

MR06

MONTHLY REPORT • ECONOMIC AND FINANCIAL MARKET OUTLOOK

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ASIA

ECONOMIC & FINANCIAL ENVIRONMENT

FINANCIAL MARKETS

*The securitisation market: from hero
to villain, and vice versa*

INTERNATIONAL ECONOMY

*South Africa: how to make your place
among the large emerging countries*

EUROPEAN UNION

The effects of the euro's appreciation

SPANISH ECONOMY

Spanish firms are getting bigger

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*Emerging Asia: past, present and,
clearly, a future*

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on track after coping with the tapering*

India: the roadmap for Narendra Modi

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June 2014

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Is the euro expensive?

The value of the euro has taken pride of place in economic debate over the last few months. Many analysts have argued that its strong appreciation has been counterproductive for the euro area's economy, hindering growth and aggravating the risk of deflation. But how much truth is there in this?

The euro's recent strong performance against the dollar is basically due to the combination of economic policies chosen by the euro area, which have been very different from the set chosen by the US. We should also remember the frequently ignored fact that the euro's value hardly changed in 2012, in the midst of Europe's sovereign debt crisis.

The US and the euro area have differed in both their fiscal and monetary policy. In the area of fiscal policy, Europe chose to quickly consolidate the public deficits caused by combating the recession in 2008 and 2009, while the US took a somewhat more lenient stance. There are even greater differences between the monetary policies implemented on each side of the Atlantic, this being much more expansionary in the US than in the euro area.

Although it is true that the US's more positive growth should push up the dollar, it has also had side effects, particularly in relation to the spectacular trend in the size of balance sheets. As of today, and not including any decisions taken by the ECB on 5 June (after closing this edition), the Federal Reserve's balance sheet has continued to expand while that of the European Central Bank has contracted as Europe's banks have returned the extraordinary three-year funding they received from the institution.

Not that we can call the ECB's monetary policy restrictive, by no means. Interest rates are very low and a large amount of long-term funding is available for financial intermediaries. But it is restrictive compared with US policy. Moreover, as happened in the US, this easy monetary policy has not managed to revitalise the economy immediately insofar as its means of transmission, namely financial institutions, have been blocked and are undergoing restructuring and deleveraging processes.

Although the hesitance shown by Europe's top monetary authority is understandable, the current situation requires more monetary expansion to put the euro on an even footing with the dollar. This renewed expansion could have several effects which would be beneficial for the euro area.

Firstly, it would help to combat deflationary tendencies which the euro area is in danger of falling into again. Inflation for the euro area crucially needs to be closer to 2% to facilitate the adjustments in competitiveness between member States, as well as to take some of the pain out of the deleveraging being carried out. A monetary injection would also support the expansion in domestic demand, particularly in those countries that need such a boost the most, where there is a great deal of surplus production capacity.

Lastly, easier monetary policies could also push down the euro against the dollar, although this impact is uncertain. On the one hand, the upswing in the euro area's economy would push in the opposite direction while, on the other, we must also remember that, in spite of complaints about the currency's value, the euro area as a whole still has a current account surplus, an underlying factor that will continue to affect the euro's price abroad.

Jordi Gual
Chief Economist
31 May 2014

CHRONOLOGY

MAY 2014

- 23 Standard & Poor's raises **Spain's credit rating** from BBB– to BBB.
- 25 **European Parliament elections** for the 2014-2019 legislature.

APRIL 2014

- 29 The **European Banking Authority** publishes the methodology and **macroeconomic scenarios** used to carry out the stress tests on Europe's banks.

MARCH 2014

- 7 The Spanish cabinet approves a **Royal Decree-Law** for the **refinancing and restructuring of corporate debt** with the aim of enhancing the survival of viable companies with a heavy financial burden.
- 20 The European Council and European Parliament reach an agreement to amend the initial proposal for the **Single Resolution Mechanism** (the periods of time established for setting up the single resolution fund are shortened and decision-making is simplified).

FEBRUARY 2014

- 3 **Janet Yellen** is sworn in as chairwoman of the Federal Open Market Committee of the United States' **Federal Reserve**.

JANUARY 2014

- 15 **Spain** successfully completes the **financial aid programme** to recapitalise its banks.

DECEMBER 2013

- 18 The Federal Reserve starts to **withdraw its monetary stimuli**, reducing its debt purchases by 10 billion dollars per month.
- 19 The European Council approves the general approach on the **Single Resolution Mechanism**, one of the key pieces in the Banking Union.

AGENDA

JUNE 2014

- 2 Savings rate of households (first quarter).
- 3 Registration with Social Security and registered unemployment (May).
- 5 Governing Council of the European Central Bank.
- 6 Industrial production index (April).
- 13 International trade (May).
- 17 Quarterly labour cost survey (first quarter).
- 18 Loans, deposits and NPL ratio (April).
Fed Open Market Committee.
- 24 Government budget expenditure (May).
- 26 European Council.
- 27 Economic sentiment index of the euro area (June).
Flash CPI (June).
- 30 Balance of payments (April).
Net international investment position (first quarter).

JULY 2014

- 2 Registration with Social Security and registered unemployment (June).
Savings rate of households (first quarter).
- 3 Governing Council of the European Central Bank.
- 7 Industrial production index (May).
- 16 Foreign trade (June).
- 18 Loans, deposits and NPL ratio (May).
- 24 Labour force survey (second quarter).
- 29 Government budget expenditure (June).
- 30 GDP flash estimate of Spain (second quarter).
Flash CPI (July).
Economic sentiment index of the euro area (July).
Fed Open Market Committee.
GDP flash estimate of the United States (July).
- 31 Balance of payments (May).

Keeping an eye on monetary policy

The overall economic outlook is good. On the one hand, cyclical indicators for Q2 point to an increasing dynamism of economies at a global level and for the developed economies in particular. At the same time the Fed's comments regarding its monetary strategy have tended to be expansionary, showing little inclination to rush into normalisation. Moreover the ECB has made the most of hinting at implementing further stimuli in the near future. These messages from the central banks have helped to relax yields on sovereign debt in both regions. Risky assets, like equity and corporate bonds, have continued to perform well, with some indices on Wall Street and in Europe even setting new records. The incredibly low volatility of the markets is also significant. With this starting point, the immense complacency currently reigning among investors could give rise, should there be a setback, to readjustments in financial asset prices and a more volatile financial environment. This might well occur if the ECB or the Fed end up taking a less accommodative stance.

The US economy is back on an upward track after a Q1 hit harder by the adverse weather conditions than initially estimated. The balance of the extensive battery of indicators published in May comes out on the positive side. Most of the business sentiment and consumer confidence indices are optimistic. The labour market is also continuing to improve although some aspects still need to be taken into consideration. In April, employment figures provided another pleasant surprise but were marred by a further drop in the participation rate. Given this gradual but still incomplete recovery, the Fed has decided to remove the numerical target of 6.5% for the unemployment rate from its monetary forward guidance. Nonetheless, it is important to keep a close eye on signs of a possible change in trend, such as business surveys on expectations of wage rises in the near future, which have already been hinted at.

Conditions have also embarked on a favourable trend in the emerging countries, albeit not uniformly. The environment is less uncertain now that the turbulence experienced at the beginning of the year has started to get back to normal. The governments and central banks in many of these countries have handled this setback well and are being rewarded by investors returning part of the capital that had left their economies at the start of the crisis. The stock markets and sovereign bonds of some of

these economies, such as Indonesia, Turkey and South Africa, have performed excellently over the last few months, recovering part of the losses suffered in 2013. In China cyclical indicators point to an end to the slowdown and the government's recently implemented economic policies, such as May's liberalisation of the capital market, are helping to rekindle expectations for its economy.

The euro area's recovery is advancing at a good pace, albeit with widening gaps between countries. For the euro area as a whole, the signs of recovery seem to be long-lasting. An increasingly strong domestic demand has joined the foreign sector, with notable improvements both in private consumption and investment. The breakdown by country is less encouraging, however. One extremely positive note is Germany's surprising growth in GDP in 2014 Q1, up by 0.8% compared with the previous quarter. At the other end of the scale are France and Italy, once again posting worse figures than expected with zero growth for the French and continuing contraction for the Italians (-0.1% quarter-on-quarter). Such results are fuelling doubts regarding the growth capacity of both countries in the medium term and scepticism concerning the structural reforms implemented. The other weak chain in Europe's macroeconomic situation is still inflation. That is why all eyes are on the ECB and especially on how it will handle the expectations that it has been encouraging over the last few months.

In Spain, domestic demand has started to grow with the breakdown of GDP for 2014 Q1 revealing notable improvement. Private consumption and investment in capital goods performed particularly well and continue to advance strongly while exports came as a disappointment, falling by 0.4% in quarter-on-quarter terms. Part of this slowdown is due to temporary factors and we still believe that the trade surplus achieved will consolidate in the medium term, although the trend in the foreign sector will now have to be closely monitored over the coming months, as well as other factors. In order to avoid risk scenarios, and acknowledging that the reforms carried out to date have been far-reaching and beneficial for the Spanish economy, the IMF still has a long and demanding list of homework for Spain. Particularly important is tax reform and the development of a framework that helps to restructure company debt.

FORECASTS

Year-on-year (%) change, unless otherwise specified

International economy

	2012	2013	2014	2015	2013 Q3	2013 Q4	2014 Q1	2014 Q2	2014 Q3	2014 Q4
GDP GROWTH										
Global¹	3.2	2.9	3.5	3.9	3.0	3.2	3.4	3.4	3.5	3.7
Developed countries										
United States	2.8	1.9	2.6	3.0	2.0	2.6	2.0	2.6	2.7	3.1
Euro area	-0.6	-0.4	1.1	1.5	-0.3	0.5	0.9	0.9	1.1	1.2
Germany	0.9	0.5	1.9	1.8	0.6	1.4	2.3	1.8	1.8	1.9
France	0.0	0.3	0.7	1.2	0.3	0.8	0.8	0.4	0.7	0.9
Italy	-2.6	-1.9	0.2	1.2	-1.9	-0.9	-0.5	0.0	0.5	0.8
Spain	-1.6	-1.2	1.2	1.7	-1.1	-0.2	0.5	1.0	1.4	1.7
Japan	1.4	1.6	1.4	1.3	2.5	2.5	2.7	1.0	0.7	1.0
United Kingdom	0.3	1.7	2.7	2.1	1.8	2.7	3.1	2.8	2.5	2.3
Emerging countries										
Russia	3.4	1.3	0.5	1.4	1.3	2.0	0.9	0.2	0.4	0.7
China	7.7	7.7	7.5	7.4	7.8	7.7	7.4	7.6	7.3	7.6
India ²	4.5	4.6	5.4	6.4	4.8	4.7	4.7	5.1	5.4	5.5
Brazil	1.0	2.5	1.7	2.4	2.4	2.2	1.9	0.9	1.9	2.0
Mexico	4.0	1.1	2.9	3.8	1.4	0.7	1.8	2.5	3.3	4.0
Poland	2.1	1.6	3.2	3.5	2.0	2.5	3.5	3.1	3.1	3.2
Turkey	2.1	4.0	2.0	3.7	4.3	4.4	2.2	1.4	2.0	2.5
INFLATION										
Global¹	4.0	3.3	3.5	3.4	3.4	3.3	3.3	3.5	3.6	3.6
Developed countries										
United States	2.1	1.5	1.7	1.8	1.5	1.2	1.4	1.9	1.8	1.9
Euro area	2.5	1.4	1.0	1.5	1.3	0.8	0.7	0.8	1.1	1.3
Germany	2.1	1.6	1.4	1.8	1.7	1.3	1.0	1.2	1.5	1.7
France	2.2	1.0	1.2	1.7	1.1	0.8	0.9	1.0	1.3	1.5
Italy	3.3	1.3	0.7	1.4	1.1	0.7	0.5	0.5	0.7	1.1
Spain	2.4	1.4	0.4	1.3	1.2	0.1	0.0	0.4	0.4	0.9
Japan	0.0	0.4	2.7	1.8	0.9	1.4	1.5	3.4	3.1	2.9
United Kingdom	2.8	2.6	1.9	2.1	2.7	2.1	1.7	1.8	1.9	2.0
Emerging countries										
Russia	5.0	6.8	6.4	5.1	6.4	6.4	6.4	6.9	6.4	6.0
China	2.7	2.6	2.6	2.8	2.8	2.9	2.3	2.3	3.1	2.8
India ³	7.3	6.4	6.2	6.5	7.0	6.4	5.7	5.2	4.1	6.2
Brazil	5.4	6.2	6.4	5.7	6.1	5.8	5.8	6.4	6.8	6.5
Mexico	4.1	3.8	3.9	3.3	3.4	3.7	4.2	3.6	4.0	3.9
Poland	3.7	1.2	1.1	2.2	1.4	0.9	0.9	1.0	1.2	1.3
Turkey	8.9	7.5	8.2	6.6	8.3	7.5	8.0	8.7	8.2	8.0

Notes: 1. In purchasing power parity. 2. Annual figures represent the fiscal year and factor costs. 3. Wholesale prices.

Forecasts

Spanish economy

	2012	2013	2014	2015	2013 Q3	2013 Q4	2014 Q1	2014 Q2	2014 Q3	2014 Q4
Macroeconomic aggregates										
Household consumption	-2.8	-2.1	1.7	1.4	-1.8	0.7	1.6	1.9	1.6	1.5
General government consumption	-4.8	-2.3	-1.1	-2.1	0.2	-3.5	-0.2	-0.5	-2.6	-1.2
Gross fixed capital formation	-7.0	-5.0	0.1	2.3	-5.3	-1.7	-1.1	0.8	0.2	0.7
Capital goods	-3.9	2.3	8.1	5.5	2.2	9.6	11.3	7.8	6.6	6.6
Construction	-9.7	-9.6	-5.4	0.2	-9.8	-8.6	-8.7	-4.8	-4.4	-3.8
Domestic demand (contr. Δ GDP)	-4.1	-2.7	0.7	0.8	-2.1	-0.6	0.6	1.1	0.5	0.7
Exports of goods and services	2.1	4.9	5.3	5.5	3.5	3.7	8.1	3.1	4.5	5.5
Imports of goods and services	-5.7	0.4	4.5	3.0	0.6	2.7	9.3	3.5	2.0	3.0
Gross domestic product	-1.6	-1.2	1.2	1.7	-1.1	-0.2	0.5	1.0	1.4	1.7
Other variables										
Employment	-4.8	-3.4	0.8	1.4	-3.3	-1.6	-0.3	0.5	1.4	1.7
Unemployment rate (% labour force)	24.8	26.1	24.8	23.6	25.6	25.7	25.9	24.8	24.1	24.4
Consumer price index	2.4	1.4	0.4	1.3	1.2	0.1	0.0	0.3	0.4	0.9
Unit labour costs	-3.0	-1.5	-1.2	0.5	-1.6	1.2	-0.9	-1.4	-1.2	-1.4
Current account balance (cum., % GDP) ¹	-1.2	0.8	1.3	1.6	0.7	0.8	0.4	1.1	1.2	1.3
Net lending or borrowing rest of the world (cum., % GDP) ¹	-0.6	1.5	1.9	2.2	1.4	1.5	1.1	1.7	1.8	1.9
Fiscal balance (cum., % GDP) ¹	-10.6	-7.1	-5.6	-4.2	-10.3	-7.1				

Financial markets

INTEREST RATES										
Dollar										
Fed Funds	0.25	0.25	0.25	0.50	0.25	0.25	0.25	0.25	0.25	0.25
3-month Libor	0.43	0.27	0.26	0.71	0.26	0.24	0.24	0.23	0.27	0.31
12-month Libor	1.01	0.68	0.61	1.14	0.67	0.59	0.56	0.56	0.61	0.69
2-year government bonds	0.27	0.30	0.52	1.45	0.36	0.32	0.36	0.39	0.57	0.78
10-year government bonds	1.78	2.33	2.84	3.63	2.70	2.74	2.75	2.61	2.83	3.14
Euro										
ECB Refi	0.88	0.54	0.16	0.15	0.50	0.33	0.25	0.20	0.10	0.10
3-month Euribor	0.57	0.22	0.25	0.27	0.22	0.24	0.30	0.29	0.20	0.20
12-month Euribor	1.11	0.54	0.55	0.73	0.54	0.53	0.56	0.57	0.51	0.57
2-year government bonds (Germany)	0.08	0.13	0.20	0.80	0.17	0.16	0.14	0.14	0.16	0.36
10-year government bonds (Germany)	1.55	1.62	1.61	2.07	1.78	1.79	1.68	1.45	1.49	1.81
EXCHANGE RATES										
\$/euro	1.29	1.33	1.36	1.32	1.32	1.36	1.37	1.37	1.35	1.33
¥/euro	102.71	129.65	142.16	147.69	131.09	136.78	140.98	141.00	142.65	144.00
£/euro	0.81	0.85	0.82	0.85	0.86	0.84	0.83	0.83	0.86	0.82
OIL										
Brent (\$/barrel)	111.38	108.47	108.08	109.43	109.24	109.23	107.74	108.39	108.07	108.14
Brent (euros/barrel)	86.61	81.67	79.74	82.79	82.46	80.24	78.61	79.03	80.25	81.10

Note: 1. Four quarter cumulative.

Forecasts

CURRENT SITUATION · The party continues, but for how long?

Expectations of more growth and more liquidity are boosting investor sentiment. On the one hand, Q2 cyclical indicators point to more dynamic economies worldwide and the developed economies in particular. Of note is the case of the US where growth is accelerating after a Q1 hindered by unusually severe weather conditions. At the same time, the comments made by the Federal Reserve (Fed) regarding its monetary strategy have been quite expansionary in nature insofar as they have no intention of hurrying up the normalisation process. Moreover, the European Central Bank (ECB) has made the most of its carrot, hinting at an impending extension to stimuli. Such messages from the central banks have helped to ease yields on the sovereign debt in both regions. Risk assets, like equity and corporate bonds, have prolonged their good performance. In fact, some indexes on Wall Street and in Europe have set new records. Also important is the incredibly low level of market volatility. From this starting point, the great complacency reigning among investors could give rise, in the case of setbacks, to readjustments in the value of financial assets and a more volatile financial environment. This might well occur if the ECB or the Fed end up taking a less accommodative stance.

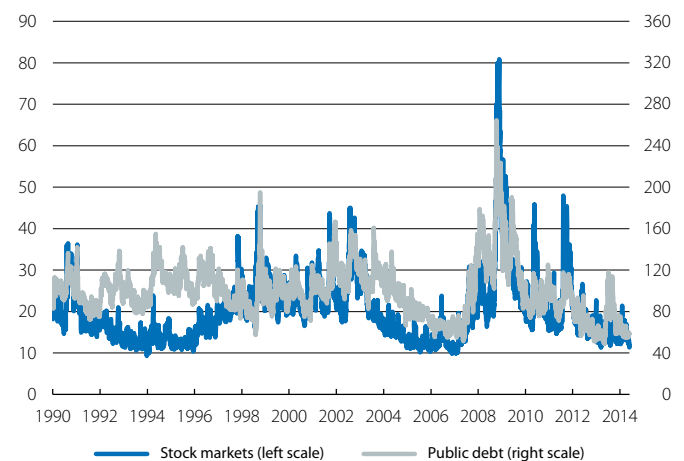
The Federal Reserve provides more information on its plans.

The minutes of the meeting held in April by the Monetary Policy Committee express a clear intention to keep monetary conditions relaxed «for a considerable time» after tapering has ended. With this discourse, the institution's aim is to convey to investors the idea that interest rates will be normalised slowly and gradually. The intention is to avoid upswings in volatility in financial markets and, ultimately, underpin the economic recovery. Thanks to these messages, investors have put back their expectations of a start to interest rate hikes to the second half of 2015 and the expected rate of increases as from that time has moderated.

The ECB makes it clear that it will act in June. Repeated statements by members of the Council have created the almost unanimous expectation that a packet of measures will be announced on 5 June. In fact, after May's meeting, the ECB's Governing Council has looked more than prepared to take additional expansionary measures due to the excessively low inflation rate. The fact that some economies in the euro area are losing steam, the strength of the euro and expectations of a negative price and credit spiral are reasons enough for the central bank to act. Although the ECB has not specified what these measures will be, the institution is very likely to cut the official interest rate to 0.10% in June (from the current level of 0.25%). It is also considering adopting measures aimed at boosting credit such as another very long-term liquidity auction (LTRO) with the condition that banks must increase lending to SMEs, or a selective ABS purchase

USA: implied volatility in financial markets

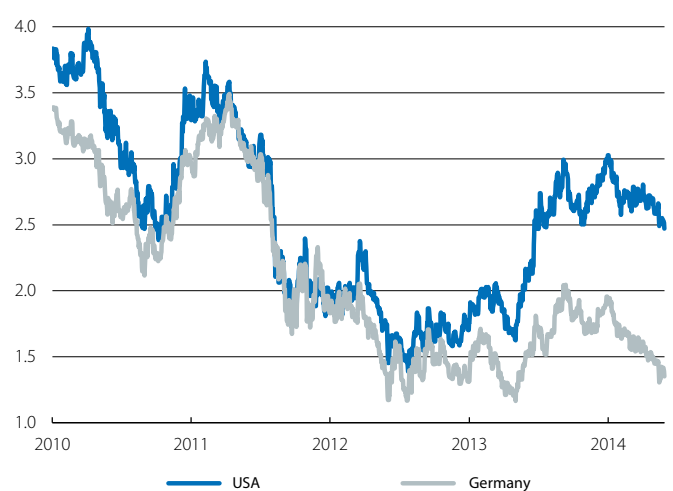
(Stock markets: VIX index; public debt: MOVE index)



Source: "la Caixa" Research, based on Bloomberg data.

Yields on 10-year public debt

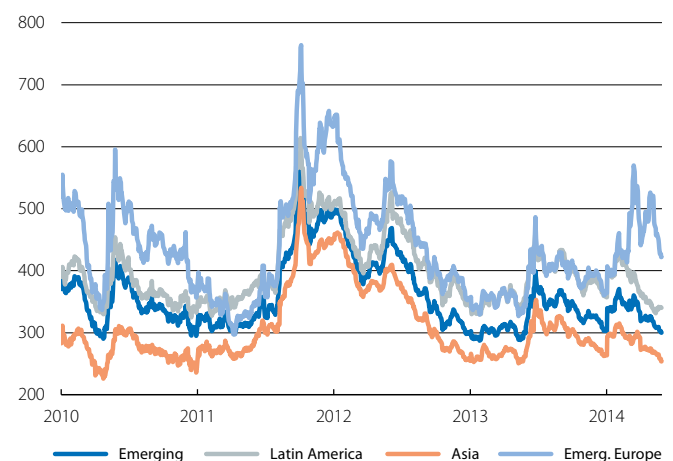
(%)



Source: "la Caixa" Research, based on Bloomberg data.

