countries are highly deregulated and that the exchange rate has no effect whatsoever on the fluctuations in the trade balance. Therefore, the 15-point decrease in the export/import ratio with EMU is an indicator (just one more in any case) of Spain's competitiveness problems.

In addition to this, the share of the US as a source of imports has diminished, while exports destined to this country have increased slightly. As a result, the export/import ratio has increased, although it remains well short of 100.

The export/import ratios with Japan and OPEC countries respectively are extremely low. Trade with Japan is minimal and appears to be decreasing over time. As regards exports, the share of OPEC countries has decreased, while imports have gained ground, thus pushing up the deficit with this group of countries.

Table 2 displays the relative share of the trade deficit (much larger in 2005 than in 1995, as displayed by Figure 3) corresponding to the various geographical/economic regions. The OECD as a whole, the US and Japan have seen their share of the deficit decrease, while the share of OPEC countries and the EU remains unchanged. However, the deficit with respect to the EMU has grown substantially, which suggests as indicated above, that Spain has lost competitiveness with a region that shares the same currency.

Table 2: Trade Balance Distribution by Region (%)

	1995	*2005*
EU	37.9	37.8
EMU	26.9	37.7
OECD	71.8	53.5
USA	15.4	2.2
JAPAN	10.9	6.1
OPEC	16.0	17.1

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

b) By Product

Table 3 displays how Spanish trade specialisation is relatively biased towards traditional consumer goods (representing 38.8% of exports) such as food (also leather, footwear, furniture, etc.) and other goods such as motor vehicles.

Table 3: Spanish Trade by Product (%) in 2005

	M	X	(1)	(2)
Total	***100.0%***	***100.0%***	***66.4%***	
Consumption	29.0%	38.8%	*89.0%*	9.5
Food	6.1%	12.2%	*133.1%*	-6.0
Motor Vehicles	8.0%	12.6%	*104.6%*	-1.1
Capital	11.8%	9.7%	*54.4%*	16.0
Machinery	6.9%	4.1%	*39.2%*	12.5
Transport Material	3.3%	4.9%	*99.6%*	0.0
Intermediate	59.2%	51.5%	*57.7%*	74.5
Energéticos	13.9%	4.1%	*19.6%*	33.2
Non-energy	86.1%	95.9%	*73.9%*	66.8

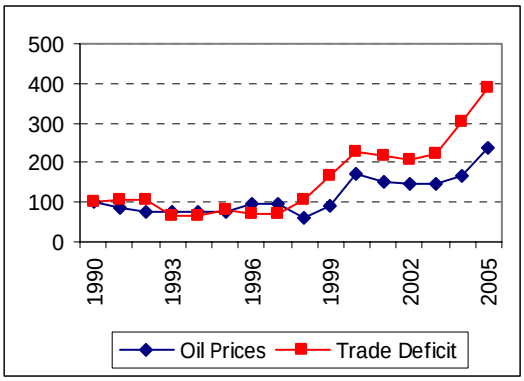
(1) Export/import Ratio (2) Trade Balance distribution by product (%)
Source: own elaboration with data from Banco de España and Customs Statistics

Despite the import/export ration being over 100 in both motor vehicles and food, the balance is negative for consumer goods as a whole as a result of the decrease in the commercial advantage of traditional consumer goods (including leather, footwear, furniture) in recent years. This situation contrasts with the competitive improvement in sectors such as motor vehicles and natural stone.

It is also worth underlining Spain's high degree dependence on foreign countries for both capital and intermediate goods. In both cases, exports represent less than 60% of imports. It is worth mentioning at least two points: on the one hand, there is an enormous dependence on certain capital goods, such as machinery. On the other hand, intra-industry trade is significant, but displays a sizeable deficit (that accounts for three quarters of the trade deficit). In this sense, there has been a change in the specialisation pattern in Spain from that based on providing natural resources and labour towards a greater presence of technological and productive factors (taking advantage of economies of scale).

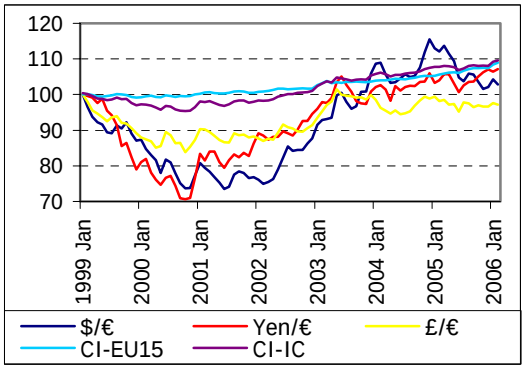
The last two columns of the table clearly show Spain's enormous dependence on foreign energy products, which registers a negative balance that is responsible for one third of the trade balance. Hence, if oil prices remain high, in light of their direct relationship with the size of the trade balance as suggested by Figure 5, if domestic demand remains strong and if the other current account item follow the same patter as in recent years (see Figure 4), the current account situation can be expected to deteriorate further (that is, an increase in the debt of the economy).

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



Source: own elaboration. Oil prices are average annual cost of oil imports in dollars/barrel (International Energy Agency). Trade deficit in millions of euros and euro/dollar exchange rate (Banco de España).

Figure 6: Exchange Rates (Jan-99=100) and Competitiveness (Q1-99=100)



Source: own elaboration with data from Banco de España
CI: Competitiveness Index with respect to the European Union 15 (CI-EU15) and industrialised countries (CI-IC). Competitiveness Indexes calculated with industrial manufacturing prices. An increase implies a loss of competitiveness.

The euro's tendency to appreciate since the beginning of 2002 (particularly with respect to the dollar), as can be observed in Figure 6, has curbed the deterioration of the energy account to a certain extent, but has contributed to the foreign trade deficit.

However, the role of the exchange rate in the deterioration of the foreign trade deficit is minimal due to trade exchanges becoming increasingly geographically specialised in Euro-zone countries. Therefore, one of the most serious problems faced by the Spanish economy is the constant loss of competitiveness.

Consequently, the main problems are not related to either the price of oil or the exchange rate. The problem is the economy's continuous loss of competitiveness. As mentioned in previous reports, the modest progress observed in productivity and the marked climb in prices help to explain this scenario and lead us to be pessimistic with regard to the outlook for the foreign trade deficit in the short and medium term.

From a macroeconomic angle, the current deficit is due to the strength of domestic demand or insufficient domestic savings (particularly private) to finance the remarkable level of investment funded by foreign resources (world savings) that, at least to date, does not appear to have significantly boosted the productivity of the economy.

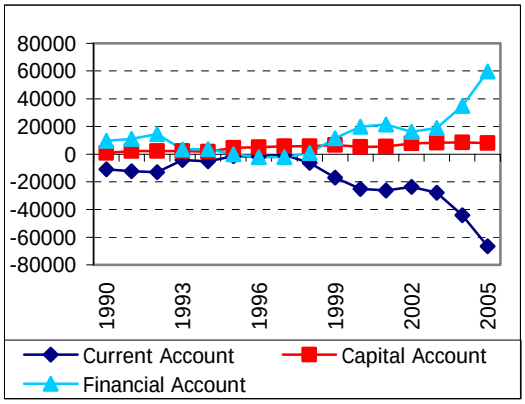
The continuous and in recent years exacerbated growth in foreign borrowing requirements is the obvious consequence of the current account deficit. The next section offers an extensive analysis of how the economy's foreign borrowing is being funded.

