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MONTHLY REPORT • ECONOMIC AND FINANCIAL MARKET OUTLOOK

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ECONOMIC & FINANCIAL ENVIRONMENT

FINANCIAL MARKETS

The ECB makes a move

INTERNATIONAL ECONOMY

Is the trend in world trade changing?

EUROPEAN UNION

The Bank of England: new measures for new times

SPANISH ECONOMY

Investment in Spain: quantity, but quality?

DOSSIER: COMMODITIES: A SOURCE OF GROWTH

The trend in commodities: a long-term view

The curious case of rare earth: a non-crisis

Could Latin America withstand a downturn in commodities?

Oil: stability has a price

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July-August 2014

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INDEX

1 EDITORIAL

3 EXECUTIVE SUMMARY

4 FORECASTS

6 FINANCIAL MARKETS

9 *The ECB makes a move*

10 *Low interest rates and little volatility: a double-edged sword*

12 INTERNATIONAL ECONOMY

15 *Is the trend in world trade changing?*

16 *A return to investment in the US: better late than never*

18 EUROPEAN UNION

21 *The Bank of England: new measures for new times*

22 *Hungary: a recovery that is running out of steam*

24 SPANISH ECONOMY

27 *Investment in Spain: quantity, but quality?*

28 *The improvement in Spain's household consumption
is in full swing*

29 *Tax reform and public deficit adjustment*

32 DOSSIER: COMMODITIES: A SOURCE OF GROWTH

32 *The trend in commodities: a long-term view*
Carlos Martínez Sarnago

34 *The curious case of rare earth: a non-crisis*
Clàudia Canals

36 *Could Latin America withstand a downturn in commodities?*
Àlex Ruiz

38 *Oil: stability has a price*
Jordi Singla Martínez

Recovery and domestic demand

The revival in the Spanish economy over the last few months has surprised a number of analysts by its continuity and strength within a euro area whose expansion is still going through some good and bad patches. This recovery was expected to be driven by exports, which has happened, but no-one anticipated domestic demand reacting with the speed and energy we have seen recently. This unexpected surge in the domestic market, particularly private consumption and machinery investment, must surely be due to the drastic change in confidence among business people and households once the apocalyptic scenarios that were being considered just one or two years ago have been abandoned. International private financing return to Spain has also been crucial, relieving internal financial tensions and helping to stop the fall in the country's asset prices.

At present a large number of economic policy proposals believe domestic demand should be strengthened to push growth even further and thereby more quickly absorb the huge unemployment figures still haunting the Spanish economy. According to this view, it is not wise to expect the recovery to come solely from exports. On the one hand, due to their relatively lower weight in the economy and, on the other, because a greater effort to reduce unit labour costs could be harmful since this would affect, so the argument goes, the population's purchasing power and ultimately consumption and the rate of activity.

However, it is important to stress the serious risks the Spanish economy would incur if its growth were based too much on domestic demand over the coming years. If this happened, it would undoubtedly be possible to achieve, and quite quickly, GDP growth rates close to 3% but at the cost of undoing part of what has been achieved recently in terms of correcting the imbalances.

Accelerated growth in domestic demand would reverse the gains made in competitiveness and the balance of the country's external accounts, achieved last year. It would probably result in a faster correction in public accounts but this adjustment would be based not on structural changes in public budgets but on cyclical trends in the economy. And, lastly, it would also put a halt to the deleveraging process which has yet to be completed, given the extent of the country's private debt. In short, it is possible for a strong push by domestic demand to lead to a boom period but this would be followed by a period of adjustment in which international financial markets or the European authorities would demand policies to once again correct macroeconomic imbalances.

The Spanish economy's recovery must continue to be based predominantly on its external competitiveness, widening its surplus compared with the rest of the world to gradually re-establish an external debt position that makes it less vulnerable to fluctuations in the sentiment of international investors. If this strategy succeeds, it will result in domestic demand expanding, gradually building up steam as citizens' disposable income improves. Moreover, it is essential to continue making an effort to improve competitiveness, both because of its beneficial effects on the external balance and also to create jobs. This is not an approach that harms domestic consumption or demand as these essentially depend on the trend in employment and, in particular, on citizens' expectations of the likelihood of finding a job.