Spreads for corporate bonds of emerging countries

(Bonds in dollars; in BPS)



Source: "la Caixa" Research, based on Bloomberg data.

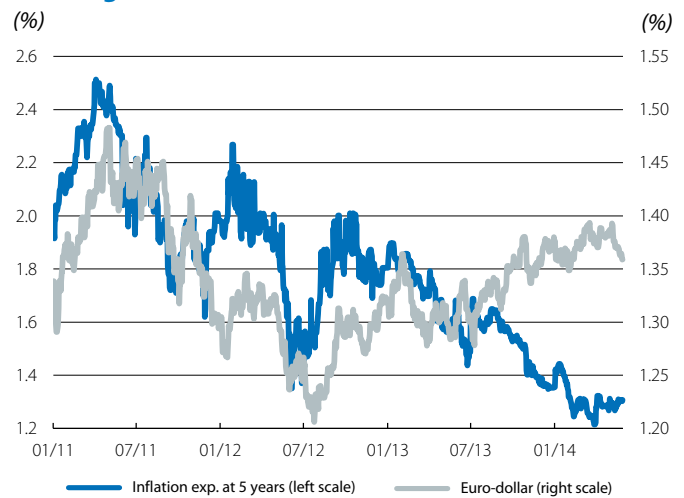
programme. The markets' reaction to this expected scenario of easier monetary conditions has initially led to a drop in the Euribor interest rate and the depreciation of the euro. The European currency has fallen by more than 2% in the last few weeks, down to around 1.36 dollars.

Treasury yields respond to expectations of accommodative monetary conditions. The Fed's dovish tone over the last month has been a key factor, just at the time when the incipient improvement in activity figures could have led to greater tension in yields. Not only have these not risen but they have even fallen considerably; in the case of 10-year Treasury bonds down to around 2.5%. This movement has been reinforced by the termination of short positions in derivative bond markets by speculative investors, who have been caught on the wrong foot. The key to this whole scenario is the absence of inflationary pressure. The Fed is attempting to highlight this point, placing particular emphasis on arguing and documenting the fact that the labour market is far from fully recovered and, therefore, is a risk to price stability. Logically, the trend in indicators capable of predicting inflation (e.g. wages) will be key for movements in the financial markets over the next few months. Deviations to the Fed's benign scenario could be very disruptive for the bond market.

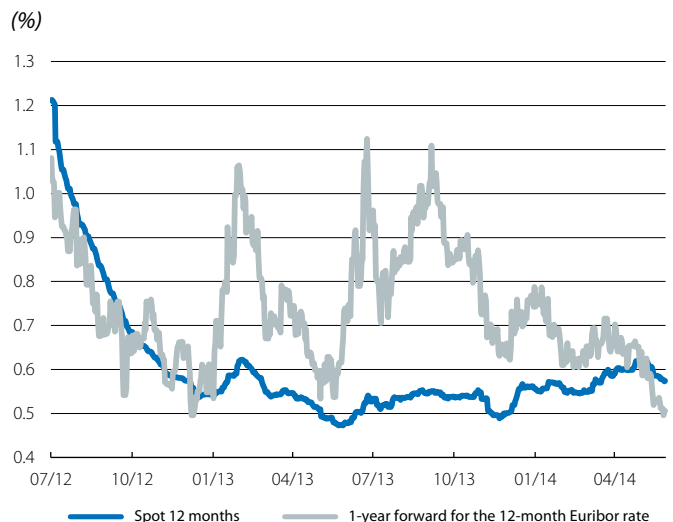
Yields on the euro area's sovereign debt are also falling. The ECB's repeated signals regarding monetary stimuli are in addition to the knock-on effect from the US. Yield on the German 10-year bund has fallen to around 1.35%, very close to its all-time low of 2012. Yields for some periphery countries are also close to new all-time lows, as is the case of Spanish and Italian debt. One contributing factor to the good performance by Spanish sovereign bonds, in addition to improved macroeconomic indicators, are the favourable assessments by several international organisations. On one hand, S&P raising its rating for Spain to BBB (from BBB-) after the recent rating improvements made by Fitch (BBB+) and Moody's (Baa2). On the other, the IMF's annual review of the Spanish economy, which has provided positive results (although proposing further reforms to be carried out in a range of areas).

Meanwhile, conditions are improving favourably in emerging countries, albeit not uniformly. The normalisation of the situation experienced at the beginning of the year has led to a less uncertain environment. Appropriate management by governments and central banks in many of these countries is being rewarded by investors returning part of the capital that had left their economies at the start of the crisis. The stock markets and sovereign bonds of some of these economies, such as Indonesia, Turkey and South Africa, have performed excellently in the last few months, recovering part of the losses suffered in 2013. For its part, cyclical indicators in China point to the end of the slowdown and recent economic policy actions, such as liberalising the capital market in May, are helping to boost renewed expectations regarding its economy.

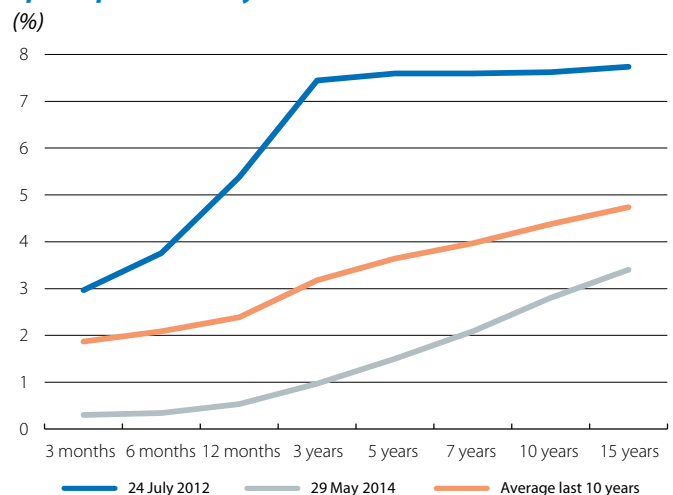
Inflation expectations and trend in the euro-dollar exchange rate



Euro area: Euribor interest rates



Spain: public debt yield curve

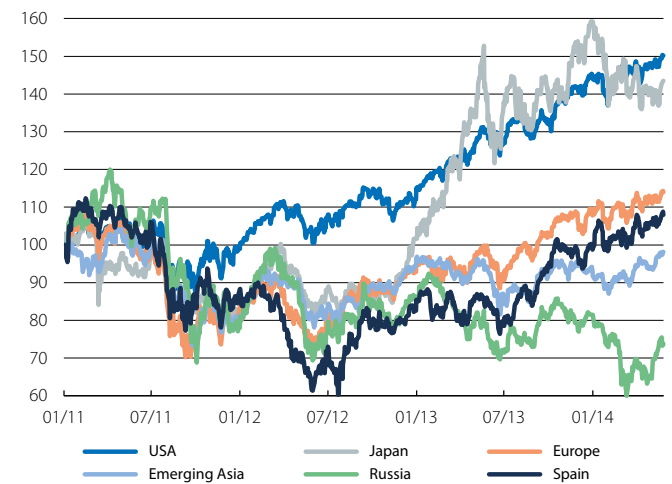


The stock markets remain firm. The expectation of accommodative monetary conditions over the coming quarters has led to a relative improvement in share prices. This situation has become stronger as the statements made by those in charge at the ECB suggest that the institution is more than likely to adopt further monetary stimuli in June, reflected in the new highs reached by some developed stock market indexes, such as the S&P 500 and Germany's DAX. In Europe, investors' risk appetite has been partly quashed by the lacklustre corporate earnings season in Q1 and by the warning of disparate growth figures among the euro area's core countries (France and Germany). In spite of the low levels of volatility in the stock markets, increasing doubts regarding the capacity of the region's activity to recover and tensions between Russia and the Ukraine have tipped the balance in favour of defensive shares to the detriment of cyclical. However, at a more specific level we should note the good performance by the Ibex 35, accumulating gains of more than 7% in the year to date. The good performance of the economy, the reorganisation of the national banking system and the fall in risk premia form the basis for the consolidation of this upward trend. With regard to emerging markets, lower Treasury yields, improved growth expectations in the region and greater investor risk appetite have helped capital flows to return to these economies, giving their stock markets a shot in the arm.

The good tone of corporate bond markets is consolidating. Large amounts of liquidity worldwide and very low interest rates are continuing to play a fundamental role in supporting high prices and low spreads for corporate bonds from the developed block. In Europe, this situation is being further strengthened by increased expectations of the ECB using stimuli measures. Given this scenario, the euro area's large financial firms are taking advantage of the current conditions in the markets to increase their capital bases by issuing hybrid bonds. Non-financial firms, on the other hand, continue to secure financing by issuing bonds, mostly classified as high yield. However, the lower yield for European corporate bonds compared with US bonds, as well as the limit reached by some European firms in terms of their capacity to issue more bonds, are bringing down the overall volume of issuances since the beginning of the year.

Trends in the main international stock markets

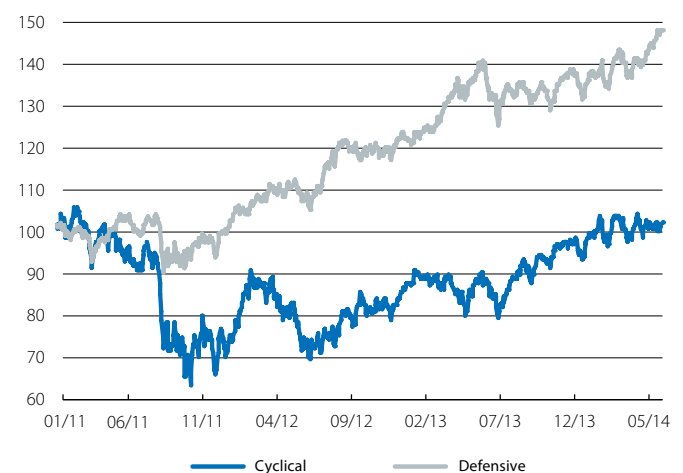
(January 2011 = 100)



Source: "la Caixa" Research, based on Bloomberg data.

Eurostoxx 600: cyclical sectors and defensive sectors

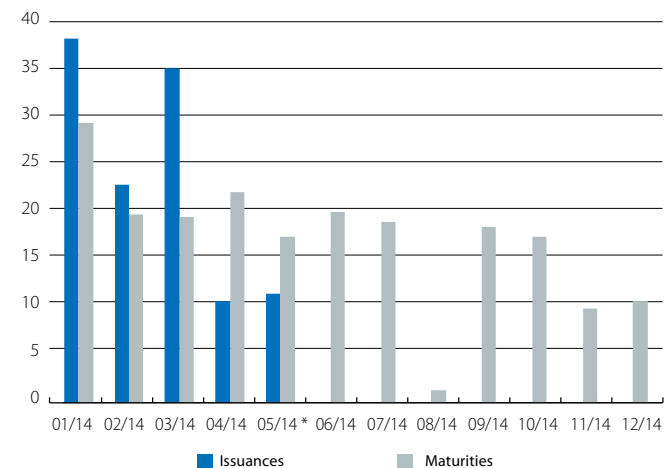
(January 2011 = 100)



Source: "la Caixa" Research, based on Bloomberg data.

Europe: debt issued by non-financial firms

(Billion euros)



Note: * Data up to 16 May.

Source: "la Caixa" Research, based on Dealogic data.

FOCUS · The securitisation market: from hero to villain, and vice versa

The European Central Bank (ECB) and the Bank of England (BoE) have recently published a joint paper calling for the revitalisation of the Europe's securitisation market. Initially, it might be surprising that two of the leading guardians of international financial stability should come out in defence of an instrument almost unanimously considered to be a partner in crime in the huge financial crisis that erupted in 2007. But first impressions are misleading: what the ECB and the BoE are proposing is to strengthen the «good» types of securitisation at the same time as getting rid of the «harmful» variants.

The distinctive feature of bank securitisation is that it allows the originator (the bank) to turn illiquid, high risk assets (such as mortgages, SME and consumer loans, etc.) into liquid assets by selling them to a third party (usually an asset securitisation fund promoted by the bank itself). In turn, this fund issues debt (securitised bonds) of varying credit quality to finance the acquisition of the underlying assets in question (which become the collateral for the bonds). In this way, the bank gets rid of its securitised portfolio and achieves three goals: it obtains liquidity, diversifies its sources of funding and passes on the risk inherent in the assets. The ECB and BoE seem convinced that releasing these resources from banks' balance sheets (liquidity and capital) would help to increase the supply of new credit, especially for SMEs. But securitisation has almost come to a complete stop in Europe at present. This is largely due to the stigma attached to it since the 2007 crisis, when the subprime mortgage fiasco in the US revealed the huge risk involved in formulas for repooling bank loans that are too opaque, complex and precarious. The ECB and the BoE therefore endorse the need to act in two broad areas: improve transparency and appropriately align the incentives for the different participants in this market. They also point out the usefulness of revising some technical aspects in the regulations regarding the capital and liquidity requirements for banks and insurance companies to make securitisation more attractive, both in terms of supply and demand.

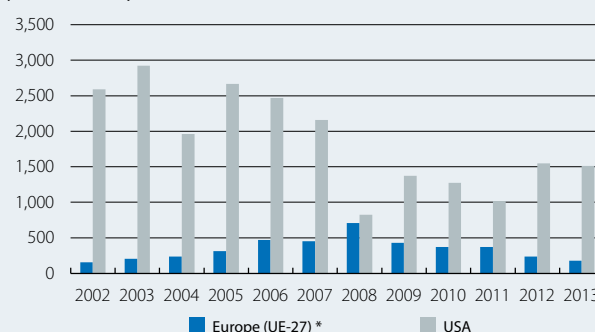
But, as is bound to be the case, perhaps the most revolutionary action has been left out of the aforementioned document: direct intervention by the ECB in the securitisation market, giving it a wake-up call to shake it out of its deep lethargy. For several months now there has been talk of the ECB possibly including asset purchases among its stimulus measures, either of sovereign or corporate bonds or ABS (asset-backed securities: securitised bonds for bank loans other than mortgage-backed securities, especially loans to SMEs). From a statutory point of view, buying up ABS is one of the least controversial options for the ECB and could be adopted at its next meeting in June. However, there are limitations and doubts regarding both its implementation and to what extent it is capable of revitalising credit. Firstly,

the modest size of Europe's securitisation market: at the end of 2013, the total outstanding balance for securitised operations was 1.54 trillion euros, of which only 8.5% correspond to ABS backed by SME loans. This is a small volume compared with markets such as that of corporate bonds or sovereign debt. Secondly, and related to the first point, the design of any ABS purchase programme faces a dilemma: whether to acquire newly originated securities (primary market) or already existing securitised debt (secondary market). The first option would have more impact on the credit being offered to firms but the second would be faster. Another important aspect is related to the level of risk the ECB is prepared to take on, given that the programme's impact would critically depend on the effective capacity of originators to pass on the risk of the underlying assets from their portfolio to the ECB. To achieve this, the ECB would have to extend the purchase of senior tranches (with a high credit rating) to those with a higher risk (including mezzanine tranches and equity), a delicate aspect at the very least. Although one alternative that would considerably reduce the assumption of credit risk by the ECB would be for the European Investment Bank to provide guarantees for bank securitised debt.

In short, the aim of revitalising the «high quality» securitisation market looks like being a huge challenge. Regulatory measures and those aimed at improving transparency could undoubtedly be of great help. But direct intervention by the ECB raises doubts.

Issuances of bank securitised debt

(Billion euros)



Note: * Includes Russia, Turkey and multinational securitised debt.

Source: "la Caixa" Research, based on data from AFME and AFI.

Europe (EU-27): outstanding balance at 31-12-2013

Market	Size (Billion euros)	Relative size of securitised debt (%)
Mortgage-backed securities	907	170.2
Securitised debt *	1,544	—
Corporate bonds	2,075	74.4
Bank credit to firms	4,000	38.6
Public debt	11,386	13.6

Note: * Includes Russia, Turkey and multinational securitised debt.

Source: "la Caixa" Research, based on data from AFME, Eurostat and BNP Paribas.

FOCUS · Corporate mergers and acquisitions: the wave is growing again

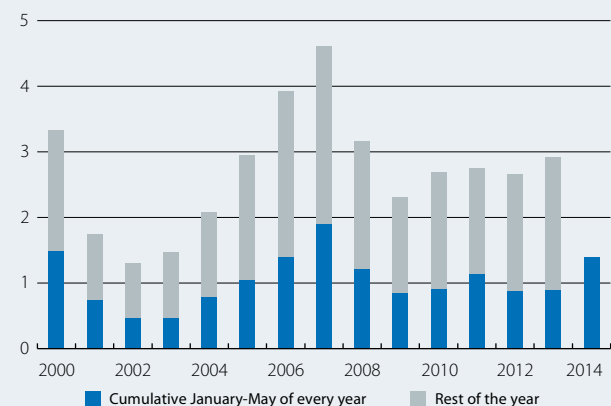
Corporate mergers and acquisitions are growing at a global level. This fact is in addition to the equally strong recovery being enjoyed by international financial markets after the crisis of 2008-2012. Several conditions have encouraged this situation: the improved macroeconomic environment, the good performance by the stock markets, the fall in financing costs and also the surplus liquidity maintained by numerous companies during the years of crisis (given the limited investment). Ultimately, the reasons behind these mergers and acquisitions (M&A) are related to the motivations of the parties involved: for the acquiring company, setting targets for growth in size or market repositioning (often internationally); and for the firm being acquired, the shareholders' desire to realise the value of their shares or to diversify risks (a clear circumstance in the case of family businesses).

The figures recorded between January and May this year speak for themselves: the total value of global M&A (announced, under negotiation and completed) has exceeded a billion dollars according to calculations by Thomson Reuters Datastream. This is only the third time the billion dollar threshold has been crossed during similar periods of the year since this agency started gathering data back in 1980. This represents more than 50% growth on the rate in 2013 and its projection for the year as a whole would bring us close to the record figures of 2006-2007. By geographical area, the US leads M&A with 51% of the total volume, followed by Europe with 24% and Asia-Pacific with 16%. These last two regions are gradually gaining share and, in the case of Asia, its volumes are almost 70% higher than those of 2013. This is related to the rise in cross-border transactions, where the companies involved come from different countries. This kind of M&A has grown significantly in 2014 (in the order of 80% year-on-year) thanks to a phenomenon that needs to be taken into account: firms from emerging countries looking for targets in other emerging countries. This can clearly be seen in markets with high growth potential such as Turkey and Vietnam. At a sector level, although there have been significant transactions in all industries, most have been concentrated in media, communication and entertainment firms, as well as in the real estate, energy and technology sectors. Another distinctive trait this year is the predominance of mega-transactions including some that are of truly incredible proportions. This has been key to achieving the aforementioned volumes as the actual number of agreements is similar to the figure for 2013.

The financial crisis seems to have introduced some new parameters when carrying out M&A. The main change can be seen in the area of financing. Whereas, in the first four months of 2007, more than 70% of M&A were financed exclusively through corporate loans, in 2014 this figure is below 50%. On the other hand, the number of transactions financed by shares from the acquiring company currently stands at 20%. Another approach that is gaining in importance is mixed financing, combining credit with issues of high-yield bonds (with a junk bond rating). According to Barclays, for the year to date an extensive group of European companies has placed 15 billion euros in this kind of debt to finance M&A, compared with 9.6 billion euros issued in the whole of 2013.

This last figure gives pause for thought. It is a well-known fact that, throughout history, M&A activity has come in waves and not gradually. But the exact reasons for any particular behaviour at any given time are less well-known. Undoubtedly factors such as the economic climate, technological innovations and regulatory changes all play a fundamental role. But there are also more elusive aspects such as liquidity conditions and risk appetite. In this respect, the current conditions created by the incredibly accommodative monetary policies employed by the main central banks play a role: they make it easier to issue high-yield bonds or shares to finance acquisitions. In the long term, the effects, both individual and collective, will depend on the efficiency of these new corporate combinations. We therefore trust that the exuberant climate that is starting to be seen is nonetheless rational in terms of the analyses carried out by corporate managers regarding such transactions.

Overall volume of M&A transactions
(Trillion dollars)



Source: "la Caixa" Research, based on data from Deutsche Bank and Dealogic.

KEY INDICATORS

Interest rates (%)

	30-May	30-Apr	Monthly change (b.p.)	Year-to-date (b.p.)	Year-on-year change (b.p.)
Euro					
ECB Refi	0.25	0.25	0	0.0	-25.0
3-month Euribor	0.31	0.34	-3	2.0	10.7
1-year Euribor	0.57	0.61	-4	1.1	8.9
1-year government bonds (Germany)	0.08	0.16	-8	-10.9	4.4
2-year government bonds (Germany)	0.06	0.14	-8	-14.7	-3.3
10-year government bonds (Germany)	1.36	1.47	-11	-53.5	-12.8
10-year government bonds (Spain)	2.85	3.02	-17	-132.7	-164.9
10-year spread (b.p.)	150	155	-5	-74.3	-147.2
Dollar					
Fed funds	0.25	0.25	0	0.0	0.0
3-month Libor	0.23	0.22	1	-1.9	-4.8
12-month Libor	0.53	0.55	-2	-4.9	-15.5
1-year government bonds	0.09	0.10	-1	-2.0	-4.1
2-year government bonds	0.37	0.41	-4	1.1	9.9
10-year government bonds	2.48	2.65	-17	-46.9	44.0

Spreads corporate bonds (p.b.)

	30-May	30-Apr	Monthly change (b.p.)	Year-to-date (b.p.)	Year-on-year change (b.p.)
Itraxx Corporate	66	70	-4	-4.9	-42.2
Itraxx Financials Senior	73	79	-6	-13.6	-81.8
Itraxx Subordinated Financials	112	121	-9	-16.1	-112.7

Exchange rates

	30-May	30-Apr	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
\$/euro	1.364	1.387	-1.7	-1.0	4.1
¥/euro	138.740	141.760	-2.1	3.9	-6.6
£/euro	0.814	0.822	-1.0	2.2	5.0
¥/\$	101.770	102.240	-0.5	2.8	-2.8

Commodities

	30-May	30-Apr	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
CRB Index	498.0	501.4	-0.7	9.3	5.4
Brent (\$/barrel)	110.7	108.7	1.8	-1.8	7.0
Gold (\$/ounce)	1,249.7	1,291.6	-3.2	3.3	-11.7

Equity

	30-May	30-Apr	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
S&P 500	1,923.6	1,884.0	2.1	4.1	17.3
Eurostoxx 50	3,244.6	3,198.4	1.4	4.4	18.1
Ibex 35	10,798.7	10,459.0	3.2	8.9	30.4
Nikkei 225	14,632.4	14,304.1	2.3	-9.9	13.4
MSCI Emerging	1,027.7	995.3	3.3	2.5	3.1
Nasdaq	4,242.6	4,114.6	3.1	1.6	22.3

CURRENT SITUATION · Prospects of improvement after the first quarter's setback

The US and China recover while disparity reigns supreme among the rest of the countries. The latest indicators for the two large engines of the world's economy point to improvement for the rest of the year. The US economy is starting to build up steam with the recovery in the labour market playing a key role. In China the slowdown seems to have stopped and, moreover, the government has taken various measures to put a stop to the risks hovering over the country and ensure its official growth target is achieved. Meanwhile disparity reigns supreme in the rest of the world's economies: Japan is being affected by its VAT hike; India and Indonesia are starting to correct their imbalances while Brazil is still mired in mediocrity.