Financial Account

The inevitable balancing entry of an enormous (and growing) current account deficit is a surplus in the financial account (net capital inflows). The relatively stable and low balance of

the capital account results in the current and financial account balances displayed in Figure 7 being practically symmetrical with respect to the x-axis. These balances appear to have been explosive over the past three years and, seemingly, are likely to continue in the same line for some time.

Figure 7: Net Current, Capital and Financial Account Balances (€mn)[a]



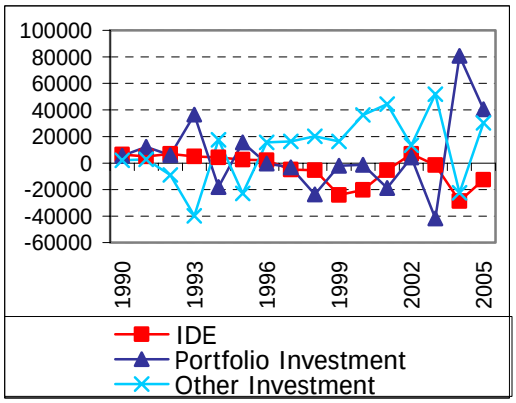
Source: own elaboration with data from Banco de España

[a] A positive sign denotes capital inflows, while a negative sign indicates outflows

The financial account balance is the difference between the net change in liabilities (NCL) and the net change in assets (NCA) from transactions including the acquisition of tradables (shares, bonds, debt), loans and deposits and reserve and asset exchanges with the Euro system.

Figure 8 shows how net capital inflows since halfway through the 1990s have been channelled to other investments, except over the last two years during which time the importance of portfolio investments has increased.

Figure 8: Main Components of the Financial Account[a]: Net Balances in €mn



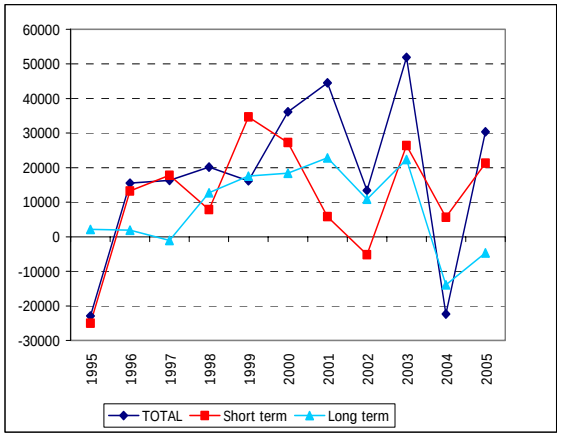
Source: own elaboration with data from Banco de España

[a] Balance=NCL-NCA. A positive sign (negative) denotes capital inflows (outflows)

Other investments include the changes in financial assets and liabilities with non-residents that are not recorded as direct or portfolio investment, such as loans between residents and non-residents, supplier loans to customers, deposits (including foreign notes held). As can be appreciated in Figure 9, short term inflows have grown in recent years. This point is particularly important as it is precisely over this period that the economy's borrowing requirements (that is, the current account deficit) have increased dramatically.

On the other hand, portfolio investments have also contributed more towards financing the economy in recent years, mainly due to bonds and debt obligations (Table 4).

Figure 9: Net Balance of Other Investments[a] (€mn)



Source: own elaboration with data from Banco de España

[a] Balance=NCL-NCA. A positive (negative) sign denotes capital inflows (outflows)

Table 4: Portfolio Investments (€mn)

	Spain Abroad		From Abroad In Spain	
	1995	**2005**	**1995**	**2005**
Total	328.1	96150.0	15874.8	136604.5
Shares[a]	398.4	15329.7	3109.0	-7802.2
Bonds and debt	81.7	77571.6	11425.3	145121.3
MMI[b]	-152.0	3248.7	1340.5	-714.7

Source: own elaboration with data from Banco de España

[a] Stocks and shares in investment funds

[b] Money Market Instruments

Figure 9 suggests that Foreign Direct Investment (FDI) is not making a significant contribution towards financing the Spanish economy's borrowing. This is probably related to the upturn in foreign investment on behalf of Spanish multinational enterprises. In this sense, as highlighted in Figure 2, 87.5% of investment abroad in 2005 corresponds to the purchase of shares and other forms of participating and reinvested profits. However, the share of these components in FDI in Spain has dropped from 71.4% to 47.1% over the period 1995-2005, whereas real estate investment has risen remarkably to 30% of total FDI received in 2005.

Table 5: Direct Investment (€mn)

	Spain Abroad		From abroad In Spain	
	1995	**2005**	**1995**	**2005**
Total	3499.5	31177.0	6048.0	18484.4
Shares	1765.7	19883.6	2354.5	2978.3
Others[a]	1207.7	7395.0	1991.9	5735.6
Financing[b]	460.3	2373.3	626.2	4232.4
Real Estate	65.9	1525.1	1075.5	5538.1

Source: own elaboration with data from Banco de España

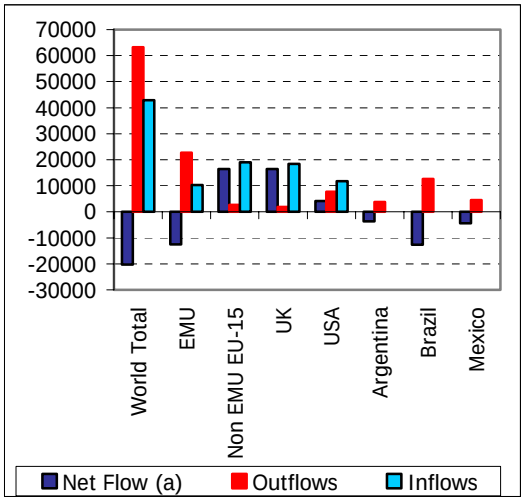
[a] Other types of shares and reinvested profits

[b] Funding related companies

This aspect is particularly important and at the same time worrying, as it completes the picture of the Spanish economy's sources of financing. Short term investments are gaining importance and, moreover, the FDI received is seemingly losing ground in favour of real estate investment. AS a result, the remarkable and increasing level of borrowing may well be unsustainable in the medium/long term. For this reason, the external imbalance (which undoubtedly reflects the weakness of the growth pattern) could emerge as the factor that brings the current growth pattern to an end. This is particularly important as the economy can no long fall back on the (historically) much used devaluations in order to correct external imbalances.