Jordi Gual
Chief Economist
30 June 2014

CHRONOLOGY

JUNE 2014

- 5 The ECB reduces the **refi rate to 0.15%** and the deposit facility rate to **-0.10%**. It also announces an extensive package of measures, particularly **refinancing operations targeting lending (LTROs)**, to be held every quarter from September 2014 to June 2016.

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.

AGENDA

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 International trade (June).
18 Loans, deposits and NPL ratio (May).
21 Financial accounts (first quarter).
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).

AUGUST 2014

- 4 Registration with Social Security and registered unemployment (July).
7 Industrial production index (June).
Governing Council European Central Bank.
18 International trade (July).
Loans, deposits and NPL ratio (June).
28 Flash CPI (August).
Quarterly national accounts (second quarter).
29 Government budget expenditure (July).
Balance of payments (June).
Economic sentiment index of the euro area (August).

2014, a year that is improving

World growth will speed up during the rest of the year.

Now that we are halfway through 2014, what can we expect from the second half of the year? Current forecasts point to the global activity rate, which was somewhat disappointing at the start of 2014 but has improved noticeably in Q2, speeding up in the last two quarters of the year. This trend will push world growth to 3.4% in 2014, its best figure since 2011. Activity will also continue its expansion in 2015 with world GDP growing by 3.9%. However, this positive outlook has not prevented the central banks from insisting on ultra-expansionary messages and actions: the Fed has repeated that monetary normalisation will be slow while the ECB has adopted an extensive package of measures that ultimately aim to allay the threat of deflation and bolster Europe's recovery. As a result of these actions, interest rates have remained low (US) and have even fallen in some cases (Germany), the risk premia for bonds (corporate, emerging and periphery) have fallen and stock markets have tended to rise. Although such financial developments are positive, of concern is the fact that such an accommodative tone taken by central banks may increase complacency to risk.

The US is growing again. As we move away from the atypical Q1, considerably affected by adverse weather and the delay in implementing Obamacare (with consumers postponing their doctor visits, waiting for the health cover to come into force so they could save on their bills), it now seems clear that the recovery is becoming more intense and solid. More intense because, once the high frequency indicators become available, Q2 growth is likely to be around 4% annualised quarter-on-quarter; and more solid because the pattern of growth will benefit from a greater contribution from private consumption, one of its least volatile components. This growth in activity is being accompanied by two additional positive trends: in spite of a slight upswing in April and May, prices are still failing to show any worrying tensions and the labour market is performing better than expected, especially in terms of job creation.

A gradual but fragmented recovery in the euro area.

Growth in the euro area stood at 0.9% year-on-year in Q1, a GDP growth rate that, considering the trend shown

by leading business indicators, could be repeated or even improve slightly. However, two aspects are still slightly disconcerting. The first, the disparity observed between economies such as Germany and some of the periphery countries, where the recovery is building up steam, and France, Italy or the Netherlands, whose figures are still disappointing. Outside the euro area, it is worth noting the expansionary tone of the British economy, whose recent performance warrants an upward revision of the growth forecast for 2014. The second area of concern is inflation remaining at a low level. Given this situation, the ECB has decided to act, implementing an extensive package of expansionary measures (interest rate cuts, further LTROs for banks, etc.) aiming to ease monetary conditions, revive bank lending and combat the risk of deflation. According to our main scenario, as 2014 progresses, and more noticeably in 2015, the recovery will tend to consolidate, helping inflation to pick up and move away from its current worrying levels.

Domestic demand underpins Spain's economic growth.