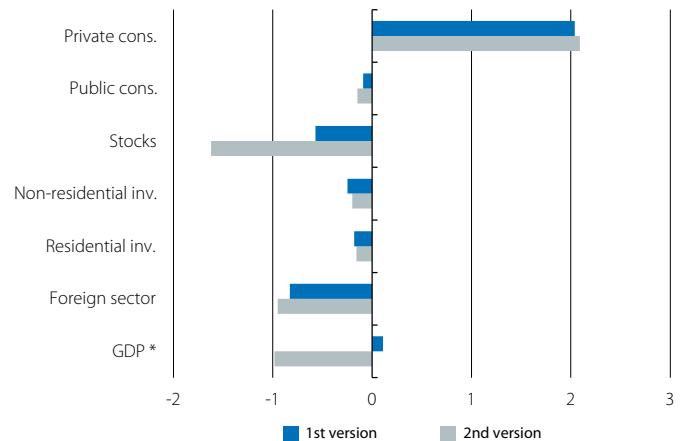
UNITED STATES

The US economy is on the up again after a Q1 that was hit harder by the adverse weather conditions than initially calculated. The GDP flash estimate for 2014 Q1 was actually revised downwards from 2.3% year-on-year to 2.0% (from 0.1% annualised quarter-on-quarter to -1.0%). This revision is entirely due to the downward revision in inventories, so that the final demand figure remained the same, and has positive implications for the next three quarters. In fact, the outlook provided by the extensive battery of indicators announced in May is positive, especially most of the indicators of business sentiment and consumer confidence. April's ISM for manufacturing rose to 54.9 points from March's 53.7; its equivalent for services also improved in April (up to 55.2 points from March's 53.1) and the increase in the PMI for manufacturing in May, produced by Markit, brought it to 56.2 points from April's 55.4. Along the same lines, May's consumer confidence index by the Conference Board rose to 83.0 points, supported by an improvement both in the component that rates the current situation as well as the one taking future prospects into account. However, retail sales disappointed (+0.1% month-on-month in April) as well as industrial production (-0.6% month-on-month in April).

The housing market continues to recover, albeit moderately. The Case-Shiller price index for 20 large metropolitan areas rose by 12.4% in March compared with the same month last year. Since the beginning of 2014, the rate of growth in prices has eased. Undoubtedly, the adverse weather conditions in 2014 Q1, mortgage rates 1 p.p. higher than last year and tougher conditions for getting a loan all lie behind a large part of this slowdown. Nonetheless, some of the latest indicators of real estate point to the sector maintaining a good level of activity in 2014 Q2. In particular,

USA: GDP by demand component

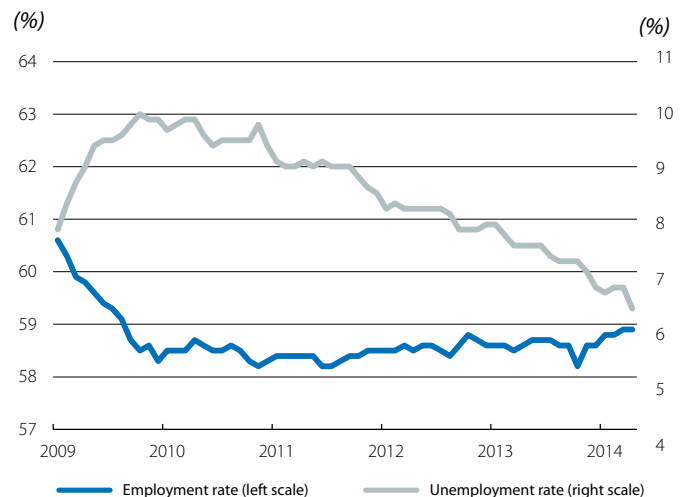
Annualised contribution to quarterly growth in GDP Q1 (p.p.)



Note: * Annualised quarter-on-quarter change.

Source: "la Caixa" Research, based on data from the Bureau of Economic Analysis.

USA: labour market indicators

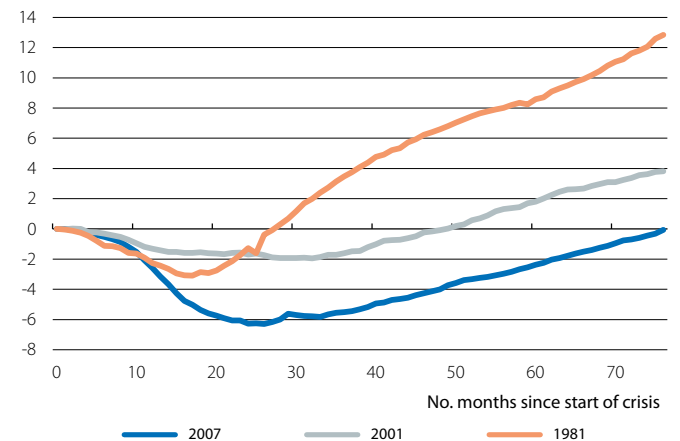


Note: Employment rate defined as the proportion of employed people to the working-age population.

Source: "la Caixa" Research, based on data from the Department of Labor.

USA: employment trend

Change compared with employment level at start of crisis (%)



Note: Base months: 1981: July 1981 = 0; 2001: December 2000 = 0; 2007: December 2007 = 0.

Source: "la Caixa" Research, based on data from the Department of Labor.

sales of second hand homes grew in April for the first time this year so far and house starts rose significantly (+13.2%).

The labour market continues to improve albeit with some exceptions. April once again provided surprisingly good employment figures: 288,000 jobs created, a much higher figure than the monthly average for the winter months (150,000). The unemployment rate also fell by 0.4 percentage points to 6.3%. However, this good news was somewhat overshadowed by the drop in the participation rate (from March's 63.2% to 62.8% in April), which might be pointing to a further upswing in the dejection effect on the unemployed. Given this gradual but still incomplete recovery, the Fed has decided to remove its numerical target of 6.5% for the unemployment rate in its monetary forward guidance. Wages at a standstill in April confirm this slack view of the labour market. Nonetheless, it is important to keep an eye on signs that might be hinting at a change in trend (such as the business surveys on expectations of wage increases, which are already pointing to increases).

Inflation is rising but is still far from showing any worrying signs of tension, allowing monetary normalisation to follow a slow course. April's CPI rose by 2.0% year-on-year, faster than March's rate of 1.5% but still at a low level. For its part, the core CPI (without energy or foods) stood at 1.8% year-on-year compared with 1.6% for the previous month. For the time being, we cannot see any inflationary pressures either in the trend in prices or in agent expectations. Our central scenario predicts an average inflation of 1.7% in 2014 and 1.8% year-on-year at the end of year.

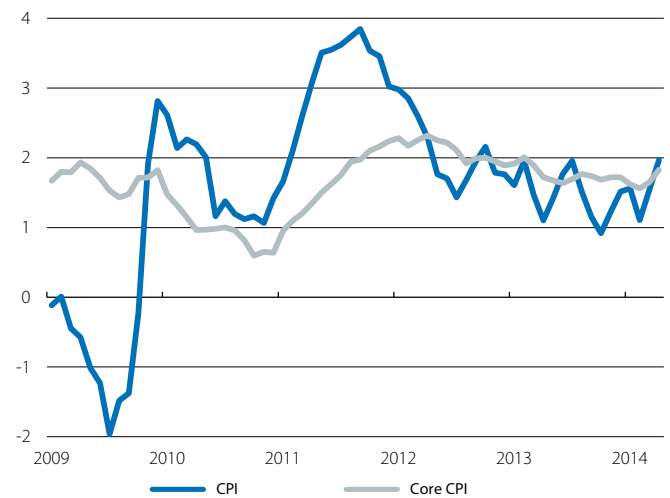
JAPAN

Growth has come as a pleasant surprise in Q1 of the year, attributable to expenditure being brought forward due to the VAT hike on 1 April. Japan's GDP advanced by 1.5% quarter-on-quarter (2.7% year-on-year), much more than the 0.1% of the previous quarter (2.5% year-on-year), boosted by private consumption and capital goods investment with purchases being brought forward to avoid higher prices after the hike. The temporary nature of this push means that we have only marginally revised our forecast for 2014 (up 0.1 percentage points to 1.4%). The growth for 2013 has also been revised upwards (to 1.6%).

Almost all recent indicators have been distorted by the VAT hike, similar to the effect seen in GDP. Consequently, we will have to wait a few months before being able to assess its definitive impact. For example, the Japanese economy reduced its trade deficit April, to a large extent because of the slowdown in imports whose demand had increased in the previous months. Although exports also contributed to this correction (+3.7% year-on-year), their growth continues to be paltry. In this respect, the yen's weak capacity to stimulate exports still comes as some surprise and is a cause for concern, as they are still 18% below the level at the end of 2007.

USA: CPI

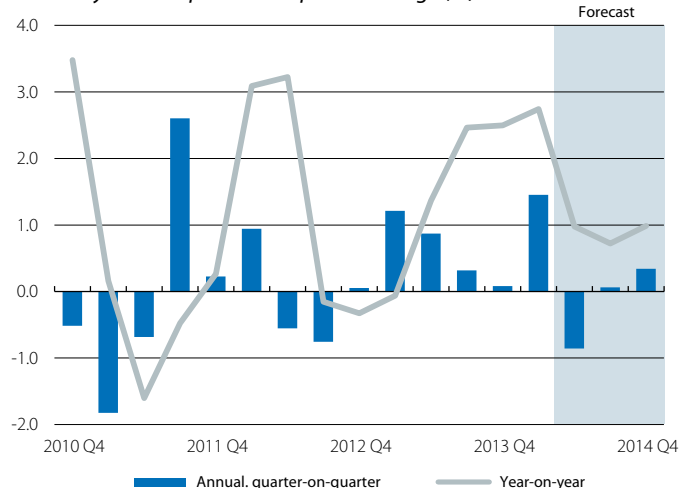
Year-on-year change (%)



Source: "la Caixa" Research, based on data from the Dept. of Commerce.

Japan: GDP

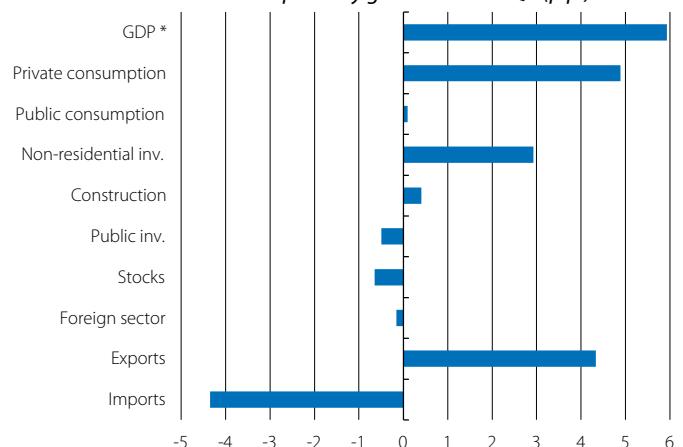
Year-on-year and quarter-on-quarter change (%)



Source: "la Caixa" Research, based on data from the Japanese Ministry of Communications.

Japan: GDP by demand component

Annualised contribution to quarterly growth in GDP Q1 (p.p.)



Note: * Annualised quarter-on-quarter change.

Source: "la Caixa" Research, based on data from the Japanese Ministry of Communications.

Within such an environment, prices unexpectedly rose in April. This could delay the application of additional expansionary measures by the central bank, which we had forecast for the beginning of summer. April's CPI increased by 3.4% year-on-year, an abnormally high figure when compared with March's year-on-year figure of 1.6%. The effect of April's VAT hike is also key here although the rise is higher than consensus estimates, which had already taken this effect into account. For its part, core inflation (without energy or foods) advanced by 2.2% year-on-year.

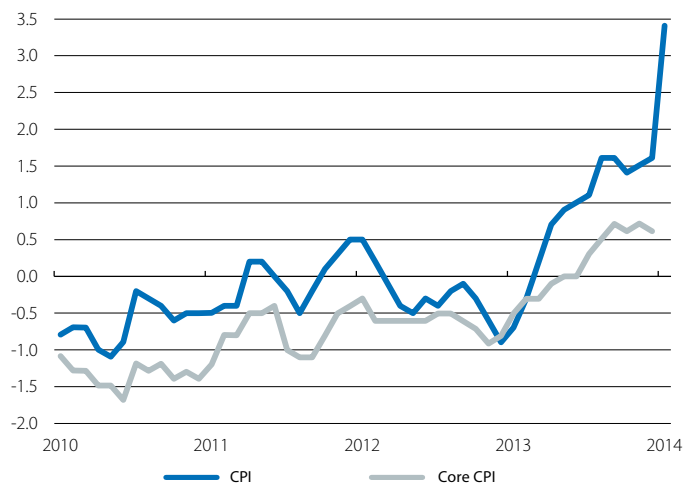
EMERGING ECONOMIES

In China, the latest activity indicators support the forecast of significant growth, namely 7.5% in 2014. The foreign sector came as a nice surprise with exports growing by 0.9% year-on-year in April after two months of year-on-year falls. These figures may seem very poor compared with the 7.9% growth recorded in 2013 but we should remember that, in the first four months of 2013, export figures were abnormally high due to temporary factors (over-invoicing), overshadowing this year's figures. For its part, the PMI flash index for manufacturing, produced by Markit, rose to 49.7 points, its highest level in the last five months. The increase was particularly large in exports, confirming the improvement seen in April's exports according to the balance of payments. The government has not hesitated to implement various anti-cyclical economic measures: in the fiscal area (increasing the «mini-stimuli» announced in April) and monetary (injecting liquidity and lowering the cash reserve ratio), among others.

The disparity of fortunes among the other large emerging countries is confirmed. On a positive note, India and Indonesia are making progress with correcting their imbalances (current account deficit and inflation). Given this situation, Indonesia grew less than expected in 2014 Q1, 5.2% year-on-year, its lowest rate in five years. However, the government veto on mining exports with the aim of prioritising local manufacturing explains this moderation at the start of the year. For its part, Narendra Modi's ample electoral victory in India has been very well received by the markets and could be crucial in carrying out inclusive reforms for the country. In Latin America, Mexico and Brazil posted weak growth figures for Q1. Specifically, Mexico grew by 1.8% year-on-year, below consensus expectations which had placed growth at 2.0%. Two factors lie behind this lower figure: the slowdown in the US economy in Q1 and the country's tax hike. However, contained imbalances and a recovery in the US economy support reasonable prospects for the region's second economy (2.9% in 2014). On the other hand, Brazil advanced by 1.9% year-on-year compared with 2.2% the previous quarter. In this case growth prospects are less favourable, especially given inflationary tensions that refuse to go away. In spite of these tensions, the central bank decided not to take any action at its last meeting, leaving the SELIC rate at 11%.

Japan: CPI

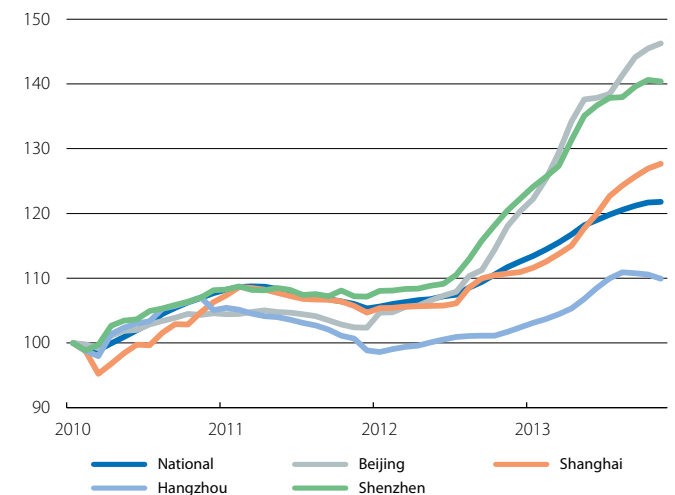
Year-on-year change (%)



Source: "la Caixa" Research, based on data from the Japanese Ministry of Communications.

China: house price

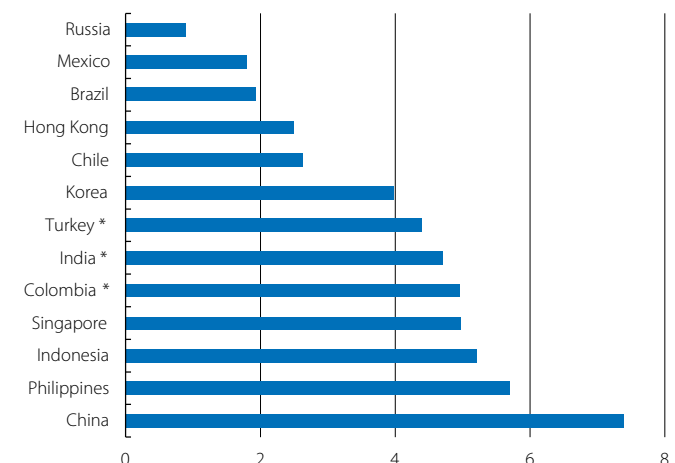
Index (June 2010 = 100)



Source: "la Caixa" Research, based on data from the China Real Estate Index System (CREIS) (SouFun.com).

Emerging countries: GDP growth in 2014 Q1

Year-on-year change (%)



Note: * Data for 2013 Q4 instead of 2014 Q1.

Source: "la Caixa" Research, based on data from Thomson Reuters Datastream.

FOCUS · South Africa: how to make your place among the large emerging countries

The party of the late Nelson Mandela, the African National Congress (ANC), won an easy victory at the elections last 7 May. Consequently, Jacob Zuma will be able to enjoy a second term as President of South Africa. Winning 62% of the votes was much more than expected as the socio-economic outcome of Zuma's first five years includes some achievements but also significant shortfalls. His challenge now is to underpin the former and remedy the latter.

South Africa's progress has been considerable since the end of apartheid in 1994. In terms of GDP growth, the most fruitful period was between 2000 and 2008. The consequence of that boom is that the country's level of development is now clearly higher than its neighbours' (per capita income in South Africa is 4.5 times the average for Sub-Saharan Africa). In fact, the new South Africa gained a leading place on the global economic map with GDP steadily increasing its relative share of the total. Symbolically, an initial from its name became part of the famous acronym «BRICS». The country has the most developed financial system on the African continent with a deep capital market and a well capitalised banking system. On the whole, the quality of its institutions is comparable with that of the advanced economies in Asia, providing a favourable framework for foreign investment.

However, ultimately the country has been affected by imbalances inherited from the apartheid era and the inability of Zuma's government to sort them out. From average growth of 4.2% in 2000-2008 it went to 1.9% in 2009-2013. The country's huge inequality is the factor underlying its main imbalances and weaknesses. According to World Bank indicators, South Africa heads the global ranking for inequality, above countries such as Brazil, Chile and Colombia. The end of apartheid did not bring with it an improvement in this area because inequality continued due to an ineffective and inefficient educational system, a dysfunctional labour market (leading to high unemployment and low productivity) and a regulatory framework that hinders the creation of small and medium-sized firms. This is particularly evident in the mining industry. In 2000, South Africa extracted 11% and 75% of the world's gold and platinum, respectively. Low mining productivity meant that these figures had fallen to 3.5% and 72% by 2013. This reduction explains part of the significant deterioration in the current deficit, as well as being a repeated source of conflict. One recent example is the four-month strike by 70,000 miners which led to a stoppage of 40% of the world's mining of platinum and 870,000 ounces not being extracted (equivalent to 0.4% of South Africa's GDP).

Fortunately, improvements in the world's economic environment will enhance South Africa's macroeconomic figures in the short term (2014-2015): an upswing in GDP, a stop to rising inflation and a contained current deficit and public debt. But the government should not become complacent. Rather it should take advantage of the situation to reactivate the levers that are truly important in the long term: reforms of education and the labour market and the elimination of obstacles to setting up SMEs are essential conditions to capitalising on South Africa's evident strengths (financial system, institutions, market size). The country has the potential to become the financial centre of an increasingly attractive Africa for international investors. May's victory gives Jacob Zuma a second chance but there will not be many more.

South Africa: key economic indicators

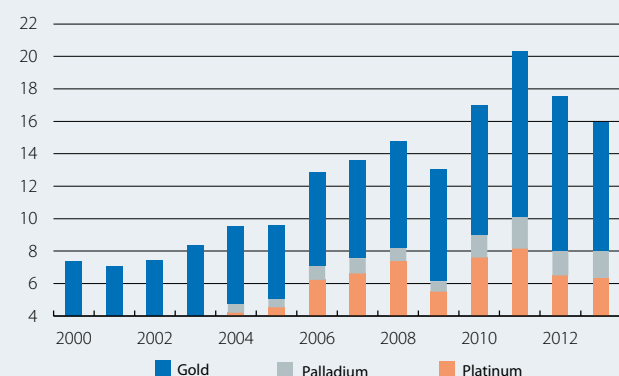
Percentage change compared with the same period a year ago unless otherwise specified

	Av. 2000-2008	Av. 2009-2013	2013	2014(f)	2015(f)
Real GDP	4.2	1.9	1.9	2.3	2.7
Per capita income ¹	8,211	10,659	11,259	11,543	11,899
Per capita income Sub-Saharan Africa ¹	1,753	2,381	2,565	2,673	2,796
Inflation	6.2	5.4	5.4	6.3	5.6
Unemployment rate (% lab. force)	25.1	24.6	24.7	24.7	24.7
Fiscal balance (% GDP)	-0.6	-4.5	-4.3	-4.4	-4.5
Public debt (% GDP)	35.1	38.6	45.2	47.3	49.6
Current account balance (% GDP)	-2.9	-3.9	-5.8	-5.4	-5.3

Note: (f) 2014 and 2015 are forecasts. 1. Purchasing power parity, in international dollars.
Source: "la Caixa" Research, based on data from the IMF and Thomson Reuters Datastream.

South Africa: market value of the precious metals mined

(Billion dollars)



Source: "la Caixa" Research, based on data from Thomson Reuters Datastream.