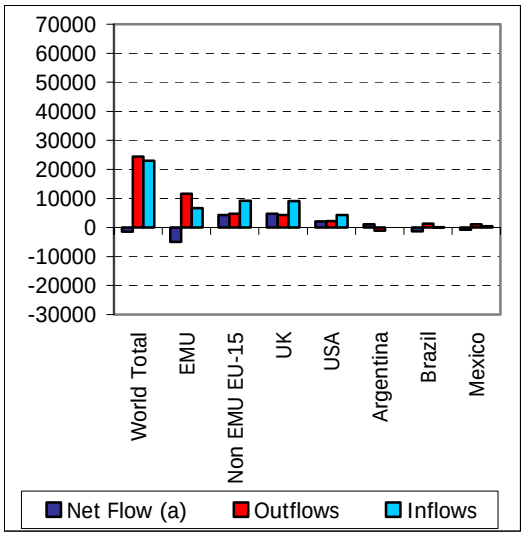
Figures 10 and 11 display the FDI in 2000 and 2003.

Figure 10: Direct Investment by Economic Region (€mn) in 2000



Source: own elaboration with data from Banco de España
(a) Positive net flows denote net capital inflows (increase in liabilities)

Figure 11: Direct Investment by Economic Region (€mn) in 2003



Source: own elaboration with data from Banco de España
(a) Positive net flows denote net capital inflows (increase in liabilities)

Spanish FDI is highly concentrated in developed nations in South America, whereas the FDI is mainly received from EMU countries, the UK and the USA.

Concluding Remarks

The current account deficit rose to the equivalent of 7.6% of GDP in 2005, double the figure recorded in 2003. The sizeable and growing current account imbalance could be due to the relative sluggishness of external markets (particularly in the EMU) and a loss of competitiveness on behalf of the Spanish economy. Internal factors such as higher inflation and low productivity growth or external factors such as the appreciation of the euro with respect to other currencies (particularly the US dollar) could be responsible for Spain becoming less competitive.

The bearish trend displayed by the euro since the beginning of 2002 (especially in comparison to the dollar), despite mitigating the deterioration of the energy account due to the upturn in energy prices, has contributed to the deterioration of the foreign deficit.

However, in light of the increasingly high level of geographical concentration of trade relations in the Euro-zone, two important aspects help to explain the growing current account deficit. In the first place, the growth differential between Spain and its trading partners. The weak economic recovery in the main Euro-zone countries is damaging Spanish exports, at the same time as imports are growing due to the boost from buoyant domestic demand. Secondly, the most import factor is without a shadow of doubt the continuous loss of competitiveness, which is the most pressing problem current faced by the Spanish economy. Consequently, the current account deficit is mainly a problem of competitiveness.

Furthermore, within the framework of the renewed Lisbon Agenda, with the

(utopian) aim of making the European Union "the most dynamic and competitive knowledge-based economy in the world" by 2010, there is also an external objective. In this sense, obtaining open and competitive markets within and beyond European Union borders has been earmarked as a priority issue. In order to achieve this, three mechanisms were proposed to strengthen growth. The first is to further open up markets and improve the access of EU products and services to them by significantly reducing tariff and non-tariff trade barriers. The second is to implement new and improved trade rules and discipline, particularly aimed at fostering trade, trade defence instruments and non-tariff measures in order to boost trade exchanges and thirdly, to clarify and extend geographical indications in order to increase the number of EU products protected by such indications and to create rules guaranteeing the trade conditions under which European companies work. Further trade deregulation will probably have a negative effect on the Spanish economy in the short term, as companies that are not competitive will disappear, jobs will be lost.... However, an EU commitment to eliminate a great deal of trade barriers, which is unlikely in the current scenario, could generate a substantial incentive for the economy to improve its competitiveness.

Another important issue is that the deterioration of the current account is a sign of insufficient domestic savings (the savings rate has remained relatively stable, despite the decrease in household savings) to finance growing investment. However, investment is not improving productive capacity, as it is highly biased towards the construction sector.

Finally, the way in which the debt is being financed is also a cause for concern. The importance of short term capital, much more volatile than long term capital, is striking, as is the shift in foreign investment towards the real estate sector. The positive FDI aspects include both the improvement and modernisation of the the country's productive capacity and technological and organisational spillovers etc. However, these positive effects appear to be only boosting the Spanish economy in the short term by complementing the vigorous domestic demand.

As a result, the external imbalance is particularly worrying. Furthermore, in view of the fact that the currency cannot be devalued in order to restore price competitiveness and the government's hands a somewhat tied when it comes to implementing demand strategies, structural reform aimed at boosting competitiveness is a pressing need in all sectors of the economy so as to make markets more flexible and to foster progress in terms of productivity.

Silviano Esteve
Valencia, 1 June 2006

4.- Germany and France.

Regarding the German economy, the current account balance has been positive and sizeable throughout 2005 and up to March 2006, as was to be expected considering that the external sector has been the main driving force behind the growth of the economy in recent years. By component of the current account, we can see that the surplus is primarily due to the trade in goods account, which is a good sign of the export strength of the German economy. The Trade in Services account, on the other hand, continues to display a deficit, but is not large enough to endanger the overall current account surplus. Finally, the income account displays a surplus, but more smaller in size even than the Trade in Services account deficit. Despite not figuring in the graph, it is worth remembering that the export/import ratio in trade in goods stood at an extraordinary 122.81% in March 2006, which is the best proof the export buoyancy mentioned above.

Table 1: German Current Account Balance

	Balance	Goods	Services	Income
2005-1	7823.36	13333.40	-1833.10	580.84
2005-2	9413.35	13571.06	-1377.59	963.22
2005-3	11895.93	16324.50	-2252.10	1591.27
2005-4	6251.65	12719.16	-1792.88	-1809.11
2005-5	5392.58	12078.64	-2354.10	-809.08
2005-6	11637.46	16745.60	-1745.18	1311.66
2005-7	8439.64	14465.88	-2813.75	875.51
2005-8	2795.59	11575.76	-5612.32	883.41
2005-9	8012.84	15017.15	-3868.35	1535.09
2005-10	6463.98	12181.28	-2455.51	1425.44
2005-11	8057.51	13306.09	-1357.19	1059.37
2005-12	6046.14	9235.60	-414.37	1035.15
2006-1	6254.31	12583.10	-3042.79	814.76
2006-2	10985.74	12950.70	-924.07	1552.08
2006-3	8954.55	14311.00	-2248.22	755.71

Source: Bundesbank

The picture of the French current account balance could not be more different from Germany's. In the first place, the overall balance of the current account is negative and much smaller than Germany's. The deficit recorded in the Trade in Goods account throughout the period under study is responsible for the French current account deficit. As a result, the French economy can be seen as a marked importer. The Trade in Services account displays a surplus, but is too small to compensate for the goods deficit. However, the income account has mainly recorded surpluses that normally offset the trade in goods and services accounts, which suggests that the current transfers account, which does not appear in the table below is mainly responsible for the current account deficit. Finally, it is worth pointing out that the import/export ratio of French goods exports stood at 94.6% in February 2006, a good sign of the problems in France's external sector.