The progress seen in the latest indicators for consumption, investment and the labour market point to domestic demand still being the main driver of the Spanish economy's increasing dynamism. This advance in domestic demand has led to a notable upswing in imports, acting as a brake on the correction in the trade deficit. Nonetheless we expect exports to return to stronger growth rates over the coming months, helped by the excellent performance of tourism. If we add to this the effect, which cannot be quantified as yet, of the ECB's expansionary measures and Spain's tax reform, the risk is that growth will end up being greater than we predict. However, in spite of this domestic recovery, the trend in prices (inflation stood at 0.2% year-on-year in May) has led us to moderately downgrade our inflation forecast for 2015, which we have now placed at 1.1% (1.3% previously). Within this context of a reviving economy and tax revenue, the government has presented a tax reform aimed at reducing the fiscal burden on companies and households. Particularly of note are the changes in income tax: a reduction in the number of tranches from 7 to 5 and a cut in tax rates.

FORECASTS

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

International economy

	2012	2013	2014	2015	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1	2015 Q2
GDP GROWTH										
Global¹	3.2	2.9	3.4	3.9	3.3	3.3	3.4	3.6	4.1	4.0
Developed countries										
United States	2.8	1.9	2.2	3.1	1.5	2.1	2.3	2.8	4.2	3.5
Euro area	-0.6	-0.4	1.0	1.5	0.9	0.9	1.1	1.2	1.4	1.5
Germany	0.9	0.5	1.9	1.8	2.3	1.8	1.8	1.9	1.5	1.8
France	0.0	0.3	0.7	1.2	0.8	0.4	0.7	0.9	1.2	1.2
Italy	-2.6	-1.9	0.2	1.2	-0.5	0.1	0.5	0.6	1.1	1.1
Spain	-1.6	-1.2	1.2	1.7	0.5	1.0	1.4	1.7	1.8	1.8
Japan	1.4	1.5	1.4	1.3	2.8	1.0	0.7	1.0	-0.2	1.4
United Kingdom	0.3	1.7	2.8	2.1	3.1	3.0	2.6	2.4	2.1	2.0
Emerging countries										
Russia	3.4	1.3	0.5	1.4	0.9	0.2	0.4	0.7	1.0	1.2
China	7.7	7.7	7.5	7.4	7.4	7.6	7.3	7.6	7.9	7.6
India ²	4.5	4.7	5.4	6.4	4.6	4.8	5.1	5.7	5.7	6.3
Brazil	1.0	2.5	1.7	2.4	1.9	0.9	1.9	2.0	2.3	2.4
Mexico	4.0	1.1	2.9	3.8	1.8	2.5	3.3	4.0	3.7	3.8
Poland	2.1	1.6	3.2	3.5	3.5	3.1	3.1	3.2	3.3	3.4
Turkey	2.1	4.0	2.3	3.4	4.3	1.3	1.5	2.2	3.0	3.2
INFLATION										
Global¹	4.0	3.3	3.5	3.3	3.3	3.5	3.6	3.6	3.5	3.3
Developed countries										
United States	2.1	1.5	1.9	1.8	1.4	2.0	2.0	2.0	2.0	1.8
Euro area	2.5	1.4	0.8	1.3	0.7	0.6	0.9	1.2	1.2	1.3
Germany	2.1	1.6	1.1	1.7	1.0	0.9	1.1	1.4	1.5	1.6
France	2.2	1.0	0.9	1.5	0.9	0.8	1.0	1.1	1.3	1.4
Italy	3.3	1.3	0.6	1.3	0.5	0.4	0.6	0.9	1.2	1.3
Spain	2.4	1.4	0.4	1.1	0.0	0.2	0.4	0.9	1.0	1.1
Japan ³	0.0	0.4	2.9	1.8	1.5	3.6	3.4	3.0	3.3	0.9
United Kingdom	2.8	2.6	1.8	2.1	1.7	1.6	1.8	2.0	2.0	2.0
Emerging countries										
Russia	5.0	6.8	6.4	5.1	6.4	6.9	6.4	6.0	5.4	5.2
China	2.7	2.6	2.5	2.8	2.3	2.2	3.0	2.6	3.0	2.9
India ⁴	7.3	6.4	6.2	6.5	5.7	5.2	4.1	6.2	8.6	6.8
Brazil	5.4	6.2	6.4	5.7	5.8	6.4	6.8	6.5	6.0	5.8
Mexico	4.1	3.8	3.9	3.3	4.2	3.6	4.0	3.9	3.6	3.4
Poland	3.8	1.2	1.1	2.2	0.9	1.0	1.2	1.3	2.0	2.2
Turkey	8.9	7.5	8.2	6.6	8.0	8.7	8.2	8.0	6.7	6.7