FOCUS · Chile: in search of lost investment

Chile's economic development is facing an important chapter in a story which, to date, has been a success in many respects. The country could not avoid the global recession of 2008 and 2009 but recovered with enviable speed: GDP grew by more than 5% year-on-year during the period 2010-2012. Moreover it did so under relatively unfavourable conditions as, at the beginning of 2011, the price of copper embarked on a clearly downward trend. It should be noted that copper is the most important item in Chile's exports, accounting for 60% of the total. The reason for such resistance being shown by growth within a relatively adverse international context is the dynamic performance by domestic demand and particularly increases of between 12% and 14% in gross fixed capital formation in each of these three years. However, quite unexpectedly this pattern of growth halted in 2013 and investment barely grew by 0.4% year-on-year. What might be the reason for this worrying figure? Will its effect be temporary or permanent?

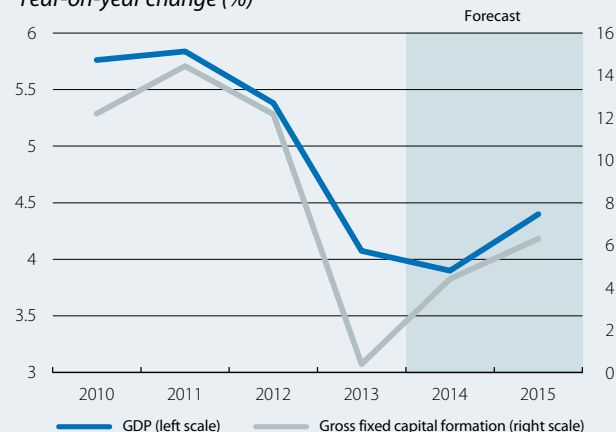
One initial element penalising gross fixed capital formation in Chile is the reduction observed internationally in commodity investments. According to data from SNL Metals & Mining, a consultancy firm specialising in monitoring the world's mining industry, there was almost a 30% global reduction in 2013 in the budgets of large corporations in the sector aimed at mining projects for non-ferrous metals (one of these being copper). This is the industry's response to the combination of lower prices and uncertain demand in many countries. But in addition to this adverse factor of external origin there is also a domestic factor: insecurity surrounding the political take-over of the centre-right by the centre-left. The elections have raised doubts not so much about the outcome per se (Michelle Bachelet's victory had been widely predicted) but for what this represents for the direction of economic policy. In particular, the business world has expressed concern about fiscal reform. The aim of the proposed legislation in this area (currently about to be passed by the Chilean Senate) is to achieve an annual increase in revenue equivalent to 3% of GDP, whose fundamental purpose is to finance higher education. According to the bill, the main source of higher revenue will be a hike in corporate tax (from the current rate of 20% to 27% in 2017) and the elimination of fiscal credits for investment.

Given this situation, how can we expect the country's investment to perform over the coming years? We do not expect any excessive change from the first of the aforementioned downward trends regarding investment, namely the declining phase of the world investment cycle in mining. However, we do believe that the

uncertainty resulting from the change in economic policy is very likely to diminish as this first year of the new legislature progresses. Chile is still the country in Latin America with the best institutional environment and the most consolidated macroeconomic stability. The experience of Bachelet's first presidency, during which time she seemed to be fully aware of the need to look after the institutional framework, lessens the risk of an excessively interventionist agenda of reforms altering this key factor for competitiveness. This should mean that, in 2014 and especially in 2015, investment will once again grow at an acceptable rate, namely above 5% year-on-year. This recovery in investment, together with other encouraging factors in the short term (the depreciation of the peso which will stimulate exports and monetary relaxation in a context of moderate inflation) will help the economy, after a relatively circumspect 2014, to grow by close to 4.5% again in 2015.

Chile: GDP and investment

Year-on-year change (%)



Source: "la Caixa" Research, based on data from the central bank of Chile.

Chile: main macroeconomic indicators

	2013	2014 (f)	2015 (f)
CPI (% , year-end)	3.0	3.0	3.1
Current account (% GDP)	-3.4	-3.3	-2.8
Fiscal balance (% GDP)	-0.7	-1.1	-0.9
Public debt (% GDP)	12.2	12.6	13.5

Source: "la Caixa" Research, based on data from Thomson Reuters Datastream, IMF and the central bank of Chile.

KEY INDICATORS

Year-on-year change (%), unless otherwise specified

UNITED STATES

	2012	2013	2013 Q2	2013 Q3	2013 Q4	2014 Q1	04/14	05/14
Activity								
Real GDP	2.8	1.9	1.6	2.0	2.6	2.0	–	...
Retail sales (excluding cars and petrol)	4.2	3.6	3.8	3.7	3.6	2.3	3.1	...
Consumer confidence (value)	67.1	73.2	75.1	81.0	74.0	80.5	81.7	83.0
Industrial production	3.8	2.9	2.5	2.7	3.3	3.4	3.5	...
Manufacturing activity index (ISM) (value)	51.8	53.9	50.8	55.7	56.7	52.7	54.9	...
Housing starts (thousands)	783.8	929.7	865	882	1,025	924	1,072	...
Case-Shiller home price index (value)	141.3	158.2	156	161	165	170	...	...
Unemployment rate (% lab. force)	8.1	7.4	7.5	7.2	7.0	6.7	6.3	...
Employment-population ratio (% pop. > 16 years)	58.6	58.6	58.7	58.6	58.5	58.8	58.9	...
Trade balance ¹ (% GDP)	–3.3	–2.8	–3.0	–2.9	–2.8	–2.8	...	...
Prices								
Consumer prices	2.1	1.5	1.4	1.6	1.2	1.4	2.0	...
Core consumer prices	2.1	1.8	1.7	1.7	1.7	1.6	1.8	...

Note: 1. Cumulative figure over last 12 months.

Source: "la Caixa" Research, based on data from the Department of Commerce, Department of Labor, Federal Reserve, Standard & Poor's, ISM and Thomson Reuters Datastream.

JAPAN

	2012	2013	2013 Q2	2013 Q3	2013 Q4	2014 Q1	04/14
Activity							
Real GDP	1.4	1.6	1.4	2.5	2.5	2.7	–
Consumer confidence (value)	40.0	43.6	44.7	44.0	41.7	38.8	37.0
Industrial production	0.2	–0.6	–3.0	2.0	5.8	8.3	4.1
Business activity index (Tankan) (value)	–5.0	6.0	4.0	12.0	16.0	17.0	–
Unemployment rate (% lab. force)	4.3	4.0	4.0	4.0	3.9	3.6	3.6
Trade balance ¹ (% GDP)	–1.4	–2.4	–1.9	–2.1	–2.4	–2.8	–2.8
Prices							
Consumer prices	0.0	0.4	–0.3	0.9	1.4	1.5	3.4
Core consumer prices	–0.6	–0.2	–0.4	0.0	0.5	0.6	2.2

Note: 1. Cumulative figure over last 12 months.

Source: "la Caixa" Research, based on data from the Communications Department, Bank of Japan and Thomson Reuters Datastream.

CHINA

	2012	2013	2013 Q2	2013 Q3	2013 Q4	2014 Q1	04/14
Activity							
Real GDP	7.7	7.7	7.5	7.8	7.7	7.4	–
Retail sales	14.3	13.1	12.6	12.8	13.0	13.1	11.9
Industrial production	10.0	9.9	9.1	10.1	10.0	0.0	8.7
PMI manufacturing (value)	50.8	50.8	50.5	50.8	51.3	50.3	50.4
Foreign sector							
Trade balance ¹ (value)	230	260	269	252	260	234	235
Exports	8.0	7.9	3.8	3.9	7.4	–3.4	0.9
Imports	4.3	7.3	5.0	8.4	7.1	1.7	0.8
Prices							
Consumer prices	2.7	2.6	2.4	2.8	2.9	2.3	1.8
Official interest rate ² (value)	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Renminbi per dollar (value)	6.3	6.1	6.2	6.1	6.1	6.1	6.2

Notes: 1. Cumulative figure over last 12 months. Billion dollars. 2. End of period.

Source: "la Caixa" Research, based on data from the National Bureau of Statistics and Thomson Reuters Datastream.

CURRENT SITUATION · Recovery, but at different speed

The euro area's recovery is progressing at a good pace. After the double dip recession that had affected the euro area since 2008, the signs of recovery seem long-lasting: gaining in strength and being distributed among the region's countries. GDP growth figures for Q1 point to an incipient but varied economic recovery with substantial differences between the different economies. Looking at the breakdown for this growth, the foreign sector has been joined by an increasingly stronger domestic demand with notable improvements both in private consumption and investment, which will provide the region with more sustained and balanced growth. The weak link in Europe's macroeconomic situation is still inflation. That is why all eyes are on the European Central Bank (ECB) and especially on how it will handle the growing expectations of the last few months.

Gaps widen between the euro area's main economies.

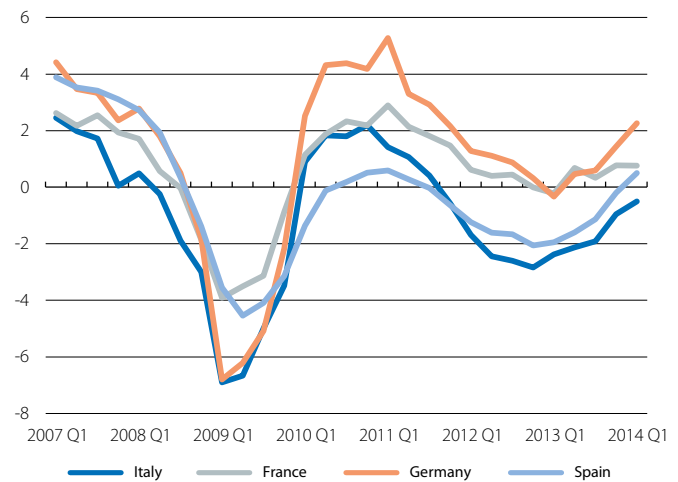
GDP for the euro area grew in 2014 Q1 by 0.2% quarter-on-quarter although there are notable differences between countries. Germany's surprising GDP growth particularly stood out, 0.8% up on the previous quarter, as well as Spain, which grew by 0.4%, showing certain solidity in its economic recovery. At the other end of the scale are France and Italy, which once again posted worse figures than expected, with zero growth for the French and continued contraction for the Italians (-0.1% quarter-on-quarter). These results fuel doubts as to the growth capacity of these two countries in the medium term and scepticism regarding the structural reforms implemented and those still pending in order to revive growth in their respective economies. This trend has also been noted by the European Commission (EC) in its spring report and clearly different growth rates between the countries of the euro area can be detected in its forecasts for 2014 and 2015. With a view to 2014, Spain will grow at a similar rate to France but ahead of Italy, while Spain is already expected to grow more than these two economies in 2015, at a level close to that of Germany.

Business and confidence indicators for Q2 also point to a recovery with significant differences between countries.

The composite PMI remained above 50 points both in Germany and Spain, around 56 points, specifically. Italy is lagging behind somewhat with 52.6 points. In France, however, the PMI was once again below the threshold of 50 points, the figure as from which negative growth is usually recorded. The economic sentiment index produced by the EC provides a very similar scenario with notable advances for the euro area as a whole and Spain and Germany in particular, while in France this index falls for the fourth consecutive month. If these differences between the two main economies of the region continue or even widen, it could lead to tensions in the coming quarters for key aspects of EU economic policy.

GDP growth

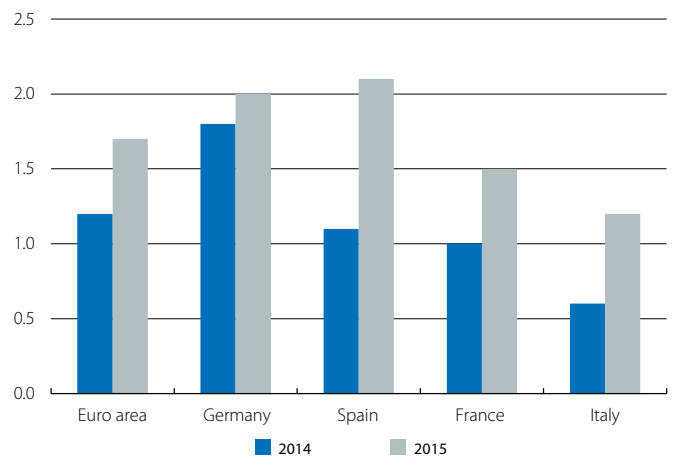
Year-on-year change (%)



Source: "la Caixa" Research, based on Eurostat data.

The European Commission's GDP growth forecasts

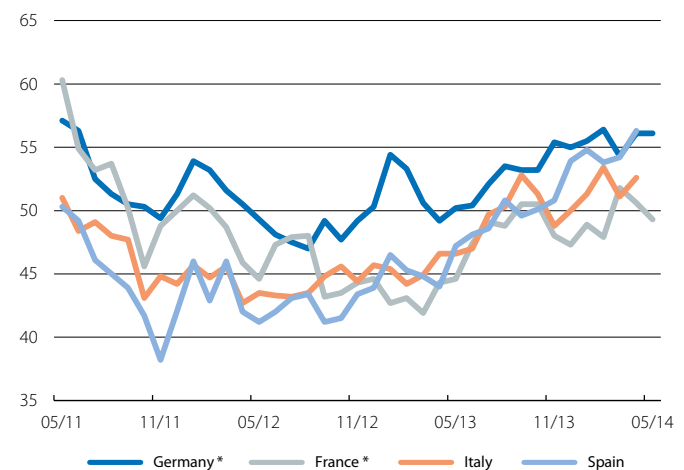
Year-on-year change (%)



Source: "la Caixa" Research, based on European Commission data.

Composite PMI

(Index)



Note: * Latest figure corresponding to May's flash PMI composite.

Source: "la Caixa" Research, based on Markit data.

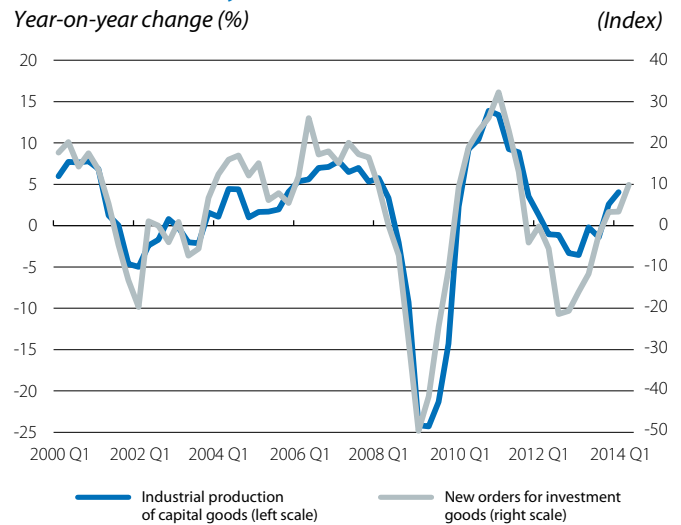
Investment is a key factor in the recovery. In the euro area as a whole, investment has spent the last three quarters posting positive quarter-on-quarter growth figures although it actually started to pick up in 2013 Q4 with a rise of 1.0%. Several leading indicators such as the industrial production of investment goods and new orders for these goods suggest that this upward trend held steady in 2014 Q1 and will continue to gain ground in the short and medium term. The EC expects notable improvement for the whole year and for 2015, of 2.3% and 4.2% year-on-year, respectively. The improved confidence of different agents, less uncertainty regarding the sovereign debt crisis and gradual normalisation of credit conditions are the main factors supporting the EC's predictions, although it also acknowledges that numerous risk factors still remain.

The improvement in household consumption is increasingly convincing. Like investment, household consumption started to record positive growth in 2013 Q2. However, unlike investment, this recovery in consumption was very modest until 2013 Q4 (latest figure available), with its growth rate barely reaching 0.1% quarter-on-quarter on average. Nevertheless, the latest leading indicators point to a possible acceleration in this rate. One clear example are retail sales which posted 1.3% growth year-on-year in March, thereby consolidating a clearly upward trend. On the whole, domestic demand therefore seems to be building up steam and the euro area's sources of growth are rebalancing after a recovery that had been overly dependent on the foreign sector.

The German economy continues to lead Europe's economic recovery. The aforementioned situation for the euro area as a whole, namely growth in domestic demand in general and investment in particular, are particularly notable in the German economy, which has provided its detailed GDP figures for 2014 Q1. The rate of growth in GDP reached 2.3% year-on-year and investment and household consumption grew by 6.6% and 1.4%, respectively. More dynamic domestic demand led to an upswing in imports, to the extent that the foreign sector's contribution to growth was zero. This is particularly relevant in the case of the German economy as, to date, the foreign sector had been the driving force behind its GDP growth. The latest high frequency indicators, which have been very positive in general, together with the good growth figures for 2014 Q1, are likely to result in the growth forecast for the German economy being revised upwards in 2014, which the consensus of analysts has currently placed at 1.9%.

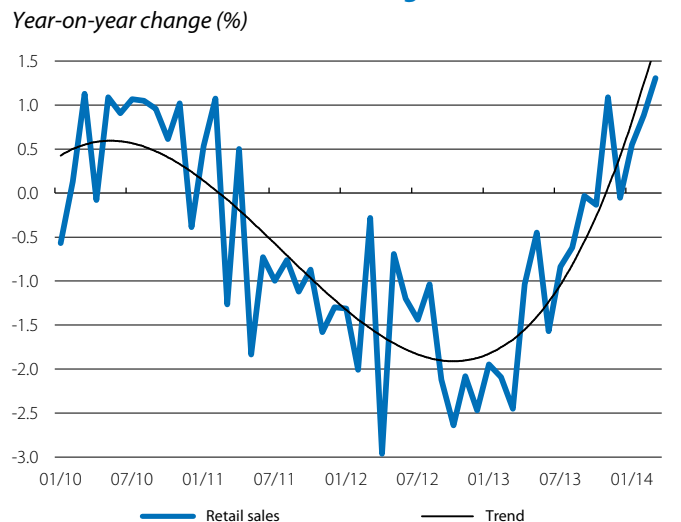
The euro area still needs to reactivate credit. The state of sovereign and corporate debt has notably improved over the last few months but bank credit has hardly progressed and there is still a great deal of fragmentation between the core and periphery countries. To a greater or lesser degree depending on the country, both supply and demand factors can be seen to be hindering the flow of credit. In spite of the

Euro area: activity indicators



Source: "la Caixa" Research, based on data from Eurostat and from the European Commission.

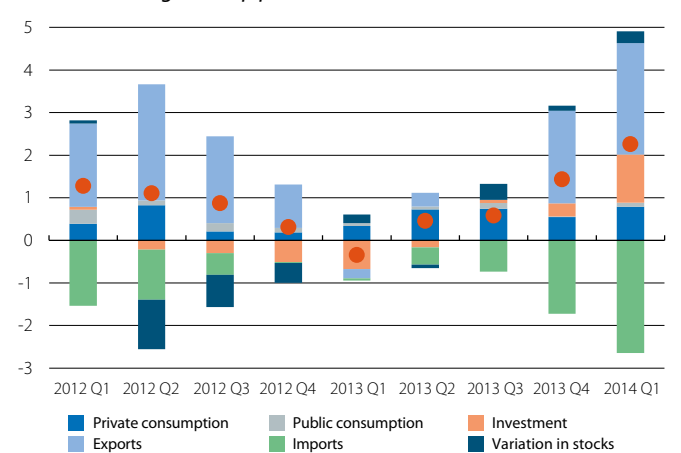
Euro area: retail and consumer goods



Source: "la Caixa" Research, based on Eurostat data.

Germany: GDP growth

Contribution to growth (p.p.)



Note: * Year-on-year change (%).

Source: "la Caixa" Research, based on data from Destatis.

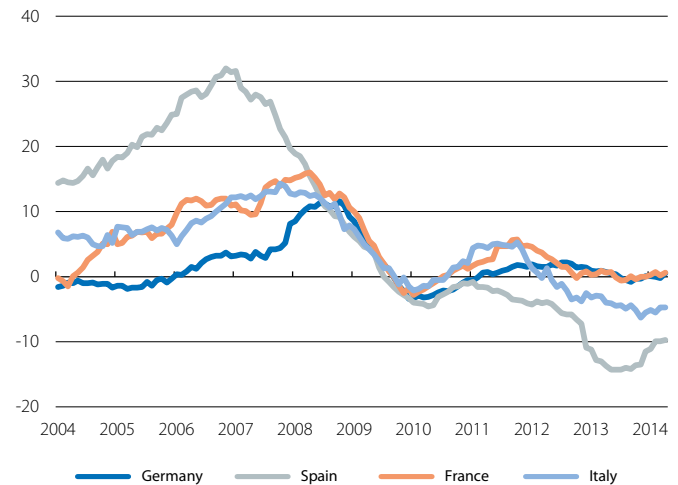
incipient economic recovery, demand's credit capacity is still affected by the delicate situation many firms and households find themselves in. Although the outlook has improved considerably, the deleveraging that many of these must carry out means that the recovery in demand's credit capacity is particularly slow. The conditions for credit supply are hardly optimal either. The uncertainty surrounding the launch of the Single Supervisory Mechanism and especially details regarding the stress tests and AQR that European banks must pass mean that they are still extremely cautious in granting loans.

Low inflation continues to pressurise the ECB. Far from embarking on an upward trend, the risk that inflation will remain at its current level or fall even further has increased. In April the year-on-year rate of change for the harmonised CPI stood at 0.7%, 0.2 percentage points above March's figure. However, this is likely to fall again in May as the figures for Spain and Italy, which have already been announced, have unexpectedly fallen. These low inflation rates have been occurring since the end of 2013 and are due both to domestic factors such as a large amount of surplus production capacity and wage adjustments in many periphery countries, as well as external factors such as relatively stable oil prices and the appreciation of the euro which is also pushing down inflation (see the Focus «The effects of the euro's appreciation» in this *Monthly Report*). Consequently, for months now all eyes have been on the ECB.

The ECB, moving towards another round of monetary stimuli. The euro area's leading monetary institution is still concerned about inflation remaining abnormally low and points to the slowness in the recovery of credit as one of the main reasons for this situation. That is why, for the last few months, Mario Draghi has been modifying the tone of his statements in his public appearances, increasingly stressing the different tools available to the ECB and, especially, his willingness to deploy them. Having reached this point, the great challenge now facing the ECB is to carefully handle the expectations, created by itself, that are keeping yields on public and corporate debt at extremely low levels. As the ECB noted in its last Financial Stability Review, these levels are extremely fragile and could suddenly rise if there are any changes in the global risk appetite or if the expectations created are disappointed. A delicate balance that the ECB must pay a lot of attention to over the coming months.