Table 2: French Current Account Balance

	Balance	Goods	Services	Income
2005-1	-2898	-2358	67	-1331
2005-2	-466	-1405	86	2843
2005-3	-1345	-2271	593	2273
2005-4	-8221	-2513	417	-4601
2005-5	-3923	-2250	546	-144
2005-6	509	-860	1524	1764
2005-7	-3170	-1471	1197	-813
2005-8	-1665	-3576	859	2987
2005-9	-490	-1410	662	2560
2005-10	-6256	-2071	1202	-3401
2005-11	-4518	-3343	140	786
2005-12	-1115	-2494	1028	3323
2006-1	-4509	-3884	-146	669
2006-2	505	-1763	-520	2022

Source: Banque de France

In Germany the balance of the Financial Account is negative towards the end of 2005, which is a clear sign of Germany's foreign bias in this sphere of

activity. A breakdown of the financial account into subsections confirms this result. The norm in these subsections is a negative balance, while the extraordinary is a positive balance, which is in any case offset by the negative balance in other subsections. Consequently, the German economy is clearly devoted to investing abroad, which explains these results.

Table 3: German Financial Account Balance

	Balance
2005-1	12505.43
2005-2	-8662.16
2005-3	-26433.78
2005-4	-17615.21
2005-5	8125.82
2005-6	-15103.07
2005-7	-5752.10
2005-8	570.81
2005-9	-10398.10
2005-10	-6148.14
2005-11	-14159.29
2005-12	-17008.12
2006-1	-11488.59
2006-2	-18367.19
2006-3	-13732.83

Source: Bundesbank

Table 4: Breakdown of the Germany Financial Account

	Direct Investment	Financial Derivatives and Portfolio Investment	Other Investment
2005-1	-7505.56	1459.78	18904.63
2005-2	-2850.51	-2343.41	-3962.23
2005-3	-2826.17	-11484.03	-11801.86
2005-4	-3799.94	-34841.28	20261.85
2005-5	571.00	24304.99	-16609.01
2005-6	-7974.26	41562.00	-49.657.81
2005-7	-4855.48	20492.46	-21713.19
2005-8	-3341.52	-8889.78	11870.31
2005-9	1672.40	-813.09	-9218.69
2005-10	395.51	-641.53	-6108.95
2005-11	19780.70	-31041.16	-3957.63
2005-12	303.59	-16.365.21	-1596.91
2006-1	-9752.95	-16.268.54	14559.23
2006-2	-4393.92	-5820.08	-9687.54
2006-3	-3018.32	16348.45	-26636.89

Source: Bundesbank

In the case of France, the financial account has alternated deficits with surpluses throughout 2005 and up to February 2006, although overall, more surpluses have been recorded. As opposed to the situation in Germany, it is not possible to locate a clear pattern in this case, although it is worth highlighting that a surplus has been recorded by the financial account in the first two months of 2006 for which data are available. The breakdown of the account does not reveal much more either. Direct investment has generally registered a negative balance (not in January and February 2006), which seemingly indicates that corporate France in general does not invest abroad. Notwithstanding, the other two entries that make up the financial account (financial derivatives and portfolio investment and other investments) display both surpluses and deficits over the period under study and once again it is impossible to find a clear pattern. The favourable balance of the overall financial account in January and February 2006 is due to the highly favourable balance of the other investments entry.

Table 5: French Financial Account Balance

	Balance
2005-1	6413
2005-2	-40
2005-3	-7962
2005-4	-2530
2005-5	594
2005-6	7276
2005-7	2318
2005-8	-26341
2005-9	39069
2005-10	-4081
2005-11	4156
2005-12	-20277
2006-1	5716
2006-2	8931

Source: Banque de France

Table 6: Breakdown of the French Financial Account

	Direct Investment	Financial Derivatives and Portfolio Investment	Other Investment
2005-1	-4311	-29402	42772
2005-2	-2966	1282	-339
2005-3	-134	15521	-21068
2005-4	-1376	-12508	7961
2005-5	255	-18018	14766
2005-6	4506	29718	-30609
2005-7	-436	-4924	5961
2005-8	-5105	7050	-27416
2005-9	-1088	19323	19632
2005-10	-2887	4688	-7217
2005-11	-11646	-23537	39226
2005-12	-14627	876	-7901
2006-1	110	-29091	34981
2006-2	1126	-6633	14094

Source: Banque de France

The capital account balance has a residual nature as it includes unilateral capital transfers and intangible asset transactions. In the case of the German economy, positive and negative balances alternate following no apparent pattern. Furthermore, the account balance is minimal in comparison to the rest of the Balance of Payments. In the case of France, the capital account balance is even smaller, although has been positive the best part of the time.

Table 7: German Capital Account Balance

	Balance
2005-1	-1220.60
2005-2	-106.79
2005-3	-164.06
2005-4	-199.21
2005-5	272.23
2005-6	33.90
2005-7	104.15
2005-8	-86.35
2005-9	42.31
2005-10	329.13
2005-11	-107.54
2005-12	-165.02
2006-1	7.47
2006-2	282.54
2006-3	-137.44

Source: Bundesbank

Table 8: French Capital Account Balance

	Balance
2005-1	-42
2005-2	153
2005-3	24
2005-4	41
2005-5	92
2005-6	253
2005-7	72
2005-8	80
2005-9	225
2005-10	-417
2005-11	58
2005-12	-14
2006-1	180
2006-2	26

Source: Banque de France

The exchange rate does not appear to have particularly affected the Balance of Payments described above, especially where the current account is concerned. Note that the euro-dollar exchange rate has dropped throughout the period under consideration, but this does not seem to have affect the Balance of Payments. This is almost certainly because most of both countries' trade exchanges occur within the EMU, where the euro-dollar exchange rate is irrelevant.

Table 9: Euro/Dollar Exchange Rate

	dollars
2005-1	1.3119
2005-2	1.3014
2005-3	1.3201
2005-4	1.2938
2005-5	1.2694
2005-6	1.2165
2005-7	1.2037
2005-8	1.2292
2005-9	1.2256
2005-10	1.2015
2005-11	1.1786
2005-12	1.1856
2006-1	1.2103
2006-2	1.1938
2006-3	1.2020
2006-4	1.2271

Source: Bundesbank

Note: ECB Minimum Bid Rate

The above conclusion is confirmed in the following tables where it is ratified that the best part of trade exchanges on behalf of France and Germany are with fellow European countries.