Notes: 1. In purchasing power parity. 2. Annual figures represent the fiscal year and factor costs. 3. Takes into account the consumption tax hike planned for April 2014. 4. Wholesale prices.

Forecasts

Spanish economy

	2012	2013	2014	2015	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1	2015 Q2
Macroeconomic aggregates										
Household consumption	-2.8	-2.1	1.7	1.4	1.6	1.9	1.6	1.5	1.4	1.4
General government consumption	-4.8	-2.3	-1.1	-2.1	-0.2	-0.5	-2.6	-1.2	-4.0	-3.0
Gross fixed capital formation	-7.0	-5.0	0.1	2.3	-1.1	0.8	0.2	0.7	1.4	2.2
Capital goods	-3.9	2.3	8.1	5.5	11.3	7.8	6.6	6.6	5.1	5.6
Construction	-9.7	-9.6	-5.4	0.2	-8.7	-4.8	-4.4	-3.8	-1.0	0.0
Domestic demand (contr. Δ GDP)	-4.1	-2.7	0.7	0.8	0.6	1.1	0.5	0.7	0.3	0.6
Exports of goods and services	2.1	4.9	5.3	5.5	8.1	3.1	4.5	5.5	7.0	5.9
Imports of goods and services	-5.7	0.4	4.5	3.0	9.3	3.5	2.0	3.0	2.7	2.9
Gross domestic product	-1.6	-1.2	1.2	1.7	0.5	1.0	1.4	1.7	1.8	1.8
Other variables										
Employment	-4.8	-3.4	0.8	1.4	-0.3	0.7	1.2	1.5	1.7	1.5
Unemployment rate (% labour force)	24.8	26.1	24.8	23.6	25.9	24.8	24.1	24.4	24.5	23.6
Consumer price index	2.4	1.4	0.4	1.1	0.0	0.2	0.4	0.9	1.0	1.1
Unit labour costs	-3.0	-1.5	-1.2	0.5	-0.9	-1.4	-1.2	-1.4	0.4	0.6
Current account balance (cum., % GDP) ¹	-1.2	0.8	1.1	1.4	0.4	0.6	0.9	1.1	1.2	1.2
Net lending or borrowing rest of the world (cum., % GDP) ¹	-0.6	1.5	1.7	2.0	1.1	1.2	1.5	1.7	1.8	1.8
Fiscal balance (cum., % GDP) ¹	-10.6	-7.1	-5.6	-4.2	-7.0					

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	0.33
3-month Libor	0.43	0.27	0.26	0.71	0.24	0.23	0.27	0.31	0.36	0.58
12-month Libor	1.01	0.68	0.60	1.14	0.56	0.55	0.61	0.69	0.82	1.02
2-year government bonds	0.27	0.30	0.53	1.45	0.36	0.40	0.58	0.78	1.07	1.31
10-year government bonds	1.78	2.33	2.84	3.63	2.75	2.62	2.85	3.14	3.40	3.55
Euro										
ECB Refi	0.88	0.54	0.19	0.15	0.25	0.22	0.15	0.15	0.15	0.15
3-month Euribor	0.57	0.22	0.24	0.19	0.30	0.30	0.19	0.18	0.18	0.18
12-month Euribor	1.11	0.54	0.53	0.53	0.56	0.57	0.49	0.48	0.49	0.50
2-year government bonds (Germany)	0.08	0.13	0.09	0.25	0.14	0.11	0.04	0.06	0.13	0.21
10-year government bonds (Germany)	1.55	1.62	1.52	1.94	1.68	1.43	1.42	1.55	1.69	1.87
EXCHANGE RATES										
\$/euro	1.29	1.33	1.35	1.29	1.37	1.37	1.34	1.31	1.30	1.29
¥/euro	102.71	129.65	141.35	144.05	140.98	140.98	141.93	141.48	141.98	143.37
£/euro	0.81	0.85	0.82	0.85	0.83	0.82	0.82	0.82	0.81	0.81
OIL										
Brent (\$/barrel)	111.38	108.47	109.39	109.43	107.74	109.65	111.61	108.47	108.63	109.12
Brent (euros/barrel)	86.61	81.67	81.15	84.88	78.61	79.96	83.30	82.80	83.78	84.48