Stock of credit to non-financial firms

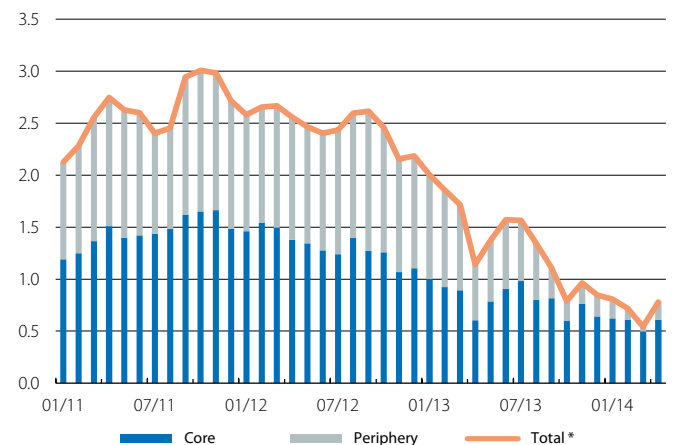
Year-on-year change (%)



Source: "la Caixa" Research, based on data from the European Central Bank.

Euro area: harmonised index of consumer prices

Contribution to year-on-year growth (p.p.)

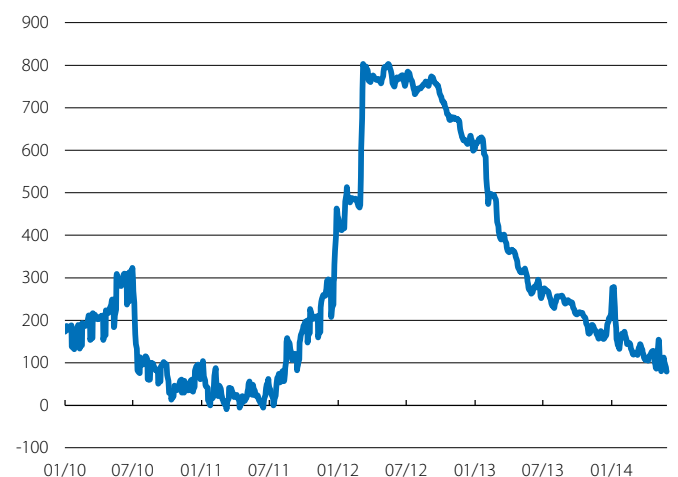


Note: * Year-on-year change (%). The countries that make up the periphery are Italy and Spain and the core, France and Germany.

Source: "la Caixa" Research, based on Eurostat data.

Euro area: excess liquidity

(Billion euros)



Source: "la Caixa" Research, based on Bloomberg data.

FOCUS · The effects of the euro's appreciation

At the meeting of the Governing Council of the European Central Bank (ECB) on 8 May, Mario Draghi expressed concern regarding the persistent appreciation of the EU's currency (reaching 1.38 dollars per euro that week, its highest value since 2011). Given the possible impact of a strong euro on the region's price stability and economic growth, the President hinted at imminent intervention by the institution with monetary stimulus measures. The markets soon reacted and the euro lost 2.2% against the dollar in one month. However, there is growing anxiety in several European capitals regarding the euro's strength and how it might harm their export capacity. In spite of this, and in the current context of low inflation and weak domestic demand, it is very important to analyse the real impact of the euro's exchange rate fluctuations on the euro area's economy.

The main channel through which exchange rate fluctuations affect the economy is by their impact on prices. This occurs via two opposing effects: on the one hand, a stronger euro makes exports more expensive, leading to a loss in competitiveness compared with other rivals and therefore a reduction in the volume of exports. But, on the other hand, a stronger euro also makes imports cheaper, reducing the cost of all those intermediate goods that are imported (for example, oil and other raw materials). The combination of these two opposing effects¹ and the ability of companies to vary the margin they operate under mean that the impact of the euro's exchange rate is not passed on entirely to export prices but is reduced and, therefore, the final impact on the volume of exports is also reduced.

Given that the main engine of growth during the crisis has been the foreign sector, it might seem that concerns regarding the strong euro are well founded, although we need to quantify the real economic impact to reach any firm conclusions. Since January 2013, the euro's nominal effective exchange rate has appreciated by approximately 5.0%. Based on a study by the ECB,² an increase of this size reduces exports by 0.6 p.p. in the first year and by close to 1.0 p.p. cumulative in the long term. Given that the region's exports of goods and services grew by 2.8% in 2013 Q4, the exchange rate pass-through does not seem to be insignificant although neither is it crucial.

With regard to the impact on the CPI, this appears to have become more significant recently as surplus output and low commodity prices have pushed down inflation, increasing the risk of deflation throughout the region. A rise in the exchange rate is passed on to consumer prices mainly by making import prices cheaper. Carrying out a similar analysis to the one above, if the euro appreciates by 5.0%, it pushes inflation down by 0.1 p.p. the first year and by around 0.6 p.p. in the long term. Consequently, the potential effect of a sustained appreciation of the euro does not seem insignificant, especially if we bear in mind inflation's very low level at present. The ECB is doing the right thing in keeping a close eye on the trend in the exchange rate.

Euro area: nominal effective exchange rate of the euro *

(Index)



Note: * Calculated as the average of euro values against the currencies of its main trading partners, weighted by the volume of exports to these countries.

Source: "la Caixa" Research, based on data from the International Monetary Fund.

1. Depending on the import content of exports, part of the gain could be passed on to inputs (cheaper imports) at a lower output price, maintaining margins.

2. See Mauro, Ruffer Bonda, «The changing role of the exchange rate in a globalised economy», ECB Occasional paper series (2008).

FOCUS · Monetary policy in Sweden: a good role model?

The monetary policy that needs to be carried out by the main developed countries continues to generate intense and interesting debate. In the US and United Kingdom, GDP growth is above 2% and people are now opening discussing the right time to start raising interest rates. In the euro area, for months now the liquidity injected over the last few years has been gradually drained off but weak growth and low levels of inflation are pressuring the ECB to continue measures to underpin the recovery. Although the monetary policy tools that have been used in the last few years are, in many cases, new, the underlying debate has not changed. On the one hand there are fears that toughening up monetary policy too soon could derail the recovery and, on the other, that prolonging easy monetary conditions too long could create new bubbles in certain real or financial assets.

The extraordinary situation over the last few years forced central banks to take innovative measures without being able to rely on the support of widely accepted theories. In such a situation, which is quite disconcerting up to a point, it would be very useful to have benchmarks that can be used to defend a measure. And this is precisely the aim of the Riksbank, Sweden's central bank, whose actions have aroused fierce debate. The point of disagreement: the consequences for the Swedish economy of the interest rate hikes carried out by the Riksbank between June 2010 and July 2011. According to Economics Nobel Prize winner, Paul Krugman, this action has led Sweden to deflation and is therefore a sign of what might happen if the ECB or the Fed rush in to toughening up monetary policy. Let us analyse this in a little more detail.

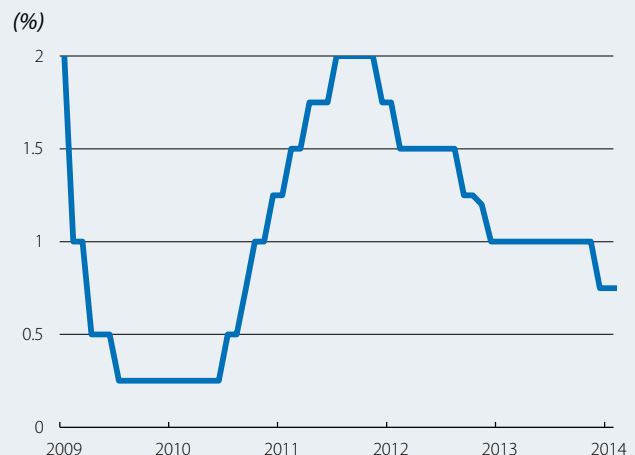
Sweden's economy, like those of the main developed countries, also suffered from the global crisis in 2009. The Riksbank, whose mandate is to maintain inflation at around 2%, responded by lowering the official interest rate to 0.50% and keeping it at this level until June 2010. At that time, the Swedish economy had exited the recession two quarters earlier and the consensus of analysts placed its rate of growth in 2011 at 2.6% and inflation at 2.1%. Given this situation, the Riksbank decided to start raising the interest rate, a trend it maintained until July 2011 when it carried out the last hike and left it at 2.00%.

Between June 2010 and June 2011, growth and inflation prospects for 2011 increased considerably, reaching 4.4% and 3.1%, respectively. Bearing in mind the fact that the effect of an interest rate hike on GDP growth or inflation usually takes about three quarters to materialise, it seems strange that, after the interest rate hikes carried out by

the Riksbank, growth prospects increased rather than falling. In fact, it was not until the summer of 2011 when they started to fall. That was precisely the moment when the euro area fell back into recession due to the worsening of the sovereign debt crisis. A crisis which also affected Sweden (exports of goods and services account for 50% of its GDP, and exports of goods to the euro area account for 40% of the total).

It is therefore true that the Riksbank's decision to raise interest rates in June 2010 is debatable. For this debate, in addition to the aforementioned arguments we should also consider other aspects such as financial stability and the economy's idle capacity. But it is not obvious that the action taken by the Riksbank was the reason for the Swedish economy's relapse and its current deflation.

Official interest rate of the Riksbank



Source: "la Caixa" Research, based on data from the Riksbank.

Inflation rate



Note: The red columns indicate when interest rates were raised.

Source: "la Caixa" Research, based on data from the Riksbank.

KEY INDICATORS

Activity and employment indicators

Values, unless otherwise specified

	2012	2013	2013 Q2	2013 Q3	2013 Q4	2014 Q1	04/14	05/14
Retail sales (year-on-year change)	-1.6	-0.9	-1.0	-0.4	0.3	0.9	...	...
Industrial production (year-on-year change)	-2.5	-0.7	-1.1	-1.1	1.5	1.1	...	...
Consumer confidence	-22.1	-18.6	-20.8	-15.9	-14.4	-11.2	-8.6	-7.1
Economic sentiment	90.8	93.8	90.2	95.3	99.1	101.6	102.0	102.7
Manufacturing PMI	46.2	49.6	47.9	50.9	51.9	53.4	53.4	...
Services PMI	47.6	49.3	47.5	50.9	51.3	52.1	53.1	...
Labour market								
Employment (people) (year-on-year change)	-0.7	-0.9	-1.0	-0.8	-0.5	...	-	...
Unemployment rate: euro area (% labour force)	11.3	12.0	12	12.0	11.9	11.8	...	...
Germany (% labour force)	5.5	5.3	5.3	5.3	5.2	5.1	...	...
France (% labour force)	9.8	10.3	10.3	10.3	10.2	10.4	...	...
Italy (% labour force)	10.7	12.2	12.1	12.3	12.6	12.7	...	...
Spain (% labour force)	24.8	26.1	26.2	26.1	25.8	25.4	...	...

Source: "la Caixa" Research, based on data from the Eurostat, European Central Bank, European Commission and Markit.

Foreign sector

Cumulative balance over the last 12 months as % of GDP of the last 4 quarters, unless otherwise specified

	2012	2013	2013 Q2	2013 Q3	2013 Q4	01/14	02/14	03/14	04/14
Current balance: euro area	1.6	2.7	2.3	2.4	2.7	2.8	2.9	2.8	...
Germany	7.4	7.5	7.5	7.4	7.5	7.7	7.6	7.5	...
France	-2.1	-1.3	-1.5	-1.6	-1.3	-1.3	-1.2	-1.2	...
Italy	-0.3	1.0	0.4	0.7	1.0	1.2	1.3	1.4	...
Spain	-1.2	0.8	0.4	0.8	0.8	0.7	0.7	0.4	...
Nominal effective exchange rate¹ (value)	97.8	101.6	100.8	101.9	103.1	103.4	103.5	104.6	104.5

Note: 1. Weighted by flow of foreign trade. Higher figures indicate the currency has appreciated.

Source: "la Caixa" Research, based on data from the Eurostat, European Commission and national statistics institutes.

Financing and deposits of non-financial sectors

Year-on-year change (%), unless otherwise specified

	2012	2013	2013 Q2	2013 Q3	2013 Q4	01/14	02/14	03/14	04/14
Private sector financing									
Credit to non-financial firms ¹	-0.3	-2.3	-2.2	-2.8	-2.9	-2.8	-3.1	-3.1	-2.7
Credit to households ^{1,2}	1.2	0.3	0.3	0.3	0.3	0.2	0.4	0.4	0.4
Interest rate on loans to non-financial firms ³ (%)	2.4	2.2	2.2	2.2	2.3	2.3	2.2	2.3	...
Interest rate on loans to households for house purchases ⁴ (%)	3.1	2.8	2.9	2.8	2.8	2.8	2.8	2.8	...
Deposits									
On demand deposits	4.1	7.9	9.3	7.6	6.6	6.2	6.2	5.4	5.2
Other short-term deposits	2.0	0.0	0.1	0.3	-1.5	-2.5	-2.6	-2.3	-2.3
Marketable instruments	0.5	-14.8	-15.5	-17.2	-16.8	-13.7	-12.4	-14.6	-15.2
Interest rate on deposits up to 1 year from households (%)	2.8	2.0	2.1	1.8	1.6	1.7	1.6	1.6	...

Notes: 1. Data adjusted for sales and securitization. 2. Including NPISH. 3. Loans of more than one million euros with a floating rate and an initial rate fixation period of up to one year.

4. Loans with a floating rate and an initial rate fixation period of up to one year.

Source: "la Caixa" Research, based on data from the European Central Bank.

CURRENT SITUATION · Domestic demand adds to growth in Spain

Growing confidence in a sustained recovery. The European Commission (EC) has joined in the widespread improvement for Spain's growth prospects in 2014 and 2015. The favourable progress made by economic indicators over the last few months and advances in correcting the main imbalances accumulated during the pre-crisis years have helped to usher in a phase of greater optimism. The improvement in activity is starting to have an effect on the labour market, leading the EC to also raise its job creation forecast. Improved consumer and business sentiment points to domestic demand lying behind the recent energy seen in the Spanish economy. Although the role played by the foreign sector will still be decisive, this boost from consumption and investment will ensure more balanced growth.

The revival in domestic demand is confirmed. According to the INE, quarter-on-quarter growth in GDP was 0.4% in Q1 this year (0.2% in 2013 Q3). The year-on-year rate stood at 0.5%, 0.1 p.p. below the initial estimate. Flash figures for consumption and investment had already pointed to more dynamic domestic demand in the first few months of the year and the INE's estimates have endorsed this theory. In fact, domestic demand's contribution to aggregate growth was 0.7 p.p. in 2014 Q1 while exports deducted 0.2 p.p. from the year-on-year rate of change in GDP. This has therefore interrupted the trend of the last few quarters in which the foreign sector was the only pillar supporting the recovery. The improvement in consumer confidence to -6.7 points in May, a notably higher figure than the historical average, suggests that private consumption will continue to be a decisive factor in the economy's recovery in 2014 Q2. However, a further decline in salaries during 2014 Q1 indicates that private consumption is unlikely to go on growing at the same pace (0.5% quarter-on-quarter on average since 2013 Q3). One favourable aspect in the breakdown of growth in 2014 Q1 has been the important role played by investment in capital goods. The growing profits of Spanish firms will probably help to maintain the solid growth in investment in capital goods recorded since the beginning of 2013.

Economic activity is progressing apace. The initial indicators for Q2 are encouraging and point to the rate of GDP growth being similar to that of 2014 Q1 or even higher. April's composite PMI rose to 56.3 points. Of note is the sharp increase in the services sector index, reaching 56.5 points, a level it has not seen since 2007. Industrial production is expected to continue its recent upward trend judging by March's 3.1% increase in industrial orders year-on-year as a whole, and 19.5% for capital goods in particular. This once again suggests that investment will become more important for the economy's recovery.

April's figures confirm the recovery in the labour market. The number of registered workers affiliated to Social Security

Change in the European Commission's forecasts

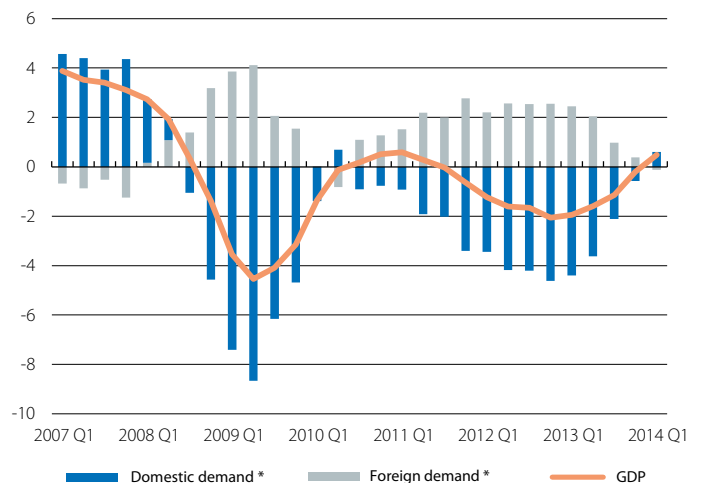
Year-on-year change (%), unless otherwise specified

	Spring 2014		Winter 2013	
	2014	2015	2014	2015
GDP growth	1.1	2.1	1.0	1.7
Unemployment rate (% labour force)	25.5	24.0	25.7	24.6
Employment	0.4	1.2	0.1	1.1
CPI	0.1	0.8	0.3	0.9
Current account balance (% GDP)	1.4	1.5	1.6	1.8
Fiscal balance (% GDP)	-5.6	-6.1	-5.8	-6.5
Public debt (% GDP)	100.2	103.8	98.9	103.3

Source: "la Caixa" Research, based on European Commission data.

Trend in GDP

Year-on-year change (%)

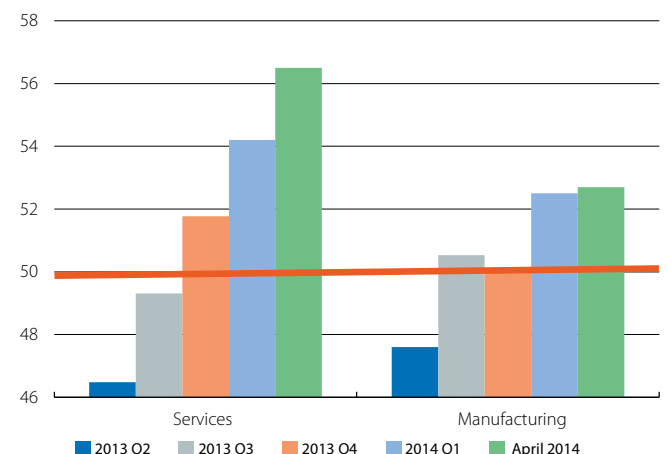


Note: * Contribution to growth in percentage points.

Source: "la Caixa" Research, based on INE data.

Activity indicators

Purchasing Managers' Index (value)



Note: Values above 50 points are usually related to positive GDP growth rates.

Source: "la Caixa" Research, based on Markit data.

grew for the eighth consecutive month, specifically by 61,111 people, seasonally adjusted. The rise seen by employment in the services sector was particularly high, even discounting the positive effect of the Easter holidays. The figures from the National Accounts system also show that the labour market created employment in 2014 Q1, up by 0.1% quarter-on-quarter in terms of full-time equivalent jobs, offsetting the somewhat disappointing figures provided by the LFS for this quarter. The employment expectations over the next three months stated in the European Commission's opinion polls point to this growth in the labour market accelerating slightly. This upward trend is especially evident in the services sector whose average for April and May is higher than the figure for 2014 Q1. This better performance by the labour market should boost consumption, leading us to believe that the risk of deflation is limited in spite of the low inflation rates (0.2% in April according to the advance by the INE). Nonetheless, the debate regarding deflation will continue in the short term because the inflation rate will remain low.

The real estate sector is entering a stabilisation phase.

Improved performance by the labour market and reduced uncertainty in the economic environment are helping the real estate market to put an end to its phase of contraction in which prices and sales plummeted. The figures are showing the first few signs of recovery in housing demand as the number of sales increased by 22.8% year-on-year in March, putting an end to ten months of consecutive declines. This high growth is partly due to the little demand for housing during the first few months of 2013 after the end of tax incentives to buy real estate. Nonetheless, the sustained improvement in the index for the intention to buy housing points to demand picking up over the coming months. Regarding the trend in house prices, their rate of contraction slowed up in 2014 Q1 to -0.5% quarter-on-quarter (compared with -1.9% quarter-on-quarter in the previous quarter). Since the peak, reached in March 2008, house prices have accumulated a drop of 37.2% in real terms. The correction in the real estate sector is coming close to its completion.

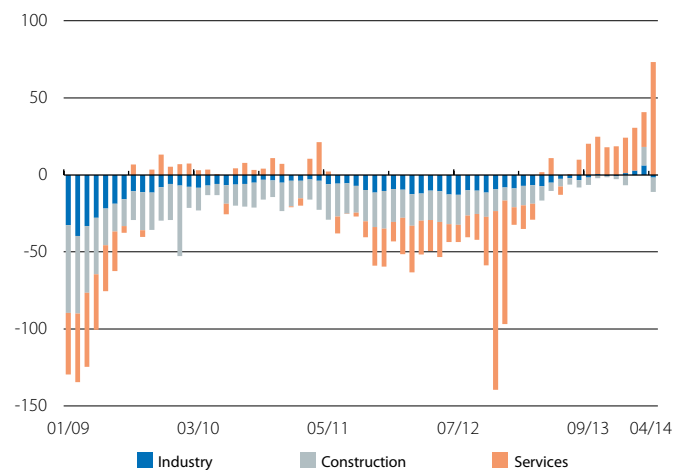
The sustainability of the trade surplus is called into question.

The growing strength in domestic demand has led to a notable upswing in imports in real terms in 2014 Q1 (12.7% compared with 3.0% for exports), according to data from the Customs Department. If this big reaction by imports to growing domestic demand continues, it could end up reducing the foreign sector's contribution to growth and undo the trade surplus achieved. Nevertheless, part of this upswing in imports is due to temporary factors such as the significant rise in automobile sales in the last few months boosted by the PIVE subsidy plan and the regeneration of stocks due to the improved economic outlook, so that we still believe the trade surplus will continue to improve in the medium term.