Table 10: France's Top 20 Suppliers (€bn)

	2004
Germany	61.1
Italy	31.6
Spain	26.0
Belgium	25.6
United Kingdom	22.8
United States	22.5
China	16.6
The Netherlands	15.6
Japan	10.7
Switzerland	8.0
Russia	7.4
Norway	6.9
Ireland	6.5
Sweden	4.5
Portugal	3.7
Turkey	3.3
Austria	3.2
Poland	3.1
South Korea	3.1
Saudi Arabia	3.1

Source: INSEE

Table 11: France's Top 20 Customers (€bn)

	2004
Germany	50.3
Spain	33.6
United Kingdom	31.3
Italy	31.3
Belgium	25.7
United States	23.1
The Netherlands	13.2
Switzerland	10.2
Japan	5.3
China	5.3
Sweden	4.6
Portugal	4.4
Poland	4.3
Algeria	4.2
Turkey	4.2
Austria	3.5
Greece	3.4
Russia	3.1
Morocco	2.8
Singapore	2.7

Source: INSEE

Table 12: Germany's Top 20 Suppliers (€bn)

	2005
France	54.6
The Netherlands	53.3
United States	41.3
China	39.8
United Kingdom	39.4
Italy	35.5
Belgium	31.1
Austria	25.2
Switzerland	23.2
Russia	21.6
Japan	21.4
Spain	17.9
Czech Republic	17.6
Poland	16.0
Ireland	15.4
Norway	14.9
Hungary	14.3
Sweden	11.3
Denmark	9.5
South Korea	9.0

Source: INSEE

Table 13: Germany's Top 20 Customers (€bn)

	2005

France	79.8
United States	69.3
United Kingdom	61.6
Italy	54.3
The Netherlands	47.7
Belgium	43.9
Austria	42.5
Spain	40.3
Switzerland	29.5
Poland	21.9
China	21.2
Czech Republic	18.8
Russia	17.2
Sweden	17.2
Hungary	13.5
Japan	13.3
Turkey	12.8
Denmark	12.3
Finland	8.2
Portugal	7.4

Source: INSEE

Antonio Cutanda
Valencia, 28th May 2006

5.- United Kingdom.

An Analysis of British Foreign Trade

Since 1998, Britain's external sector has been characterised by a strong pound sterling, an increasingly large deficit in trade in goods (particularly with the European Union), a steady fall in foreign direct investment inflows and a current account deficit financed by debt and non-resident bank deposits, favoured by the relatively high interest rates in the United Kingdom.

Current Account Deficit at 2.6% of GDP in 2005

The current account deficit in 2005 amounted to nearly £32 billion, almost 25% more than in 2004. This is the equivalent of -2.6% of GDP, compared to -2% in 2004 and is the largest deficit since 1999. However, the deficit is still far from being as high as the mid 1970s (-4.0%) and late 1980s (-5.1%). Furthermore, the current account deficit swelled to -3.6% of GDP in the fourth quarter of 2005, the same as in the previous quarter. These results are considerably worse than in previous quarters.

Several factors have contributed to the increase in the deficit in 2005. The trade in goods deficit has risen by £5 billion to £65.6 billion, with the United Kingdom being a net importer of oil for the first time since 1979. The surplus in trade in services shrank by £3.5 billion to £17.9 billion, partly echoing the insurance payments for the damage caused by Hurricane Katrina. The deficit in the current transfers account also rose by £1.5 billion to £12.4 billion, as a result of the increase in contributions to the EU budget that partly respond to the accession of 10 new members that year. On the positive side, the income account recorded a surplus of £27.4, an increase of £1 billion.

Table 1: Annual Balance of Payments in Billions of Pounds

	Goods	Services	Goods & Services	Income	Transfers	Current Account
1985	-3.4	6.8	3.4	-1.0	-2.9	-0.6
1990	-18.7	4.3	-14.4	-3.0	-4.9	-22.3
1995	-12.0	8.5	-3.5	2.1	-7.6	-9.0
2000	-33.0	13.7	-19.3	5.2	-9.8	-24.4
2001	-40.6	13.7	-26.9	11.4	-6.6	-22.2
2002	-47.1	15.5	-31.6	23.7	-8.6	-16.5
2003	-47.9	16.9	-31.0	25.0	-10.0	-15.9
2004	-60.5	21.4	-39.0	26.4	-10.9	-23.6
2005	-65.6	17.9	-46.9	27.4	-12.4	-31.9

Source: National Statistics

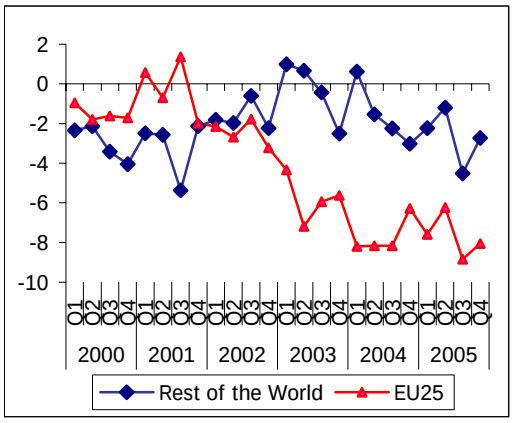
Table 2: Quarterly Balance of Payments in Billions of Pounds

	Goods	Services	Income	Transfers	C/A	C/A % of GDP
'04Q1	-13.6	5.4	6.1	-2.7	-4.8	-1.7
'04Q2	-15.6	5.5	6.9	-2.4	-5.6	-1.9
'04Q3	-15.4	5.3	5.1	-2.8	-7.8	-2.7
'04Q4	-15.9	5.2	8.3	-3.0	-5.4	-1.8
'05Q1	-15.7	5.0	7.7	-3.6	-6.5	-2.2
'05Q2	-15.5	5.1	9.6	-2.6	-3.4	-1.1
'05Q3	-17,2	2,9	6,3	-3.1	-11,0	-3,6
'05Q4	-17,3	5,7	3,7	-3,2	-11,0	-3,6

Source: National Statistics

The current account balance with the EU displayed a deficit of £30.7 billion in 2005, similar to that observed in 2004. The increase in the deficit in trade in goods and services as well as in current transfers was offset by the improvement in the income account surplus. Over the same period, the current account deficit with non EU countries increased from £6 billion in 2004 to £10.6 billion in 2005, following negative results in the trade in services and income accounts.

Figure 1: Current Account Balance with the EU-25 and the Rest of the World in Billions of Pounds



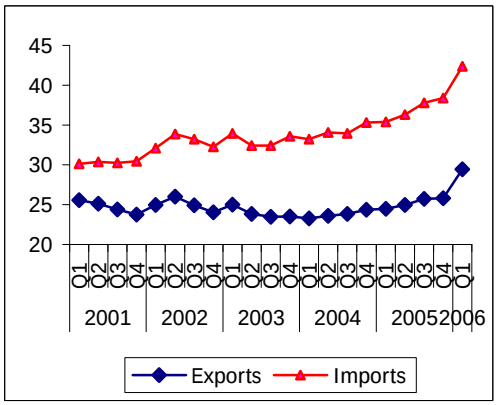
Source: National Statistics

Trade Deficit Rises Significantly in 2005

As regards trade in goods, by destination the United States is the UK's number one customer in terms of exports (15.4%), followed by Germany (11%), France (10%) and the Netherlands (7.2%). The EU15 accounts for 55.5% of total UK exports. As far as imports are concerned, the top trading partner is Germany (14.3%), followed by the US (9.7%) and France (8.6%). The EU15 represents 54.7% of total UK imports.