Note: 1. Four quarter cumulative.

Forecasts

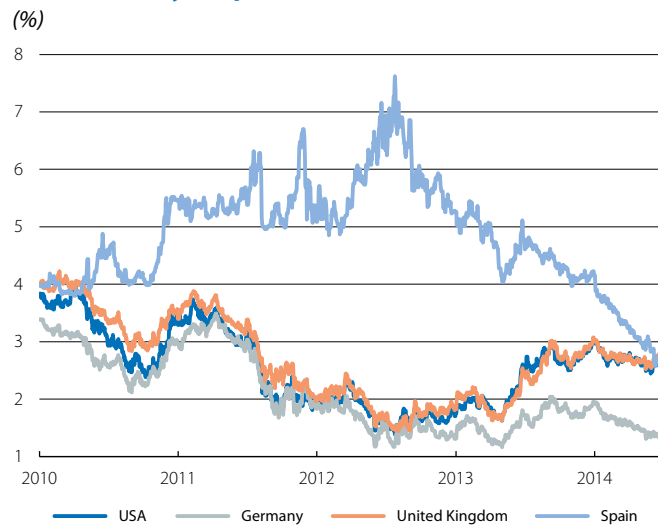
CURRENT SITUATION · The temperature is rising

The combination of good economic growth figures with the ultra-expansionary actions or messages of central banks has once again had a strong impact on the markets. The Fed has repeated its dovish message and insists that monetary normalisation will be slow. For its part, the ECB has adopted an ambitious package of measures to underpin growth in the euro area and allay the threat of deflation. Investors have reacted unequivocally: risk-free interest rates and yields have remained at low levels (US) or have even entered negative terrain (Germany); risk premia on corporate bonds, periphery and emerging sovereign debt have narrowed and the stock markets have reached new all-time highs in some indexes. Volatility is at a very low level in all asset categories. One of the keystones to this situation is the increased appetite for risk among investors. However, the accommodative tone of central banks might be exacerbating the degree of complacency regarding risk, helping to overheat share prices and/or investors to enter into unsustainable debt.

The ECB has softened its policy. The bank more than met the expectations, at its June meeting deciding to implement an extensive and ambitious package of expansionary measures (see the Focus «The ECB makes a move»). Particularly important is the cut to the official interest rate down to 0.15% and in the deposit facility interest rate to -0.10%, as well as providing banks with very long-term financing on the condition they grant new loans (TLTROs). These actions are justified by the following reasons: (i) the appropriateness of relaxing monetary conditions (short-term interest rates and the value of the euro), (ii) the need to revive bank credit, and (iii) the aim of combating the risk of deflation. These actions might help the economic situation to improve gradually and inflation to rise. However, Draghi insisted that the ECB was prepared to extend stimuli even further if necessary. He announced that the bank is carrying out preparatory work for a possible ABS purchase programme (securitisation, possibly bank loans to SMEs). The debate on whether this would be advisable or feasible is intense. The ECB President has insinuated that such a tool will only be used if new loans and inflation expectations do not start to rise. For the moment, the reaction of the money markets has been immediate, especially with the EONIA and Euribor rates falling to minimal levels. There has also been a drop in yields in the debt markets. The euro's exchange rate has lost ground against the dollar but not much: it is still around 1.36 dollars.