Private sector deleveraging continues. Among the different imbalances amassed by the Spanish economy before the recession, high household debt is perhaps one of the most

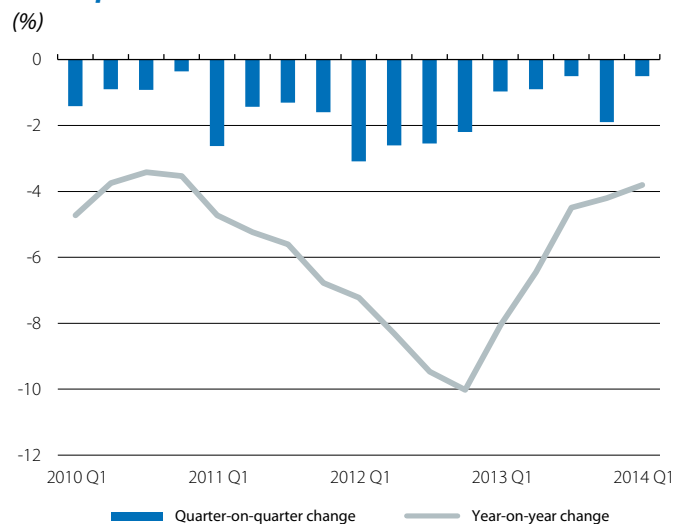
Employment trend

Month-on-month change, seasonally adjusted (thousands)



Source: "la Caixa" Research, based on data from the Ministry of Employment and Social Security.

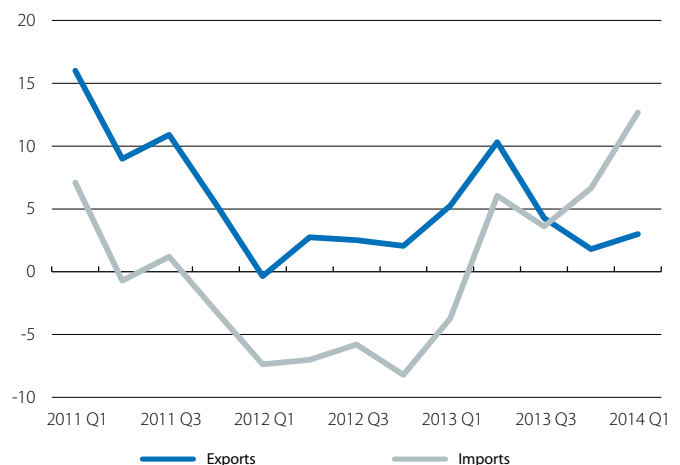
House price



Source: "la Caixa" Research, based on data from the Ministry of Public Works.

Trend in the trade of goods

Year-on-year change (%)



Note: Exports and imports in real terms.

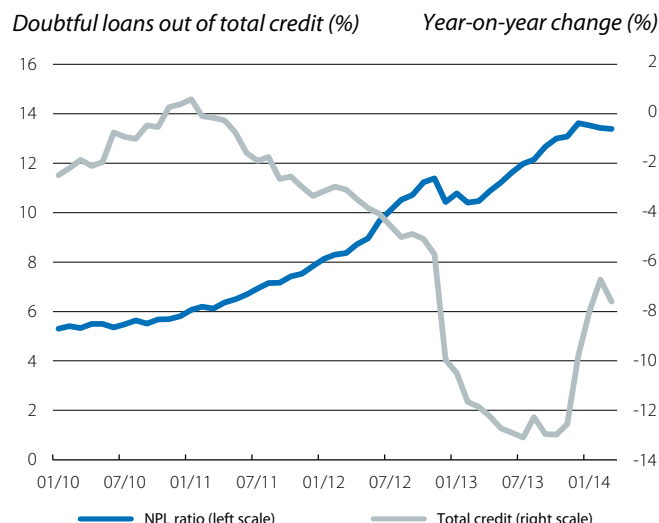
Source: "la Caixa" Research, based on data from the Customs Department.

difficult to correct. One of the consequences of this debt during the crisis was the rise in non-performing loans. In this respect, the most recent figures give cause for optimism as they show an NPL rate that is gradually falling away from its peak reached in December 2013. In March, the rate of contraction for non-performing loans, namely 13.4%, was halted by a higher fall in the credit balance (–7.6% compared with –6.7% in February). Nonetheless, we expect the trend observed at the beginning of year to continue, leading to further reductions in non-performing loans. On the other hand, the increase in new loans being granted to SMEs is also favourable. Although the level is still low, it is notable that this was 5.3% higher in 2014 Q1 than the same quarter a year ago.

Fiscal consolidation efforts must go on. One of the factors that will determine whether the public deficit target is achieved, which the government has set at 5.5% of GDP for this year, will be the progress made in revenue. The figures for tax revenue show a positive trend although this is largely due to regulatory changes affecting the different types of taxation. Over the next few months, in addition to the possible reforms that may be carried out to the tax system, the recovery in economic activity is also expected to boost revenue. At the same time, the government must continue to closely monitor trends in public spending. One positive fact in this respect is that current expenditure between January and March 2014 was 9.06% of GDP, almost 0.2 percentage points lower than the figure for the same period one year ago. Public expenditure is expected to continue along the same lines for what remains of the year, so its contribution to growth will be limited.

The main recommendations by the IMF: tax reform and encouraging the restructuring of private debt. According to this institution, an adjustment in accounts should be accompanied by an increase in tax revenue by raising special and environmental taxes and gradually reducing the preferential VAT treatment enjoyed by some goods. The IMF also suggests lowering Social Security contributions for employing low-skilled workers, reducing exceptions, special income tax regimes and corporate tax. With regard to the financial sector, the IMF recommends that banks continue to improve their capital and limit payouts of cash dividends in order to revive credit (albeit admitting exceptions depending on the solvency and expected margins for banks). Similarly, in order to keep companies operationally viable, the IMF recommends that the Tax Department and Social Security should also be involved in restructuring corporate debt and that banks should promote a personal bankruptcy scheme to offer small businesses a fresh start. In spite of the reforms made over the last few years, the homework set by the IMF is still long and comprehensive. All this should help to improve Spain's business competitiveness, which is at a very low level according to international rankings.

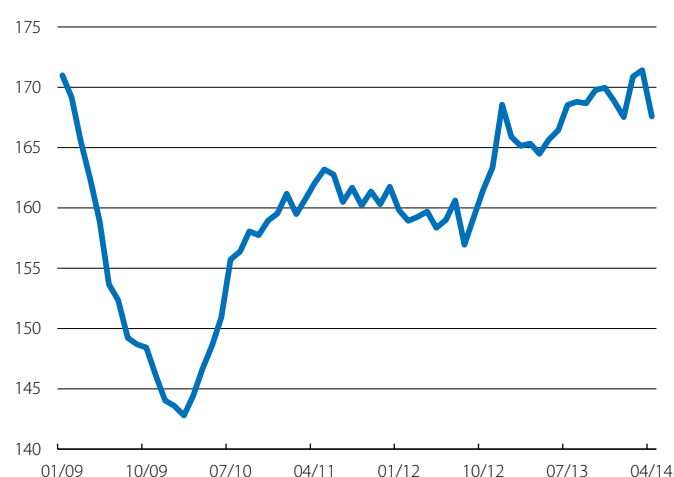
NPL ratio and bank credit



Source: "la Caixa" Research, based on data from the Bank of Spain.

Tax revenue

Cumulative figures over 12 months (billion euros)



Source: "la Caixa" Research, based on data from the Tax Agency.

Business competitiveness ranking

Competitiveness ranking of 60 countries

	Global index	
	2014	2013
US	1	1
Switzerland	2	2
Singapore	3	5
Hong Kong	4	3
Sweden	5	4
Germany	6	9
Canada	7	7
United Arab Emirates	8	8
Denmark	9	12
Norway	10	6
Spain	39	45

Source: "la Caixa" Research, based on data from the IMD World Competitiveness Yearbook 2014.

FOCUS · Spanish firms are getting bigger

In general, the productivity of large firms is greater than that of small firms. In Spain, the gross value added per worker of companies with more than 250 employees is 65% greater than companies with fewer than 50 employees. The proportion of large firms is therefore one of the determining factors in a country's productivity: those countries with a higher proportion of their labour force in large companies usually show higher levels of productivity.

In 2010, the last year for which the OECD publishes comparable data between countries, the proportion of companies with more than 250 workers in Spain was slightly lower than that of the main developed countries. While only 0.12% of the firms in Spain had more than 250 workers, these companies accounted for 0.32% of the total in the US and 0.47% in Germany. The differences may seem small but the implications are not. While Spanish firms with more than 250 workers employed only 24.5% of employed people, in the US and Germany they gave work to 49.8% and 37.0%, respectively. However, the dynamics over the last few years have been changing this pattern in Spain.

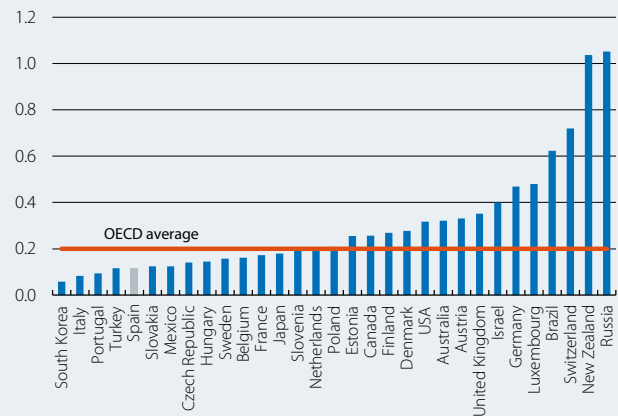
The recession suffered by the Spanish economy has affected the whole business world but, in general, large companies were able to weather the storm better. The percentage of firms with more than 250 employees remained relatively stable up to 2007 but from then on started a clearly upward trend. Job losses were also concentrated in smaller companies while the number of workers in large firms has actually been posting a year-on-year positive growth rate for the last six months. The percentage of employed people in a company with more than 250 workers in April was 3.5 p.p. higher than in 2006.¹

This relatively better trend for larger companies has been helped by the foreign sector's good performance. According to data from the SEPI foundation, in 2011 92.5% of manufacturing companies with more than 200 employees exported their products, while only 61.1% of those with fewer than 200 employees were exporting. It therefore comes as no surprise that those industries with a bigger number of large companies have seen the highest growth in exports over the last few years. It is interesting to note, however, that medium-sized firms are also taking advantage of the boost provided by the foreign sector. Although data are still not available to verify this properly, it can be observed that, in industries where the proportion of medium-sized firms has grown the most, so have exports over the last few years. An encouraging trend for Spain to extend its more productive corporate base.

1. Data not comparable with those from the OECD, which focuses its analysis on market sectors and includes the number of self-employed workers.

Companies with more than 250 workers *

Proportion of all companies (%)

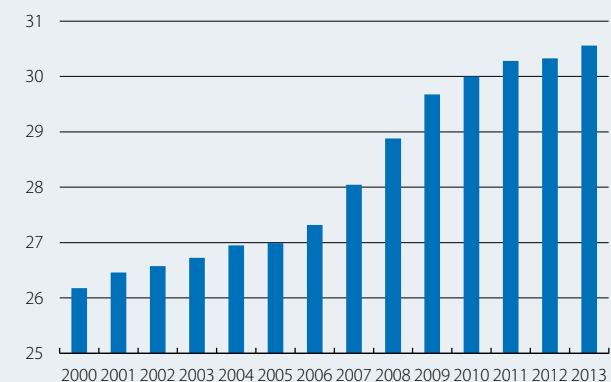


Note: * Data from 2010.

Source: "la Caixa" Research, based on OECD data.

Employed in companies with more than 250 workers

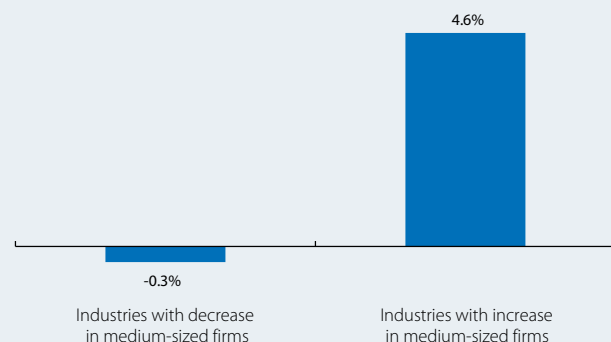
Proportion of all employed (%)



Source: "la Caixa" Research, based on data from the Ministry of Employment and Social Security.

Changes in export growth and the proportion of medium-sized firms *

Change in the average annual growth of nominal exports, 2010-2013 vs. 2000-2007 (%)



Note: * Medium-sized firms: between 100 and 500 workers.

Source: "la Caixa" Research, based on data from the INE and Comex.

FOCUS · Levers to adjust Spain's public deficit

Over the last five years, correcting the public deficit has been one of the government's priorities for its economic policy. In spite of the economy's deterioration, efforts made in the area of fiscal consolidation managed to reduce the deficit by 4.5 p.p. between 2009 and 2013, down to 6.6% of GDP. In the coming years, this process will be boosted by the improved economic situation. However, the still high levels of public deficit and debt (the latter reached 93.9% of GDP in 2013) require renewed efforts to ensure the sustainability of the public accounts and make the adjustment process more credible. The new Stability Programme contains the main tools that will be used by the government to achieve this.

One initial aspect to be considered is how much the government plans to reduce the public deficit over the next few years. Taking 2014 as our benchmark, the Stability Programme's figures contain a 1.1 p.p. reduction in the fiscal imbalance to 5.5% of GDP. This adjustment is 0.3 p.p. bigger than the one contained in the previous Stability Programme due to a larger correction in the deficit's cyclical component (which occurs when the economy is not performing at 100%). Lower expenditure on unemployment benefit and increased VAT revenue are clear examples of this effect. The forecast for the structural deficit (what would be observed if the economy were performing at 100%) has remained unchanged.¹

According to the new programme's figures, fiscal consolidation will continue to focus on adjusting the cyclical balance over the next few years, at an almost constant rate of contraction of 0.9 p.p. every year between 2015 and 2017. Nonetheless, the adjustment of the structural balance, which will decrease at a rate of 0.5 p.p. per year, will still be considerable. With all this, a structural surplus of 0.1% would be achieved by 2017, three years in advance of the target equilibrium level for the structural balance established by the Organic Law on Budget Stability.

The government's fiscal strategy over the coming years represents a clear shift in orientation from the adjustment measures already adopted: while in 2012 and 2013 fiscal adjustment was spread more or less evenly between revenue and expenditure policies, in the coming years it has a clear bias towards expenditure, representing 70% of the impact of all the measures planned.

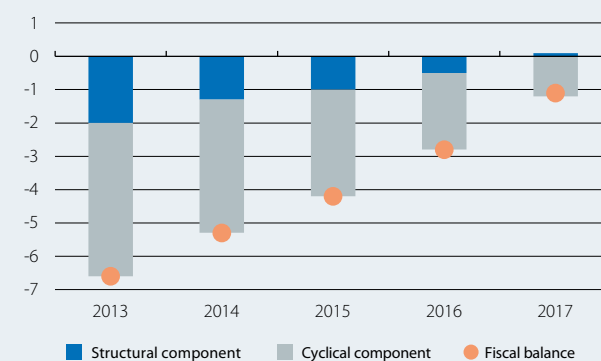
This shift in focus will significantly reduce public spending in relation to GDP, from 44.4% in 2013 to 40.1% in 2017. Unlike the situation over the last few years, according to the Stability Programme the main support for this reduction will be contained public wages and intermediate consumption (reducing their relative share as a percentage of GDP by 2.8 p.p.). The government's recently approved Public Administration Reform will certainly play a key role in this reduction. Another factor

to bear in mind is the fall in spending on social benefits (1.2 p.p. of GDP) due particularly to the expected drop in unemployment benefit payouts as a result of the improved labour market. On the other hand, investment expenditure, among the hardest hit by adjustment policies over the last few years, will stop decreasing, remaining at 1.5% of GDP (although still far from the 4.0% of GDP seen in 2010).

In short, the new Stability Programme has outlined a path for adjustment that, if followed, will reinforce the credibility of the fiscal consolidation process without harming economic growth. However, the government will need to continue concentrating all its efforts to ensure this is achieved.

Breakdown of the fiscal balance established by the Stability Programme *

(% of GDP)



Notes: * Does not include temporary measures affecting the fiscal balance (0.5% of GDP in 2013 and 0.2% in 2014).

Source: "la Caixa" Research, based on data from the Stability Programme.

Level of public expenditure and trend by item

	2013 (% GDP)	Change 2010-2013 (million euros)	Expected change 2013-2017 (million euros)	2017 (% GDP)
Total expenditure*	44.4	▼ 30,076	▲ 8,772	40.1
Wages and intermediate consumption	16.9	▼ 15,154	▼ 9,950	14.1
Social transfers in kind**	2.7	▼ 3,568	▼ 1,412	2.3
Social benefits***	16.6	▲ 8,318	▲ 7,663	15.4
Interest	3.4	▲ 14,533	▲ 8,902	3.8
Investment	1.5	▼ 26,529	▲ 2,134	1.5
Other expenditure****	3.2	▼ 7,676	▲ 282	2.9
Nominal GDP (million euros)	1,022,988	22,632	130,412	1,153,400

Notes: * Does not include expenditure for aid to financial institutions (0.5% of GDP in 2013).

** Includes expenditure on education and healthcare. *** Mainly expenditure on pensions and unemployment benefit. **** Subsidies, capital transfers and other current transfers (international aid, EU institutions, etc.).

Source: "la Caixa" Research, based on data from the State Public Accounts and the Stability Programme.

1. For a detailed discussion of the problems of measuring the structural deficit, see «Output gap, GPS and other fallible guides» from IM05 2013.

FOCUS · Social Security accounts

The recent economic crisis has highlighted the fragility of Spain's pension system. To give a recent example, last year the Social Security deficit rose to 1.2% of GDP. This imbalance forced the government to use part of the resources built up in the Reserve Fund during the surplus years in the first decade of the century. Specifically, since 2012, 18.7 billion euros have been used, a figure similar to the contributions made between 2007 and 2009.

This deterioration in the Social Security accounts is basically due to two factors of a different nature. The first is cyclical: the extensive economic crisis over the last few years has significantly affected Spain's labour market, reducing the number of registered workers affiliated to Social Security by just over 3 million between 2008 and 2013, down to 16.4 million. As a result, the system has seen a 10% reduction in its revenue from Social Security contributions. The second factor to take into account is more of a structural nature, associated with Spain's population getting steadily older. In the last five years the number of pensioners has grown by 9.6%, particularly boosted by the sharp increase in the number of retirees (12.8%) who, at 5.4 million, already account for 65% of all Social Security beneficiaries.

The combination of both these factors has reduced the number of contributors to receivers in the pension system from 2.6 in 2007 to just under 2 in April 2014. The long-term outlook is not encouraging either. In spite of the expected recovery in the labour market over the next few years, an EC report predicts that, without reforms, the number of Social Security contributors for each retiree could fall to 1.3 by 2060, an unsustainable figure whichever way you look at it.¹

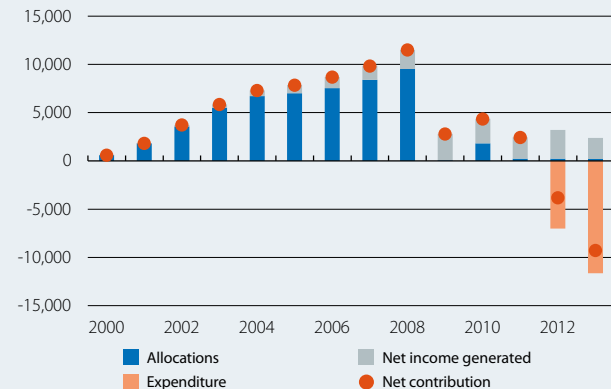
A further factor pressurising Social Security expenditure has been the progressive increase in the average size of pensions. From 2008 to 2013 this increased by 19.0% (20.3% if we only take retirement pensions into account). A large part of this increase is due to the higher amount paid for new pensions which, between 2010 and 2013, were 28.0% larger than the old pensions being cancelled. This phenomenon explains why, in spite of the small increase applied to pensions for 2014 (0.25%), their average value between January and April is 1.8% higher than the value in 2013.

Given these figures, the reform announced in 2013 represents an important step forward in ensuring the pension system can be maintained in the long term; a guarantee that would be reinforced by further advances in labour market efficiency and productivity in the economy.

1. See the European Commission, «The 2012 Ageing Report: Economic and budgetary projections for the UE27 Member States (2010-2060)».

Net contribution to the Social Security Reserve Fund

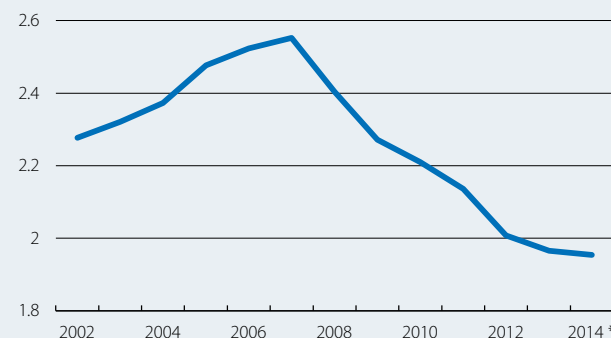
(Million euros)



Source: "la Caixa" Research, based on data from Social Security.

Relation between Social Security affiliated workers and pension beneficiaries

Number of affiliates to total beneficiaries of Social Security

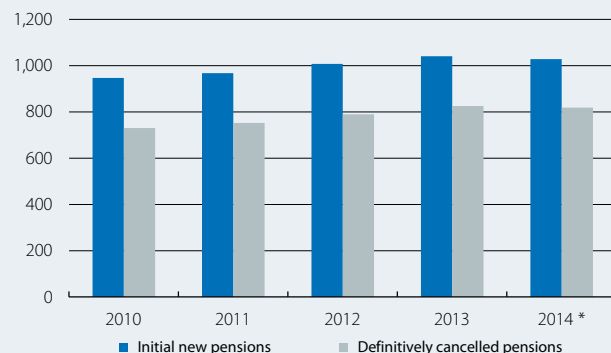


Note: * March figures.

Source: "la Caixa" Research, based on data from the Ministry of Employment and Social Security.

Value of new pensions and of old pensions cancelled

Average monthly amount in the period (euros)



Note: * Data up to March.

Source: "la Caixa" Research, based on data from the Ministry of Employment and Social Security.

KEY INDICATORS

Year-on-year (%) change, unless otherwise specified

Activity indicators

	2012	2013	2013 Q2	2013 Q3	2013 Q4	2014 Q1	04/14	05/14
Industry								
Electricity consumption	-2.2	-2.1	-2.3	-2.4	0.1	-0.6	-0.2	...
Industrial production index	-6.6	-1.5	-2.5	-0.7	1.1	1.5	...	...
Indicator of confidence in industry (<i>value</i>)	-17.5	-13.9	-15.4	-12.8	-11.6	-9.1	-9.3	-8.0
Manufacturing PMI (<i>value</i>)	43.8	48.5	47.6	50.5	50.1	52.5	52.7	...
Construction								
Building permits	-42.7	-22.8	-27.2	-24.0	-11.9	-7.8	...	...
House sales	-8.7	-2.7	0.6	-9.7	-9.8	-9.3	...	...
Services								
Foreign tourists	2.0	5.7	5.4	4.9	10.8	8.1	13.2	...
Services PMI (<i>value</i>)	43.1	48.3	46.5	49.3	51.8	54.2	56.5	...
Consumption								
Retail sales	-7.1	-3.7	-5.0	-1.8	0.4	-0.1	1.0	...
Car registrations	-13.5	5.6	2.5	8.3	22.6	11.8	28.7	...
Consumer confidence index	-31.7	-25.3	-28.7	-20.5	-19.4	-11.8	-7.8	-6.7

Source: "la Caixa" Research, based on data from the Ministry of Finance, Ministry of Public Works, INE, Markit and European Commission.