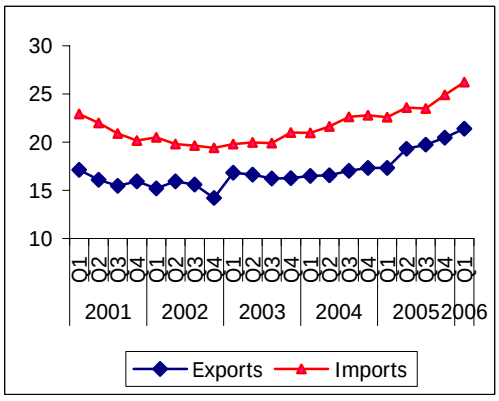
The trade in goods deficit with the EU amounted to £34.7 billion 2005. EU-bound exports increased to the value of £8.4 billion, while imports from the EU rose to £12.3 billion, thus continuously enlarging the trade deficit with the EU. At the same time, the trade in goods deficit with the rest of the world increased to £30.9 billion in 2005. Exports to the rest of the world rose by £10.9 billion, while imports were up by £12.2 billion.

Figure 2: Trade in Goods with the EU25 (Excl Fuel and Volatile Components) in Billions of Pounds



Source: National Statistics

Figure 3: Trade in Goods with the Rest of the World (excl. fuel and volatile components) in Trillions of Pounds



Source: National Statistics

The slow economic recovery in Germany and France is behind the deterioration in the trade deficit with the EU between 2003 and 2005, whereas the strong growth in the US economy and the relative depreciation of the pound sterling are behind the favourable pattern observed in exports to the rest of the world over the period dating from 2003 to 2005 in comparison to the period from 1999 to 2002.

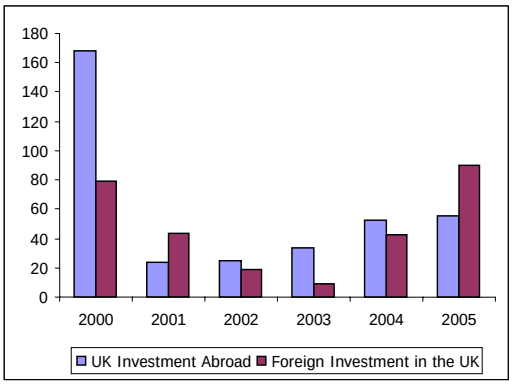
FDI Rebound in the UK in 2004 and 2005

The financial account recorded net inflows to the value of £24.8 billion in 2005, compared to £15.5 billion in 2004. Expenditure on investment abroad amounted to £720.5 billion (£527.2 billion in 2004), whereas foreign investment in the UK amounted to £745.3 billion (£524.7 billion in 2004). Both figures confirm the continuous increase in capital flows witnessed in the UK since 2001.

British direct investment abroad crashed between 2000 and 2001, when only £23.7 billion was invested, compared to £168.5 billion the previous year. Direct investment abroad has since risen slowly to £55.6 billion in 2005. During this year, the largest investment flows abroad were channelled through reinvesting profits, whereas investment through purchasing shares dropped slightly and disinvestment occurred in other capital transactions.

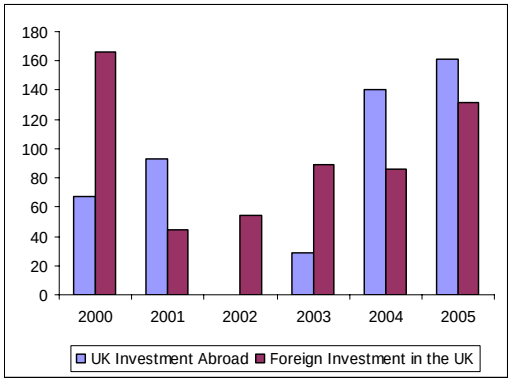
Foreign Direct Investment in the United Kingdom amounted to £90.5 billion, compared to £42.4 billion in 2004 and £8.9 billion in 2003. This means FDI has recovered markedly since 2003, when the lowest level since 1994 was observed. The upturn in merger and takeover activity is behind this trend.

Figure 4: Direct Investment



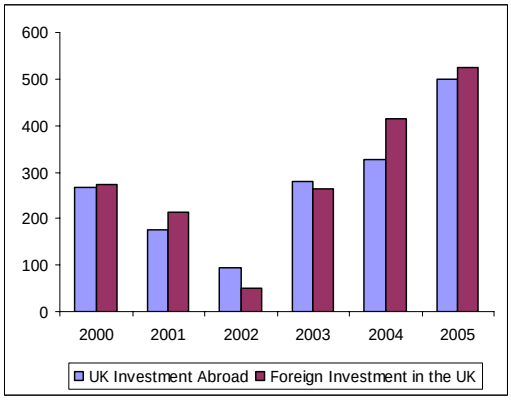
Source: National Statistics

Figure 5: Portfolio Investment



Source: National Statistics

Figure 6: Other Investment



Source: National Statistics

UK Portfolio investment abroad in 2004 and 2005 amounted to a total of £140.8 and £161.2 billion respectively, compared to the investment observed in 2002 and 2003, which totalled £0.8 and £28.8 billion respectively. The

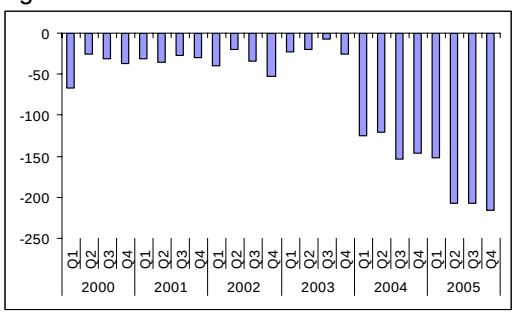
strong growth in 2004 and 2005 has occurred in purchases of both shares and debt and British banks have been the main buyers.

Portfolio investment on behalf of foreigners in the United Kingdom has also tended upwards since 2002, rising from £86.5 billion in 2004 to £131.1 billion in 2005. Once again, this increase is due to an increase in both net share and also debt transactions.

Finally, other types of investment on behalf of both the UK abroad and foreign investors in the UK have increased since 2003, bucking the downward trend observed between 2000 and 2002. Other British investments abroad rose from £325 billion in 2004 to £500 billion in 2005, mainly due to the increase in bank deposits. Other investments on behalf of foreign investors in the UK increased from £413 billion in 2004 to £523 billion in 2005, due to a great extent to the increase in short term loans.

In short, the UK's net financial position is one of indebtedness. The largest increase in foreign investment in the UK occurred in 2004 and 2005, whereas British investment abroad has not grown as strongly. As a result, net borrowing as a percentage of GDP was -12.6% in 2004 and rose to -17.8% in 2005.

Figure 7: International Financial Position



Source: National Statistics

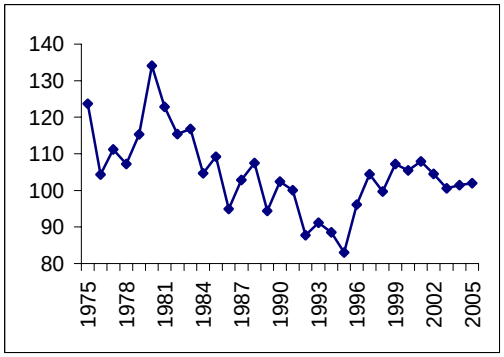
The current account deficit has been mainly financed by purchasing long term debt, due to the high interest rates in the UK in comparison to equivalent issues in dollars.