The Federal Reserve is taking its time. The meeting of the FOMC did not arouse as much expectation as that of the ECB although it could end up having more impact on markets in the medium term. The tone was clearly dovish. It is true that, as expected, the Fed agreed another step in tapering, reducing its monthly bond purchases by a further 10 billion dollars

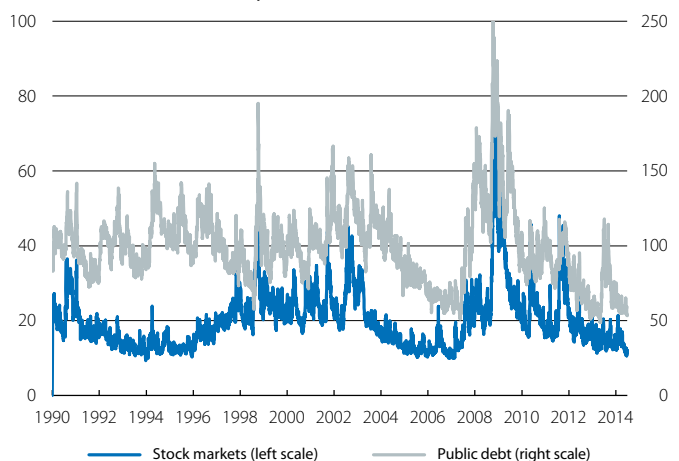
Yields on 10-year public debt



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

USA: implied volatility in financial markets

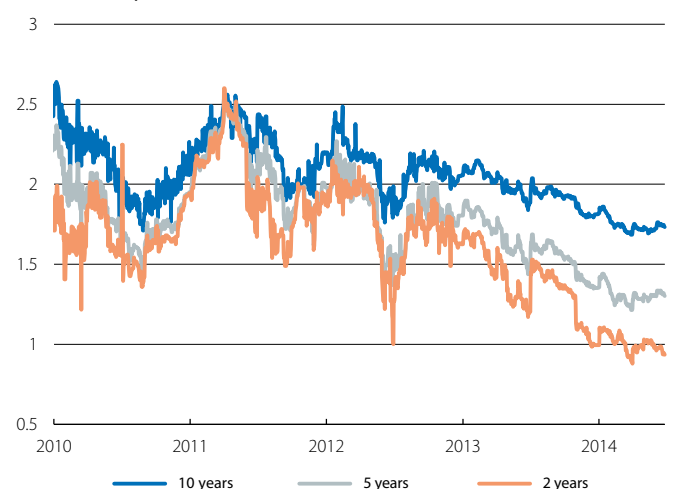
(Stock markets: VIX index, public debt: MOVE index)



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

Euro area: inflation expectations

Inflation swaps (%)



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

(now standing at 35 billion). But the rest of the meeting's content was accommodative. In fact, more information was expected on the roadmap for monetary normalisation but the Chairman, Janet Yellen, chose not to go into too much detail although she did try to convey the message that the institution is in no hurry to turn its strategy around. She insinuated that, once tapering has finished (at the end of year), the bonds maturing will be reinvested, thereby maintaining the size of the Fed's balance sheet. Regarding official interest rates, the plan is to keep them at very low levels for a prolonged period of time. The forward guidance is ambiguous at present. Fed members agree as to when interest rate hikes should start (mid-2015) and the long-term equilibrium level (3.75%) but there is a lot of disagreement regarding how far they should rise: for some the appropriate level at the end of 2016 should be 3.75%, while for others it is just 1%. Yellen came down on the side of the slow rate. The markets reacted with gratitude: stability in Treasuries and gains in the S&P 500. But all the evidence suggests that the debate regarding monetary normalisation will continue to be lively and might lead to more volatility than seen at present.

The emerging countries are heading in the right direction but at different speeds.