Employment indicators

	2012	2013	2013 Q2	2013 Q3	2013 Q4	2014 Q1	03/14	04/14
Registered as employed with Social Security¹								
Employment by industry sector								
Manufacturing	-5.3	-4.3	-5.1	-3.9	-2.5	-1.3	-0.8	-0.3
Construction	-17.0	-12.1	-13.8	-10.8	-7.9	-5.3	-3.6	-3.0
Services	-1.7	-2.0	-2.5	-2.1	-0.4	1.1	1.4	2.0
Employment by professional status								
Employees	-3.8	-3.8	-4.4	-3.9	-1.8	0.1	0.5	1.0
Self-employed and others	-1.4	-0.6	-1.1	-0.5	0.4	1.4	1.8	2.1
TOTAL	-3.4	-3.2	-3.8	-3.3	-1.4	0.4	0.7	1.2
Employment²	-4.3	-2.8	-3.4	-2.5	-1.2	-0.5	-	-
Hiring contracts registered³								
Permanent	29.7	-14.2	-29.0	-27.8	-2.1	6.8	15.7	24.7
Temporary	-4.0	6.4	6.0	7.1	15.0	19.4	26.6	11.3
TOTAL	-1.6	4.0	2.0	2.7	13.5	18.2	25.5	12.4
Unemployment claimant count³								
Under 25	4.5	-6.2	-6.1	-6.4	-8.0	-9.4	-10.0	-12.4
All aged 25 and over	11.7	3.7	5.2	2.3	-1.2	-3.7	-4.2	-5.5
TOTAL	10.9	2.7	4.0	1.5	-1.8	-4.2	-4.8	-6.1

Notes: 1. Mean monthly figures. 2. LFS estimate. 3. Public Employment Offices.

Source: "la Caixa" Research, based on data from the Ministry of Employment and Social Security, INE and Public Employment Offices.

Prices

	2012	2013	2013 Q2	2013 Q3	2013 Q4	2014 Q1	04/14	05/14
General	2.4	1.4	1.7	1.2	0.1	0.0	0.4	0.2
Core	1.6	1.5	1.9	1.3	0.3	0.1	0.3	...
Unprocessed foods	2.3	3.6	4.3	6.0	0.7	0.7	-0.5	...
Energy products	8.8	0.1	-1.1	-2.1	-1.1	-1.0	1.6	...

Source: "la Caixa" Research, based on data from the INE.

Foreign sector

Cumulative balance over the last 12 months in billions of euros, unless otherwise specified

	2012	2013	2013 Q1	2013 Q2	2013 Q3	2013 Q4	01/14	02/14	03/14
Trade of goods									
Exports (year-on-year change)	3.8	5.2	3.9	11.9	4.4	0.8	3.1	4.9	1.7
Imports (year-on-year change)	-2.8	-1.3	-6.9	0.6	-0.6	2.0	-0.6	6.9	15.4
Current balance	-12.4	8.0	-2.8	4.0	7.7	8.0	7.6	6.9	4.0
Goods	-27.8	-11.6	-20.9	-14.5	-11.5	-11.6	-10.8	-11.1	-13.9
Services	37.6	40.9	38.2	38.7	39.3	40.9	41.3	41.5	41.6
Income	-17.9	-15.3	-16.3	-15.0	-14.6	-15.3	-16.8	-17.2	-17.2
Transfers	-4.3	-6.0	-3.9	-5.2	-5.5	-6.0	-6.1	-6.3	-6.4
Net lending (+) / borrowing (-) capacity	-5.8	15.8	4.5	12.1	15.6	15.8	15.5	14.1	12.5

Source: "la Caixa" Research, based on data from the Department of Customs and Special Taxes and Bank of Spain.

Public sector

Percentage GDP, cumulative in the year, unless otherwise specified

	2012	2013	2013 Q2	2013 Q3	2013 Q4	2014 Q1	03/14	04/14
Net lending (+) / borrowing (-) capacity	-10.6	-7.1	-3.0	-4.5	-7.1	...	-	-
Central government ¹	-8.1	-4.9	-3.5	-4.0	-4.9	-0.9	-0.9	-1.4
Autonomous regions	-1.9	-1.5	-0.8	-1.0	-1.5	-0.3	-0.3	...
Local government	0.2	0.4	0.2	0.5	0.4	...	-	-
Social Security	-1.0	-1.2	0.8	-0.3	-1.2	-0.3	-0.3	...
Public debt (% GDP)	86.0	93.9	92.2	93.3	93.9	...	-	-

Note: 1. Includes measures related to bank restructuring but does not include other central government bodies.

Source: "la Caixa" Research, based on data from the IGAE, Ministry of Taxation and Bank of Spain.

Financing and deposits of non-financial sectors

Year-on-year change (%), unless otherwise specified

	2012	2013	2013 Q2	2013 Q3	2013 Q4	01/14	02/14	03/14	Balance 03/14 ¹
Financing of non-financial sectors²									
Private sector	-4.0	-7.8	-8.2	-8.1	-7.4	-6.1	-6.1	-6.0	1,825.7
Non-financial firms	-4.1	-9.8	-10.5	-10.2	-8.7	-6.4	-6.5	-6.5	1,051.0
Households ³	-3.8	-4.9	-4.8	-5.0	-5.5	-5.7	-5.5	-5.5	774.7
General government ⁴	14.9	17.0	18.5	17.5	13.1	10.8	8.0	7.2	990.5
TOTAL	0.6	-0.9	-0.9	-0.9	-1.4	-0.9	-1.6	-1.8	2,816.1
Liabilities of financial institutions due to firms and households									
Total deposits	-4.5	2.1	1.8	4.7	2.2	1.3	-0.3	-0.5	1,176.8
On demand deposits	0.2	4.2	3.2	4.6	8.1	11.0	5.9	5.2	289.3
Savings deposits	-2.8	-0.1	-1.1	-0.2	1.4	3.4	3.9	4.0	203.6
Term deposits	-6.7	1.7	1.6	5.7	0.2	-3.0	-3.8	-4.0	663.6
Deposits in foreign currency	-4.0	16.8	22.7	24.1	-0.1	3.5	-2.0	-4.9	20.3
Rest of liabilities ⁵	-13.2	-16.8	-19.2	-15.3	-12.7	-11.4	-8.4	-13.5	131.1
TOTAL	-5.7	-0.2	-0.9	2.3	0.5	-0.1	-1.2	-2.0	1,307.9
NPL ratio (%)⁶	10.4	13.6	11.6	12.7	13.6	13.5	13.4	13.4	-
Coverage ratio (%)⁶	73.8	58.0	65.8	63.8	58.0	58.0	58.0	58.6	-

Notes: 1. Billion euros. 2. Resident in Spain. 3. Including NPISH. 4. Total liabilities (consolidated). Liabilities between different levels of government are deduced. 5. Aggregate balance according to supervision statements. Includes asset transfers, securitized financial liabilities, repos and subordinated deposits. 6. Data end of period.

Source: "la Caixa" Research, based on data from the Bank of Spain.

EMERGING ASIA: ENCOURAGING PROSPECTS

Emerging Asia: past, present and, clearly, a future

The main countries that make up what is commonly known as emerging Asia are China, India, the Philippines, Indonesia, Malaysia, Thailand and Vietnam, although the region can be much larger (the IMF, for example, includes a total of 29 countries). Both the epithet «emerging» and the presence of China and India in the list immediately imply that the economic development of the area as a whole has been positive over the last few years but the actual figures are still astonishing. As can be seen in the first graph, while in 1980 the region accounted for 7.5% of the world's GDP, a figure that lagged far behind the 24.9% of the US and the 30.9% of the European Union, in 2010 its share had rocketed to 23.3%, clearly outdoing the 19.9% of the US and the 20.3% of the European Union. Although this excellent progress raises many different questions, we will attempt to provide a simple answer to two of them: How did emerging Asia manage to achieve this position and, particularly, will this trend continue?

Before starting to analyse the region's main features, it is useful to take a moment to underline the fact that the differences between its different countries have been and continue to be substantial. At the top of the list, of note are Malaysia, China and Thailand, with a GDP per capita in purchasing power parity of 16,000, 8,600 and 9,000 euros, respectively. At the other end of the scale are Nepal, Myanmar and Bangladesh, with a GDP per capita of around 1,500 euros. Now that we have stressed the deeply heterogeneous nature of emerging Asia, we will analyse those factors that characterise it and have made the region as a whole one of the world's leading economic blocks.

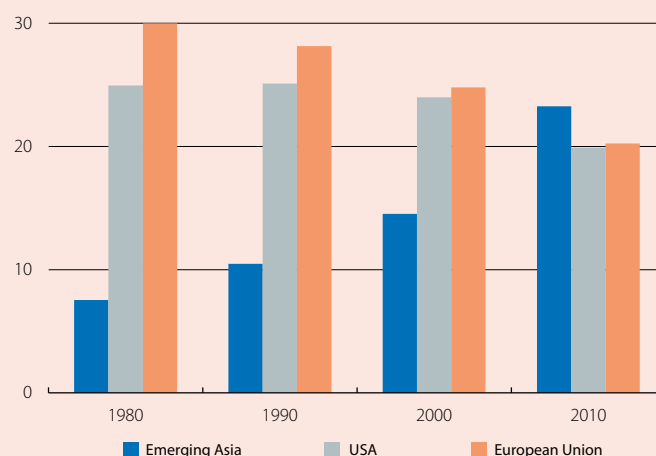
One of the factors accompanying the region's growth over the last few decades has been a sharp rise in credit, something which has often raised doubts regarding the sustainability of the level of activity achieved by the region. But although it is true that the ratio of private credit to GDP has grown considerably over the last few decades, in general this has been a natural process of convergence as the financial system was highly undeveloped: in the main countries of emerging Asia, the ratio of private credit to GDP in 1980 was only 35.6%, reaching 98.2% of GDP in 2010 (whereas in the US private credit already represented 94.2% of GDP in 1980). In this aspect, however, we should also point out the region's lack of homogeneity. In general, this ratio tends to be higher in the more economically mature countries such as Malaysia, where it stands at 117% of GDP. However, in Indonesia, with a GDP per capita of 4,700 euros, it is only 29.0%.

We should also remember that the rise in credit has occurred while external financing has remained at moderate levels. In the region as a whole, external debt peaked in 1998 when it reached 35% of GDP. From that point onwards it fell to 15%, a figure at which it has stabilised over the last few years. One of the lessons learned by the countries suffering from the Asian crisis at the end of the 1990s is that they needed to achieve more balanced growth without resorting too much to external financing. The current account, which had maintained a deficit in the 1980s and 1990s, increased considerably from that moment, reaching an average of 3.0% between 2000 and 2013. This has meant that, in general, the region's countries have accumulated a significant buffer of reserves to help them tackle potential episodes of financial instability with more confidence.

This combination of a solid external position and enviable growth capacity has been achieved thanks to a dramatic expansion in export capacity. This is surely the key to the region's success. By way of example, in 2010 exports of goods and services from emerging Asia accounted for 30% of the world's total, according to UNCTAD data, a figure higher than that of the European Union and the countries of the Free Trade Area of the Americas. Fundamentally this change was brought about by two factors. Firstly, in 2001 China joined the World Trade Organization (WTO). Secondly, the revolution in Information and Communication Technology (ICT). China joining the WTO and the competitive advantage provided by its low labour costs were a massive attraction for the more labour-intensive jobs in production which, indirectly, also benefitted its neighbouring countries in the region, which have gradually joined the production chain led by China, supplying it with intermediate goods.

Breakdown of world GDP

GDP in purchasing power parity (% world GDP)



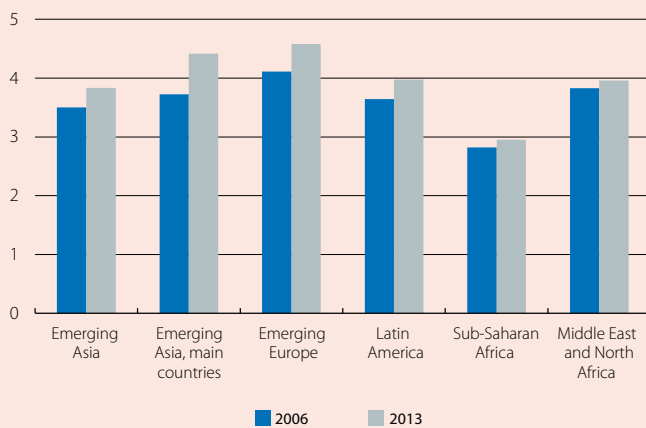
Source: "la Caixa" Research, based on IMF data.

The ICT revolution is equally important. Lower communication costs have helped firms monitor their production processes much more thoroughly, irrespective of where each of the production stages is located, and the main Asian countries are taking advantage of this. According to the World Economic Forum index, which measures each country's technological capacity, the region's situation has improved considerably over the last few years but what is particularly notable is the progress made by the main emerging Asian countries, now in second place in the ranking of the various emerging areas, only behind Europe.

This positive development on the part of these Asian economies is supported by two additional factors: the population's higher educational attainment and solid investment in infrastructures. Once again the World Economic Forum index is useful to summarise the educational situation of the different emerging countries. The European countries also outperform their Asian counterparts in education but this time by a smaller margin. With regard to investment in infrastructures, however, it is revealing that nine out of the ten main ports on the planet are located in Asia.

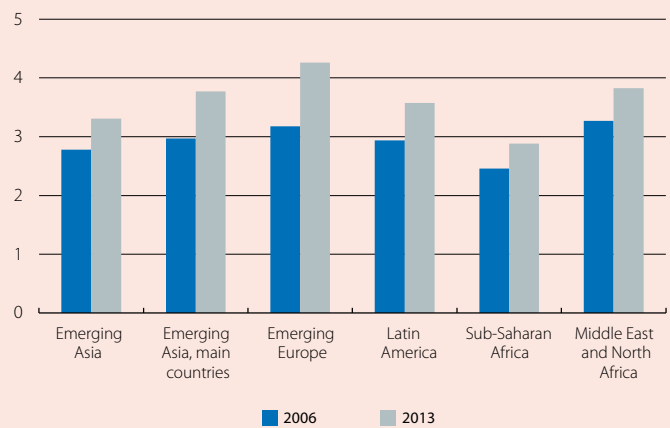
Quality of higher education

(Index)



Technological capacity

(Index)



Note: Emerging blocks according to the IMF definition. The main emerging countries of Asia are China, India, Philippines, Indonesia, Malaysia, Thailand and Vietnam.

Source: "la Caixa" Research, based on data from the WEF.

But it is not all good news. It goes without saying that there are also risks threatening the region, particularly inequality and institutional fragility. It comes as no surprise that the very fact of becoming more industrialised and growing at very fast rates thanks to external demand should increase inequality between those regions involved in this globalisation (for example, those with access to the sea) and inland regions without access to international trade. However, the growing trend over the last few years has led to several indicators reaching worrying levels. For example, one way of measuring inequality is by comparing the income of those representing the richest 10% and those representing the poorest 10% of the population. Following this procedure, while an individual who forms part of the richest 10% in the US in 2004 had 5.4 times more than the poorest 10%, this figure rises to 10.8 in India and 13.7 in China. These are clearly very high figures that could cause serious social tensions.

Economic growth is also testing the region's institutional quality. As the level of activity rises, it is increasingly important to have solid institutions capable of providing a stable, efficient legal framework. The «rule of law» index calculated by the World Bank is highly illustrative in this respect since it measures how confident citizens are in their rights to property and contracts being respected and in the justice system and the police. This index varies between -2 and +2, the higher number reflecting the best institutions. As a benchmark, in 2010 this index was 1.6 in the US. However, it should be noted that the average for the region of emerging Asia has fallen between 2000 and 2010, from 0.1 to 0.0. Once again there are many differences between countries: for example, it improved in China (from -0.5 to -0.3) and Malaysia (from 0.3 to 0.5), and fell in India (from 0.3 to 0) and Thailand (from 0.5 to -0.2).

To conclude, although we have seen that the countries of emerging Asia cannot be treated as a homogeneous whole, the region's leading role in the world economy looks like continuing in the future. For this to be the case, it will be necessary to carry out institutional reforms, to continue investing in ICT to be able to benefit from its advantages and potential and, naturally, to also improve education.

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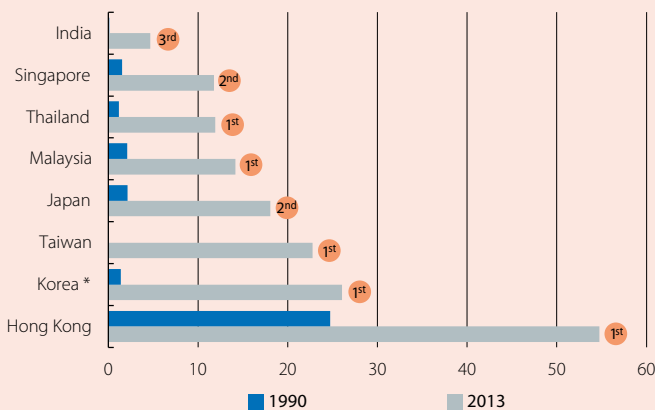
China, at the heart of «Factory Asia»

In addition to being the region's leading demographic and economic power, China has now become the core of so-called «Factory Asia». This term refers to the continent's particular industrial interconnections that have undoubtedly been a leading factor in the considerable progress observed in the last few decades in a large number of the countries in the area. But the future of this success story is not guaranteed, particularly given the significant transformations the Chinese giant is undergoing.

According to the United Nations' figures, intermediate goods and services account for about 60% of international trade. These intermediate inputs are moved from one country to another as they are successively incorporated within the production processes of other goods and services, until reaching the end of the chain. At this point, the goods and services are ready to be consumed by their end users. In other words, over the last few years production processes have fragmented beyond the countries' borders, giving rise to «global value chains» (GVC). Different corporate offshoring strategies have shaped these chains but their spread is due to two key events: firstly, the advances made in transportation and, subsequently, the revolution in information and communication technology (ICT). Both have helped to «shorten» geographical distances to an unexpected extent.

Exports to China

Total of the exporting country's exports (%)



Note: * Exports of manufactured goods. The numbers next to the bars represent China's position in the ranking of the main destinations for each country's exports.

Source: "la Caixa" Research, based on data from the IMF (DOTS) and Taiwan's Finance Ministry.

Asian countries (and especially those of Southeast Asia) represent a case in point for these chains due to the high degree of fragmentation applied in producing many of their products, as well as the huge complexity of many of them (such as the electronics industry). It is precisely this exceptional nature, together with the fact that most of the final production is shipped to advanced countries (in other words, the US and Europe), that has led to the terms «Factory Asia» and «the world's factory» being used for these countries as a whole and for the processes that make up this highly integrated GVC. The drastic cuts in import tariffs carried out by many of the region's countries, either individually or multilaterally, have been another key factor in the emergence and success of the Asian GVC. In these extra-territorial supply chains, the different inputs or intermediates incorporated into the final good cross the borders of the countries involved in the process many times, so high import tariffs would make the final

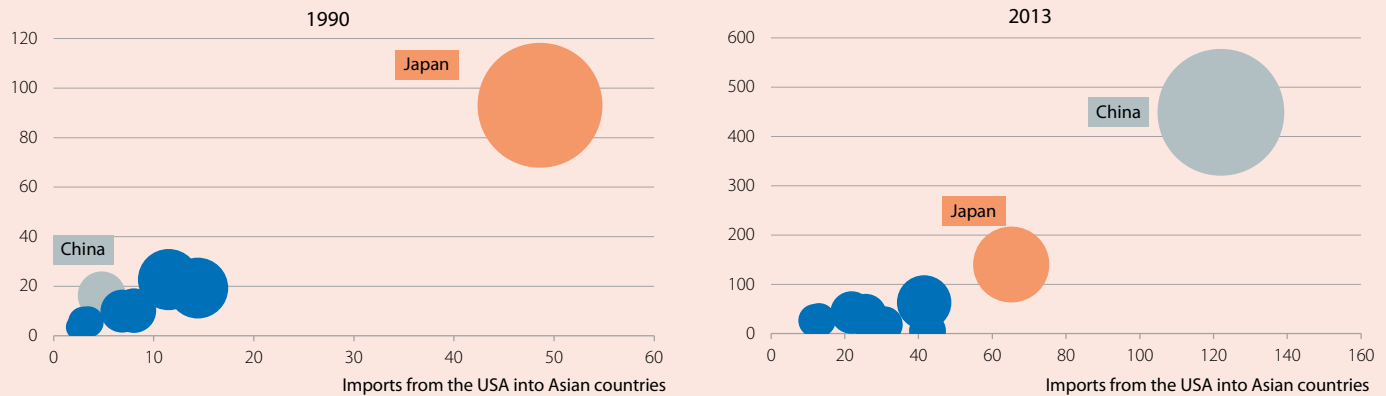
manufactured good too expensive. It is worth mentioning the free trade agreement established in 1992 by the countries that make up the Association of Southeast Asian Nations (ASEAN) and subsequent agreements by this Association with other countries in the region, such as China in 2005, Japan in 2009 and Korea and India in 2010.

China's role is crucial in this network of commercial and business relations that make up «Factory Asia». As of today, China absorbs half the intermediate goods exported by the rest of the Asian countries and supplies them with close to a third of all intermediate goods received from abroad. This makes the Asian giant the main destination and source of inputs for the region (see the first graph on the importance of China for its neighbours in terms of overall trade). This is undeniably a hegemonic situation but a relatively recent one as, in the 1990s, the heart of this factory of the East was still Japan. It was not until the middle of the first decade this century that China took over as leader (as can be seen in the second graph).