Continuous Depreciation of the Pound since September 2005

The historical pattern of the "real effective exchange rate" since 1975, except during the 1992-1996 period, displays a value of more than 100 (base year 1990=100). The fall of the pound in 1992 was a "competitive" devaluation due to the unstable economic and financial environment at the time. This situation is highly unlikely to occur in the current international and domestic scenario. The Pound Sterling remained strong between 1998 and 2002 in foreign exchange markets, with the exception of the first half of 2003 when it depreciated by 4.2%. Since then, the pound has remained slightly above 100.

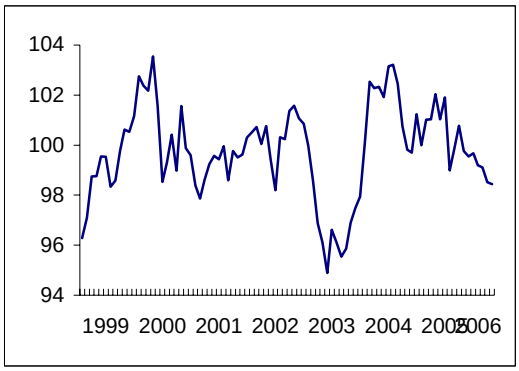
So far this year, the effective exchange rate displays a downward trend, mainly due to the appreciation of the euro (the pound has depreciated 2.2% with regard to the euro between December 2005 and April 2006).

Figure 8: Effective Exchange Rate of the Pound Sterling 1975-2005 (1990=100)



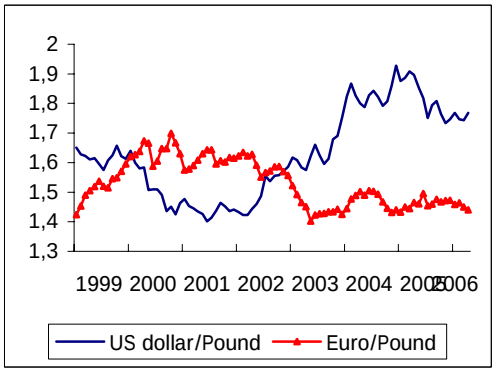
Source: Bank of England

Figure 9: Monthly Effective Exchange Rate of the Pound Sterling 1999(1)-2006(4) [2005=100]



Source: Bank of England

Figure 10: Dollar/Pound and Euro/Pound Nominal Exchange Rates



Source: Bank of England

Francisco Requena Silvente
Valencia, 31th May 2006

6. - China

Economic reform began in China in 1978, since which time the country has gradually opened its doors not only to international trade, but also to Foreign Direct Investment (FDI). This process has required a new legislative framework in order to regulate trade and investment policies, adapting them to the demands of the World Trade Organisation (WTO). In this sense, the main objectives of the Foreign Trade Law, reviewed in 2004, are:

- Increasingly open up to the rest of the world
- Develop foreign trade
- Stimulate healthy economic growth

The public sector's direct intervention in the economy has given rise to regulations that are much more open to the external sector. Import barriers have been enormously reduced and FDI has been encouraged, particularly in the sectors that require a great deal of capital and/or high technology. Foreign capital enjoys a much cheaper tax system than those levied on national companies (tax rates of 17% compared to 33%). In fact, some even become tax exempt if the foreign investment is channelled to given sectors or regions.

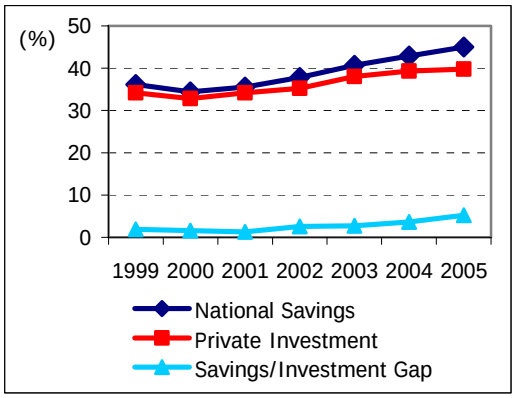
At present China is not only a member of the WTO, but has also signed trade agreements with the Association of Southeast Asian Nations, Chile, Pakistan, the special administrative regions of Hong Kong and Macao and is in the midst of negotiating with many other countries. This has resulted in a significant decrease in China's trade tariffs and import quotas. For example, the average rate charged to WTO countries dropped from 15.6% in 2001 to 9.7% in 2005. However, China maintains its import ban on certain products for safety and health reasons[10].

The quotas imposed on Chinese exports are the centre of continuous disputes, due to the large trade deficits in receiving countries. Restrictions are not only imposed on textiles and footwear, but also on cattle trade, tobacco, certain agricultural products, silver, etc.

The latest trade conflict in March 2006 involved China, the United States and the European Union. The two western regions have jointly presented a formal complaint to the WTO concerning China's motor vehicle policy, accusing the Asian giant of levying unfair tariffs on imports of motor vehicles and spare parts.

Throughout this opening up process and development, one of the decisive factors has been the Chinese population's accumulation of capital. In this sense, gross private investment and gross national savings rose to 39.3% and 42.9% of GDP respectively (Figure 1).

Figure 1: Savings/Investment Gap



Source: National Statistics Bureau

[10] Certain agricultural products, minerals, fertilizers, residuals among others.

Over the past few years, the increasing difference between savings and investment (1.3% in 2001 compared to 5.2% in 2005) has resulted in identical growth rates in the current account surplus, which in 2005 represented 7.2% of GDP, a gigantic hike with respect to the 1.3% figure recorded in 2001.

The forecast for 2006, according to the Central Bank, is that China is heading towards yet another sizeable current account surplus, on the back of a booming trade surplus and a smaller deficit in the services account.

In the table below presents the most important Balance of Payments indicators[11] for the period dating from 2000 to 2004.

Table 1: Foreign Trade Indicator Growth

	'00	'01	'02	'03	'04
C/A Balance	1,7	1,3	2,4	2,8	3,6
N Goods trade	2,9	2,6	3,0	2,7	3,1
Exports	20,8	20,1	22,4	26,7	30,7
Imports	17,9	17,5	19,4	24,0	27,7
Services a/c	-0,5	-0,4	-0,5	-0,5	-0,5
Financial a/c	0,2	2,6	2,2	3,2	5,7
Direct Inv.	3,1	2,8	3,2	2,9	2,8

Source: National Statistics Bureau

The main entries in the Balance of Payments are analysed below[12].

Foreign Trade in Goods

China's trade surplus trebled in 2005, totalling 102 billion US dollars. The country has maintained this trend in recent years that has been the driving force behind the enormous growth of the economy.

Chinese exports are almost entirely manufactured goods, which in 1998 represented 87.2% of the total (91.4% in 2004). However, while proportions have remained practically unchanged, the total monetary value of exports has trebled, rising from 183.809 billion dollars in 1998 to 593.325 in 2005 (Table 2).