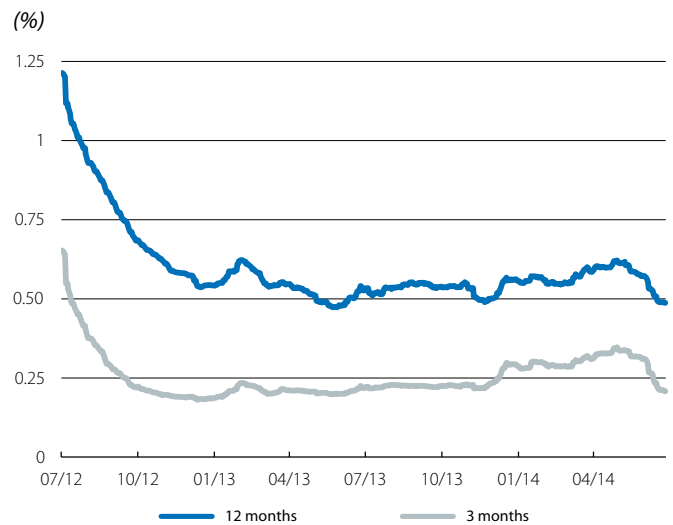
The overall diagnosis for these countries continues to improve. Within the context of low volatility dominating international financial markets, capital inflows to emerging markets are starting to recover after the outflows suffered between May 2013 and the beginning of this year. Two points stand out in this movement: (i) the solid cyclical indicators for China, supported by the positive effect of fiscal and monetary stimuli, and (ii) the albeit modest progress being made in correcting imbalances in Asian countries. The other side of the coin is provided by countries such as Brazil and Turkey whose economies are still under too much inflationary pressure.

Easy monetary conditions are affecting the US bond market.

The stability of Treasury yields is still the predominant tone, within a scenario of little volatility. Given this situation, investors appear to have paid more attention to the dovish tone of the Fed Chairman than the debate raging among its members regarding the right interest rate level for the coming years. Confirmation of the setback in GDP at the start of the year and the slow recovery in household consumption also affected the mood of agents throughout June. However, if economic activity continues to grow, as expected, and the labour market goes on improving, given the first signs of inflation picking up we expect the next few months to witness an increase in interest rates throughout all tranches of the curve.

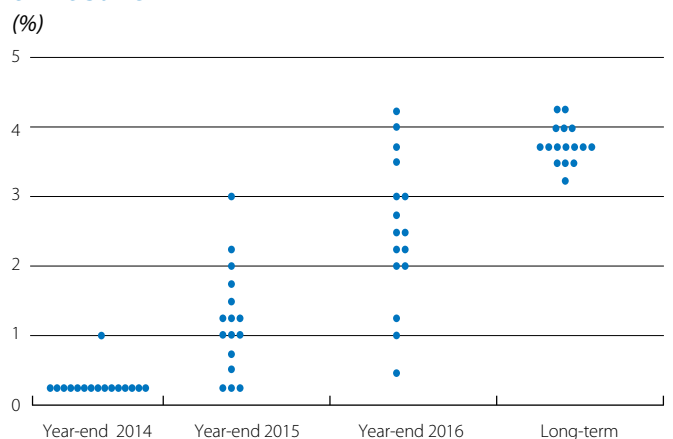
Europe's sovereign debt yields have fallen again. The measures adopted by the ECB and the Fed's stance have been sufficient to intensify investors' search for yield. This helped to push down the yield on the German 10-year bund to 1.25% at the end of June. With regard to the periphery,