The Chinese government's drive to progressively open up the country's economy to international trade and investment has certainly encouraged this rapid shift in the centre of gravity of Asia's production chain. China's transition towards a more open economy started in the 1980s with the authorisation of inflows of foreign direct investment, further boosted by the creation of four zones with special economic privileges. This process culminated in 2001 with the country joining the World Trade Organization, forcing it to reduce its import tariffs. The large number of Chinese firms specialising in processing components or assembling different intermediate products from the rest of Asia has also helped to place China at the centre. Its very large and cheap workforce at the start of these reforms towards a more open economy encouraged such business. As a result, the last stop for a large number of the «Made in Asia» manufactured goods consumed in the US and Europe is China where, after giving them the finishing touches, they are loaded onto one of the many container ships crowding the country's busy ports (six of the largest

Asia's trade with the USA

Exports from Asian countries to the USA (billions of dollars)



Note: The size of the bubbles is proportional to the total trade (imports and exports) with the USA. The blue bubbles correspond to Singapore, India, Thailand, South Korea, Hong Kong, Malaysia and Taiwan.

Source: "la Caixa" Research, based on data from the IMF (DOTS) and from the US Census Bureau.

ten ports in the world in tonnage capacity terms are located in China). It therefore comes as no surprise that, year after year, China records large trade surpluses with the euro area and the US (62 and 222 billion dollars, respectively, in 2013, the equivalent of 1% and 2.5% of China's GDP) and deficits with many of its Asian neighbours (1% with Korea and 0.5% with Taiwan, for example).

This singular anatomy of the production process must be taken into account when evaluating aspects such as economic policy and future prospects. The frequent accusations received by China of its mercantilist behaviour due to its trade surpluses with the large advanced economies do not always consider that these are largely the consequence of the productive organisation of the Asian chain and that, consequently, there are many more countries involved when handing out pluses and minuses. On the other hand, given China's central role in «Factory Asia», we must wonder about the consequence of the much-feared slowdown in the Asian giant on the rest of the countries taking part in the chain. Above all, it is important to remember that the main threat in the short term to the demand for «Made in Asia» products is the uncertain outlook for the US and the euro area and not so much that of China. In fact, in spite of the improvement expected in the advanced economies over the coming years, their potential demand for Asian manufactured goods is actually quite moderate and vulnerable in comparison with previous cycles, due to three factors: weaker financial conditions and confidence after the tough crisis, an older population and the growing trend in some multinationals towards reshoring. In this respect, the change in the growth model that the Chinese economy hopes to encourage in the medium term, with greater weight being given to domestic consumption, will help to sustain Asian production in the face of more contained demand from the advanced economies. This model aims to give China's new and growing middle classes a larger consumption capacity which could undoubtedly be easily satisfied with the region's manufactured goods. But it is also true that, until this transformation matures, a slowdown in China due to domestic factors (for example, problems in the real estate and financial sectors) would affect the rest of the region's countries. Firstly, because of a drop in demand for manufactured goods from «Factory Asia» on the part of today's consuming middle classes in China. But especially because such a slowdown would more than likely lead to a significant reduction in the country's public and corporate investment, both of which have required large amounts of commodities from neighbouring countries.

In short, the development of «Factory Asia» has clearly been a winning strategy. The best proof of this is the progress made by Southeast Asia in the last few decades. Similarly, China's more open stance, gradual but powerful, has been crucial to the success of this regional production chain. A success whose survival depends, once again, on the Asian giant and its capacity to orchestrate a change in model that sustainably boosts Chinese consumers.

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Indonesia and Malaysia are back on track after coping with the tapering

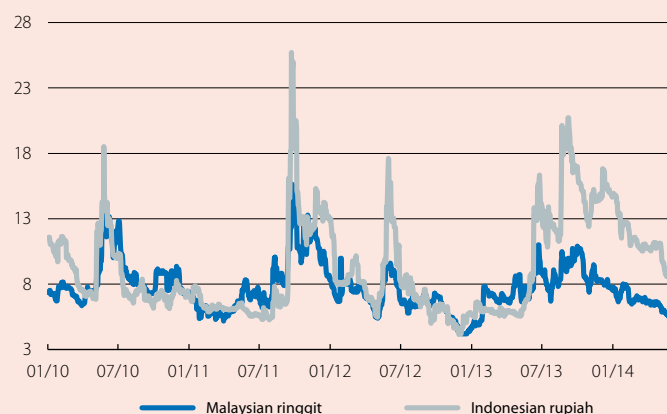
The emerging countries of Asia make up a multifarious group, both in terms of the structural conditions of each economy as well as the economic policies adopted. Two neighbours, Malaysia and Indonesia, are a case in point. Both are becoming increasingly important thanks to favourable but clearly different economic advantages.

Malaysia is a country which, with an average per capita income of around 16,000 euros (in purchasing power parity) and in the midst of shift towards a much more services-oriented economy, is in a position to become an advanced economy within less than one generation. This position has led to a range of highly ambitious government programmes to reform its economy. The two main levers are support for investment in technology, telecommunications, nuclear energy, etc. and the modernisation of its business environment, reducing corruption and improving education. Its size, relatively small by Asian standards (30 million inhabitants) and the open nature of its trade (exports of goods and services account for 82% of GDP) make this aspiration feasible.

In comparison, Indonesia is a less prosperous country (its per capita income is less than one third of Malaysia's, around 4,700 euros in purchasing power parity) with an economic model that still depends greatly on the primary sector and commodity exports. However, the contribution of these last two areas does not prevent its economy from being relatively closed (total exports represent just 24% of GDP) considering its substantial size (it has more than 251 million inhabitants and, after China and India, is the third largest economy of emerging Asia). Nevertheless, the country still has a lot of potential. According to a recent study by the IMF, its long-term growth trend is around 6%.¹ At this rate, the country could see a significant increase in the segment of its population with a standard of consumption befitting that of an emerging middle class: according to a study by the McKinsey Global Institute, by 2030 135 million people would make up this group, compared with 45 million in 2010.²

Implied volatility * of emerging currencies against the dollar

(% annualised)



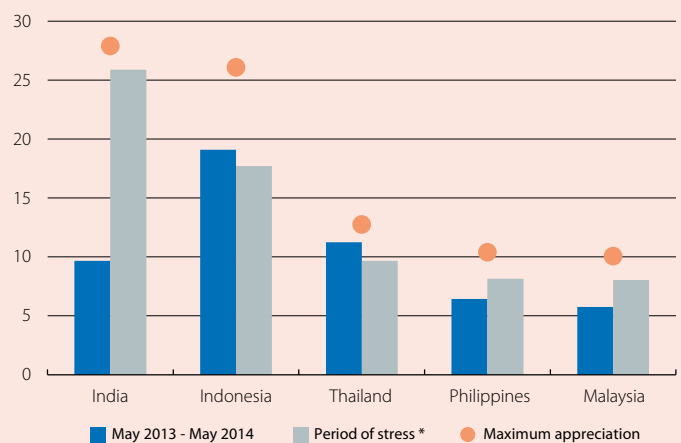
Note: * Deduction for volatility in the options market.

Source: "la Caixa" Research, based on Bloomberg data.

bonds, corporate bonds and stock markets). There was a further outbreak of tension at the beginning of 2014, this time caused by factors such as the devaluation of the Argentine peso and the Ukraine crisis.

Appreciation of the dollar compared with emerging currencies

May 2013 = 100 (%)



Note: * Period between May and September 2013.

Source: "la Caixa" Research, based on Bloomberg data.

However, such attractive prospects need to be achieved without taking any shortcuts that may be tempting in the short term but harmful in the long run. The recent episodes of financial stress affecting the emerging economies are a warning that should not go unheard. Let us recall the chain of events. In May last year, the Federal Reserve Chairman at that time, Ben S. Bernanke, announced, by surprise, the Fed's intention to start gradually reducing its monthly bond purchases (tapering) at the end of 2013, provided the economy continued to make good progress. International investors reacted sharply: rapid rises in long-term interest rates on US government bonds and a strong upswing in global risk aversion, which hit the financial markets of a large number of countries from emerging Asia particularly hard. The region's financial environment deteriorated dramatically due to heavy capital outflows during the second half of 2013, affecting the currencies and most asset prices (sovereign

1. Rahul, A., Cheng, K., Rehman, S. and Zhang, L. (2014), «Potential Growth in Emerging Asia», IMF WP 14/02.

2. McKinsey Global Institute (2012), «The archipelago economy: Unleashing Indonesia's potential».

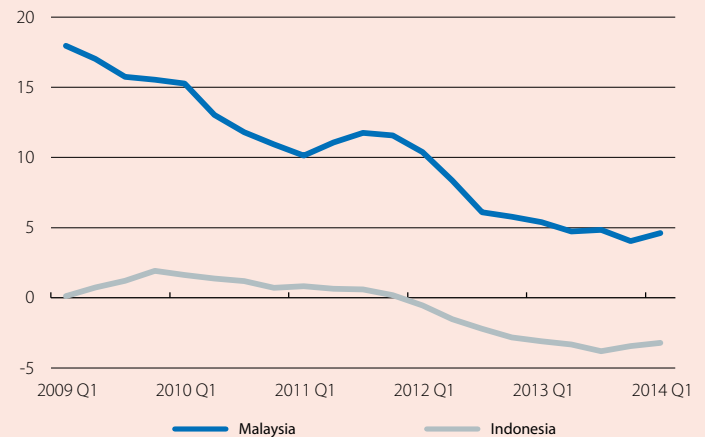
The Asian continent had already suffered several episodes of financial tension in the past but these latest ones were different insofar as there was clear discrimination in the punishment inflicted on various countries. This can be seen by comparing the nominal depreciations in their respective currencies throughout the last year. In this respect, Indonesia and Malaysia are a case in point: today the Indonesian rupiah is 20% below its value against the dollar in May 2013, while the Malaysian ringgit has depreciated little, merely 6%. Similarly, the trend in the implied volatility of the exchange rate for each of these currencies against the dollar (an indicator of the risk perceived by operators in the foreign exchange market) provides a similar conclusion: systematically, during the episodes of financial stress last year, the volatility of the Indonesian rupiah was at a higher level than that of the Malaysian ringgit.

What is this disparate risk assessment telling us? The episodes of financial turbulence were quickly interpreted as the result of excessive macroeconomic imbalances, both external (current account) and internal (inflation, fiscal balance). The most vulnerable countries in these areas were considered to be fragile and more susceptible to capital outflows, with the consequent drop in the values of their currencies and risk assets. According to this interpretation, the punishment meted out to Indonesia is understandable: in 2012, in the run-up to the crisis, its current account had a deficit of 2.8% and inflation was around 4%. However, Malaysia, with a current account surplus of 6.1% and inflation at 1.2%, had a lower risk profile. Nonetheless, in the Malaysian case, the poor state of its public finances was a downside (its public deficit in 2012 was –3.6%, more than double that of Indonesia). A dynamic evaluation of these same indicators of vulnerability helps to improve our diagnosis; but it also complicates it. During the period 2010–2012, both economies had exited the global recession of 2008–2009 with an important feature in common: considerable economic dynamism (after China and India, Indonesia was the country from emerging Asia with the fastest growth during this period and Malaysia the fourth) which aggravated the aforementioned imbalances. In particular, the combination of the real appreciation of their currencies and growth in domestic demand worsened the external position of both economies: Malaysia went from a current account surplus of 15% of GDP in 2009 to 6.1% in 2012 while Indonesia went from a current account surplus of 2% of GDP to a deficit of 2.8%. Together with these crucial elements, analysts also highlighted other imbalances, particularly serious in the case of Indonesia, such as strong stock market gains and the significant rise in private credit. As mentioned previously, these all pointed to excessively fast growth. After the episode of the financial crisis, Indonesia suffered an initial stage of rising inflation. Fortunately, in the last few months this has started to fall again. Another imbalance starting to correct itself is the external deficit. The strong nominal depreciation of the rupiah and the reduction in the inflation differential with its main trading partners is helping to adjust the current deficit. For its part, Malaysia has also started an incipient correction in inflation and, more visibly, has seen its current surplus increase after years of decline.

The financial upsets of the last few months and the inevitable need to redress imbalances are threatening to jeopardise the growth of these countries over the coming years. The IMF's World Economic Outlook published last April predicts average growth over the next five years of 5.0% for Malaysia, while Indonesia is expected to grow by 5.9%. In April 2013, a few weeks before the turbulences erupted, the forecasts given by the IMF were 5.2% and 6.4%, respectively. The price paid by Malaysia for these tensions has therefore been relatively modest, while Indonesia has paid a higher price due to its relative weaknesses. But this is far from being a dramatic scenario. When we look back, with hindsight, at the episode of 2013 and the tail-end of the tensions in 2014, we will probably tend to minimise their importance. In no way has this been a crisis such as the one affecting Asia in 1997. In fact, the lessons learned from that episode are still present today (as witnessed by the high accumulation of reserves and prudential management of external debt by Asia's economies) and have prevented the recent crisis from being any greater. Nonetheless, we should not forget that, on the road to prosperity, it is advisable to avoid any shortcuts.

Malaysia and Indonesia: current account

Cumulative over 12 months (% of GDP)



Source: "la Caixa" Research, based on data from Thomson Reuters Datastream, the Statistics Office of Indonesia, the Central Bank of Indonesia and the Statistics Office of Malaysia.

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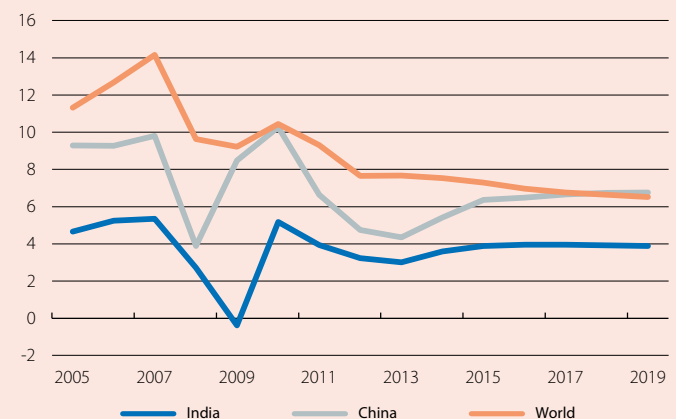
India: the roadmap for Narendra Modi

On 16 May, it was officially announced that Narendra Modi's Bharatiya Janata party had won the general election. It was a landslide victory: 282 seats compared with the 44 won by the Congress Party. This result put an end to the Nehru-Gandhi era, a virtual dynasty that had governed the world's largest democracy almost uninterrupted for more than 60 years. Narendra Modi, an ascetic who does not belong to the urban elite of India's previous leaders, has two sides to him. There is a reformist Modi who puts health before devotion, prioritising spending on hygiene and administrative transparency above the veneration of temples. But there is also a Modi with a past linked to radical Hinduism whose worst moment was his role as senior governor of the state of Gujarat during the disturbances between Hindus and the Islamic community in 2002. Which Modi will prevail now? Judging by the gains in the Mumbai stock market and the appreciation of the rupee after his victory was announced, the markets and analysts seem to be clearly betting on the reformist Modi.

Modi is faced with an India that is a behemoth with huge growth potential. It is the second most populous nation on the planet and the third in terms of its GDP in purchasing power parity (the 13th in dollars at market prices). India multiplied its GDP by five between 1993 and 2013, with notable development in the services sector and 12 of its companies in the FT500 (Germany has 20; Spain 6). Similarly, the forecasts given by leading organisations such as the IMF place India's long-term growth close to 7% annually, higher than China's. But India is also the country with the largest number of poor people in the world. According to the World Bank, 295 million Indians (24% of the total) survived on less than 2 dollars a day (in purchasing power parity) in 2010, compared with 121 million Chinese. India's per capita income is one fifth of China's, investment in infrastructures and manufacturing has yet to materialise and the public sector is particularly inefficient. Modi's parliamentary majority gives him free reign to undertake a programme of reforms that needs to be ambitious. The aim is to remove the obstacles that are preventing the country's huge potential from being exploited. More doubtful are the details of the roadmap to reach the desired destination. There is a risk of getting lost along the way or getting stuck. A recent article by the consulting firm McKinsey contains interesting proposals in this respect.

India: GDP growth

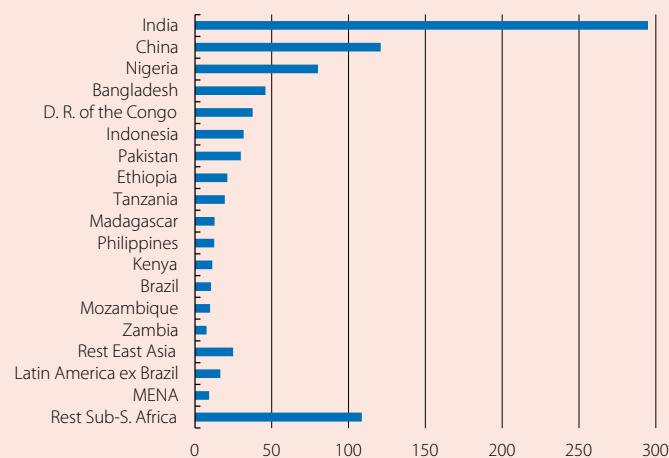
Year-on-year change in GDP (%)



Note: Forecasts as from 2014. The world GDP figures are weighted by purchasing power parity.
Source: "la Caixa" Research, based on IMF data.

Poverty in the world

(Million) *



Note: * Number of people with less than two dollars a day, weighted by purchasing power parity.
Source: "la Caixa" Research, based on data from the World Bank.

The Gordian knot is how to escape from the poverty trap. In fact, this problem is considerably more serious than suggested by the statistics regarding the 2 dollar a day threshold. McKinsey uses the term «empowerment line» to express the minimum income that provides access to the most basic health and hygiene, lighting, energy for cooking, primary education, a diet of 2,100 calories a day, drinking water and a home measuring between 21 and 28 m². According to McKinsey, 680 million Indians (56% of the population) fall below this empowerment line (which would place monthly expenditure at 1,336 rupees) or, in other words, they do not have access to the aforementioned basic services.

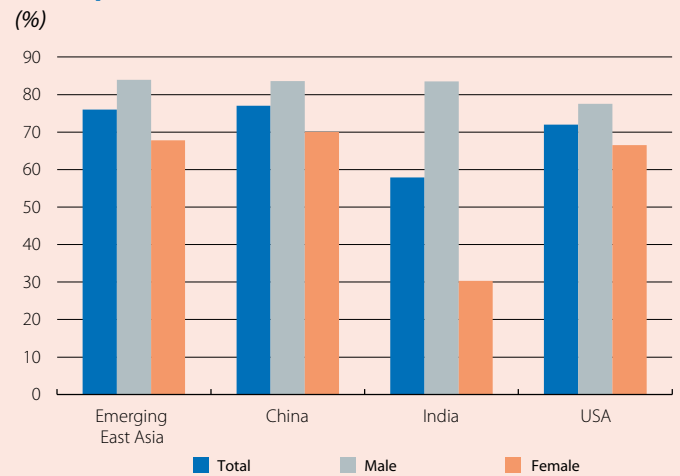
Although Modi's ample victory provides him with a mandate without the need to compromise with other political forces, it would be preferable if reforms to tackle the problem of poverty were inclusive. Reducing the share of the population below the empowerment line would be the equivalent of

creating an Indian middle class, as is already happening to a greater or lesser degree in other emerging countries of East Asia. The inclusive reforms that Modi should tackle are based on four fundamental pillars: increasing employment (the participation rate),

raising farm productivity, reinforcing public spending on the aforementioned basic services and introducing reforms that ensure this spending on services reaches the right recipients.

The first pillar, creating jobs by increasing the participation rate, would have the greatest quantitative effect. In 2012 India's participation rate was 58% (for the population aged between 15 and 64, according to the World Bank), while the figure for the whole of emerging East Asia was 76%. Considering that 65% of India's population is within this age range, the country's labour force deficit represents 142 million jobs. Most of these jobs must be created in industry (construction and manufacturing). The actions required to increase the participation rate include a drastic improvement in infrastructures (mainly energy generation and transport) in order to encourage growth in the manufacturing sector, which is a real weak point in the economy. The administrative burdens that stifle companies would also need to be reduced, eliminating some distorting taxes and improving how the real estate market works. These improvements should help to combat one of India's most important weaknesses: the insufficient size of its firms, with the consequent reduction in productivity. In India, 84% of manufacturing firms employed fewer than 50 people in 2009 whereas this share was 25% in China.

Participation rate *



Note: * Percentage of economically active people out of the total population aged between 15 and 64.
Source: "la Caixa" Research, based on data from the World Bank.

Another essential objective of the employment pillar is to reduce gender differences. India's low participation rate can be entirely explained by the limited participation of women in the labour market. 83% of the male population aged between 15 and 64 were working or looking for work in 2012, a figure very similar to the 84% of emerging East Asia. However, this percentage falls to 30% for the female population while, in emerging East Asia, it was 68%. This gap between men and women (53 p.p.) is one of the biggest in the world. It is advisable not to take too long to apply corrective measures as, according to the International Labour Organisation, the situation is getting worse: the female participation rate is falling. Although it is true that more women are going to university and there are always errors in measuring such statistics, this would merely explain one part of the decline. Other possible causes relate to cultural factors: many women leave employment once the family's income rises above subsistence, or they are «attached» to sectors with little growth, such as agriculture, or which have been harder hit by the economic crisis.

In this respect, the second pillar becomes more important: raising farm productivity. India's deficiencies in the secondary sector mean that a large portion of the population still works in agriculture (according to the World Bank, agriculture absorbed 47% of India's employees compared with China's 34%). This gap is exacerbated by the low productivity of India's agricultural sector compared with other emerging economies. Reforms should include the elimination of restrictions on agricultural prices (revising 2003's Law on Market Committees and rationalising administrative price controls which notably distort the market). It is also desirable to establish insurance schemes for poor harvests (involving the private sector), reform the land market, improve farmers' access to credit, encourage the use of technology and reduce the number of public bodies involved in agricultural policy.

The third pillar consists of increasing public spending on basic services, which in 2012 was equivalent to 11% of GDP. According to McKinsey, a 6.7% increase per year over 10 years (reasonable considering India's growth) should be enough to put most of the population above the empowerment line. However, given the governmental inefficiency, the success of this action cannot be assured without the contribution of the fourth pillar. In other words, it will be difficult to increase spending if there are no changes, either before or at the same time, to how the public administration works. This reform must achieve greater transparency, decentralise powers to the Gram panchayats (local governments), redesign civil servant incentives, combat corruption and create an independent agency focusing on the big priorities.

It is a huge challenge but Modi's clear victory releases him from the need to make concessions and the reward is certainly worth the effort: 1.2 billion Indians are waiting.

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"la Caixa" GROUP: KEY FIGURES

As of December 31, 2013

Financial activity

MILLION €

Total customer funds	304,636
Receivable from customers	206,479
Profit attributable to Group	745

Commercial activity and resources

Customers (million)	13.6
Staff	33,291
Branches	5,730
Self-service terminals	9,597

Community projects: budget for activities in 2014

MILLION €

Social	335
Science and environmental	66
Cultural	64
Educational and research	35

TOTAL BUDGET

500

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