Almost half of Chinese exports are destined for Asia (45.6% in 2005). More precisely, Japan and Hong Kong received 11% and 16.3% of Chinese exports respectively. The rest went to the USA (21.4%) and EU-25 (18.9%).

Table 2: Breakdown of Foreign Trade 2001-2004

	2001	2002	2003	2004
Total Exports[1]	**266**	**325.5**	**438.2**	**593,3**
Primary goods[2]	11.2	9.9	9.2	8.4
Manufactures[2]	88.6	89.9	90.6	91.4
Miscellaneous[2]	0.2	0.2	0.2	0.2
Total Imports[1]	**243.5**	**295.1**	**412.7**	**561.2**
Primary goods[2]	21.3	19.2	20.1	23.4
Manufactures[2]	78.0	80.2	79.6	76.3
Miscellaneous[2]	0.7	0.5	0.3	0.3

[1]Billions of dollars

[2]Percentage

Source: UNSD and NSD, Comtrade database, General Administration of Customs (2005)

Manufactures also figure prominently in imports. However, the development of the country and the lack of raw materials have boosted the demand for primary goods, mainly mining. In fact, oil imports in 1998 represented only 2.3% of the total, whereas in 2004 the figure had risen to 6%.

[11] The latest final data available correspond to 2004

[12] See Trade Policy Review (2006), World Trade Organization

Oil imports account for 40% of the crude oil consumed by the country. However this figure only represents 8% of the world total, which means that the demand in China is not responsible for the price of a barrel of oil reaching $75. Furthermore, China has many sources of alternative energy, such as coal or natural gas, the former accounting for 75% of total energy consumption.

The EU was China's number one trading partner in 2005, following a 22.6% increase in trade exchanges, which amounted to 217 billion US dollars. The United States was China's second trading partner with total trade to the value of 211 billion US dollars, followed by Japan with 184 billion US dollars.

In view of size of the gap between exports and imports, China is this year showing signs of beginning to take steps to balance the enormous trade surplus. This will be carried out by stimulating imports, boosting domestic demand and reducing export aid.

Foreign Trade in Services

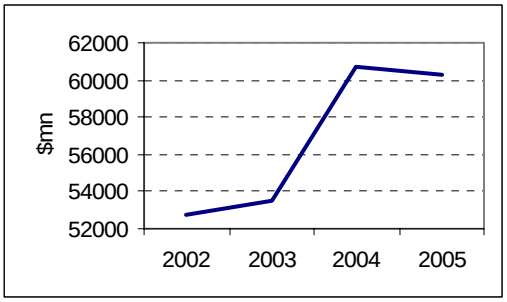
The services sector, despite playing a secondary role in the country's foreign trade, has also trebled figures over the period dating from 1998 to 2004. Services represented 9.5% of total exports and 11.9% of total imports in 2004 (62.4 billion dollars and 72.1 billion dollars respectively).

Tourism has emerged as a sector with enormous possibilities. China received approximately 109 million visitors in 2004. The Chinese National Tourism Administration and the EU signed a Authorised Destination Agreement in 2004 that affects 12 EU member states and which resulted in simplified procedures for Chinese travellers to obtain tourist visas when processed by designated tourism agencies.

Foreign Investment

Economic growth and the country's inclusion in the WTO continue to make China an attractive investment. China received FDI to the value of 60.33 billion dollars in 2005 and has been the largest receiver of FDI in the world for some years now.

Figure 2: FDI



Source: National Statistics Bureau

Hong Kong is China's most important source of foreign investment, accounting for 31.3% of total direct investment. However, the fact that a significant proportion of this figure is due to other sources that merely use the island as an intermediary must be taken into account.

The advantageous tax treatment received by foreign investment (17% corporate tax compared to 33% for Chinese companies) have resulted in national companies moving their capital to Hong Kong and investing it from there in order to take advantage of these benefits. Other important destinations for FDI include Japan, South Korea, Germany, USA and Taiwan.

The manufacturing sector has received the most foreign investment for years, including electronic and communications equipment. The real

estate and energy sectors and to a lesser extent farming, cattle and fishing also figure prominently.

Trade Agreements

China, as mentioned earlier, has struck a wide variety of trade agreements in terms of how far reaching they are. In order to summarize, these agreements could be classified as follows:

1. World Trade Organisation

On becoming a member of this organisation, China was forced to carry out a thorough review of its trade legislation. Furthermore, membership prohibited China from using illegal trade practices. Even still, in 2005 China became the WTO member to receive the most antidumping sanctions. The WTO is investigating 33 cases and has already applied 22 final antidumping measures.

2. Regional Agreements

These agreements complement that described above and are necessary to complete trade deregulation. The following can be quoted as examples:

- *Asia-Pacific Economic Cooperation* (APEC)

More than 60% of Chinese foreign trade is concentrated in this region and almost 70% of FDI originates from other members of the APEC.

- *Asia-Europe Meeting* (ASEM)

This agreement was signed in 1996 and is a plan of action to boost trade by reducing tariffs, improving transaction transparency and promoting trade opportunities between Asia and Europe. China, Japan, Korea together with seven ASEAN nations and the EU-15 signed the agreement.

- *China-ASEAN*

China and the ASEAN have signed a multitude of agreements, all of which are aimed at eliminating tax charges and non-tariff goods and services trade barriers. They are also intended to promote legislation that favours FDI flows among member states.

3. Bilateral Agreements

There has been a wide variety of agreements, all of which are aimed at achieving free trade.

- *CEPAs: China-Hong Kong, China-Macao*

In 2003, China signed the CEPAs agreement with both Hong Kong and Macao. The agreement included the elimination of the trade tariffs imposed on the imports from these countries.

- *China-Chile FTA*

This document signed in 2005 states that Chile recognises China as a "market economy". In addition, it has resulted in all trade tariffs being gradually reduced, as is the case with the rest of bilateral agreements signed with Pakistan, Australia and New Zealand.

4. Unilateral Preferential Trade Agreements

These agreements awarded preferential treatment to the trade in certain goods with less developed countries.

Exchange Rate Pattern

July 21 was an important day for the Chinese economy, as the yuan was revaluated by 2% and linked to a basket of foreign currencies, ending years of being pegged to the US dollar. From this moment onwards, the central exchange rate is established on a daily basis from a weighted average of the

value given to the currency by all those involved in the market, including the main national banks.

As a result of the above, the yuan displays an upward trend, recording an all-time high in May 2006 when it broke the barrier of 8 yuan. However, only a few days later, the exchange rate dropped back to 8.025 yuan to the dollar.

However, the United States sustains that the increase in the fluctuation of the yuan remains insufficient and therefore fails to reduce this country's enormous trade deficit with China, as can be appreciated in national statistics. US industry believes that the yuan is 40% undervalued, which makes US products more expensive in China and Chinese products cheaper in the US. From the US point of view, this situation is unfair and is provoking serious trade conflicts between the two countries.

Mª Luisa Martí Selva
Rosa Puertas Medina

Valencia, June 1 2006