Euro area: Euribor interest rates



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

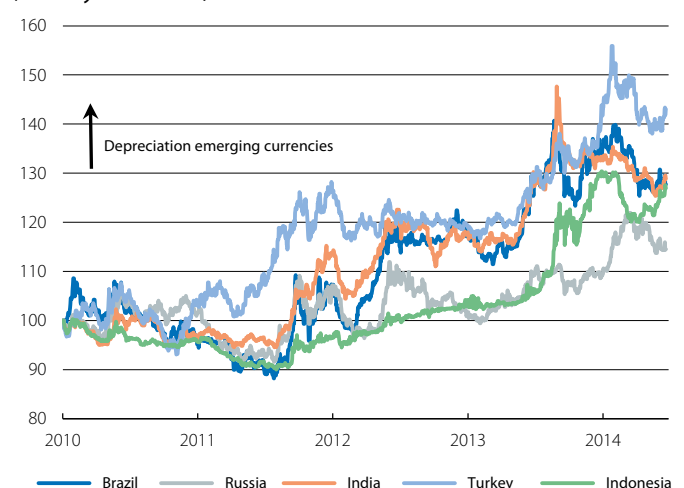
Fed: appropriate level for the official interest rate, according to Committee members on 18 June



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

Values of emerging currencies against the dollar

(January 2010 = 100)



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

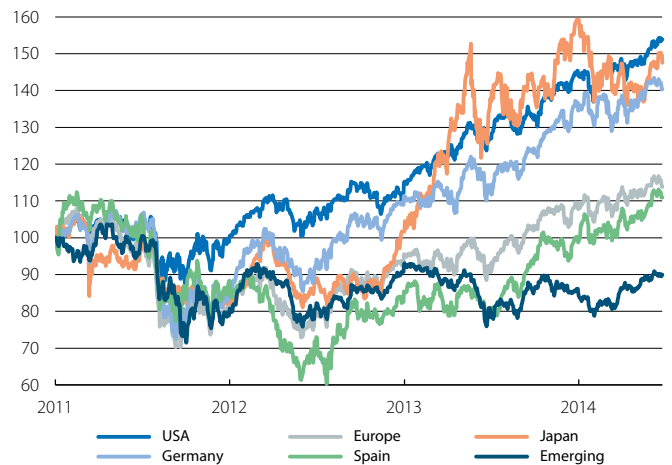
their performance has been good but the rally of the last few quarters appears to be flagging. Spain's sovereign debt risk premium has fluctuated around 135 basis points, a level that seems to be in line with the fundamental variables. In the medium term, the measures implemented by the ECB are likely to favour periphery debt more than that of the core countries. In Spain, the Treasury ended the first half of the year with a positive balance, having covered 57% of all gross issuances planned for the year.

Equity is on the up. The increased appetite for risk, reinforced by very low volatility, means that international stock markets are booming. Indexes such as the S&P 500 and DAX, where there are still some signs of over-buying, have set new records. Several factors have helped to produce these gains such as easy monetary conditions, larger flows of capital towards equity, the capacity of multiples to expand (higher in the stock market than the bond market) and the upswing in global mergers and acquisitions. In Spain, the Ibex 35 was above 11,000 points for a large part of June's sessions, thanks to the consolidation of growth and the ECB's announcements. However, several aspects can be observed in the current environment that might threaten these booming stock markets: high share price ratios in the US stock market, exuberant sentiment indicators and the fact that investors are likely to become complacent. Neither should we ignore the risks resulting from the conflict between Russia and the Ukraine or the recent tensions in Iraq with their consequences for oil prices. The stock markets of the emerging countries have continued to see gains over the last few weeks and the stabilisation of the risk premia for their economies and liquidity provided by the developed monetary authorities have led to foreign capital returning.

Corporate bonds are making the most of the current situation. The actions taken by central banks are crucial for the development of capital markets and specifically corporate bonds. The latest actions in the monetary area are contributing even further to the narrowing of spreads for bonds of companies in developed countries. In Europe, apart from senior corporate debt, 2014 is being a good year for the primary market. The total volume of bonds issued in the first six months is close to 800 billion euros, 12% up on the same period last year. Hybrid and high yield bonds, together with the subordinated debt of financial institutions, are meeting the rising demand for high risk and high yield products. Over-activity in these segments of the bond market is coming close to its level before the financial crisis. This has set alarm bells ringing regarding the possible formation of credit bubbles in some sectors and the irrational nature of some issuances within a context where guarantees for bond holders have been reduced.

Trends in the main international stock markets

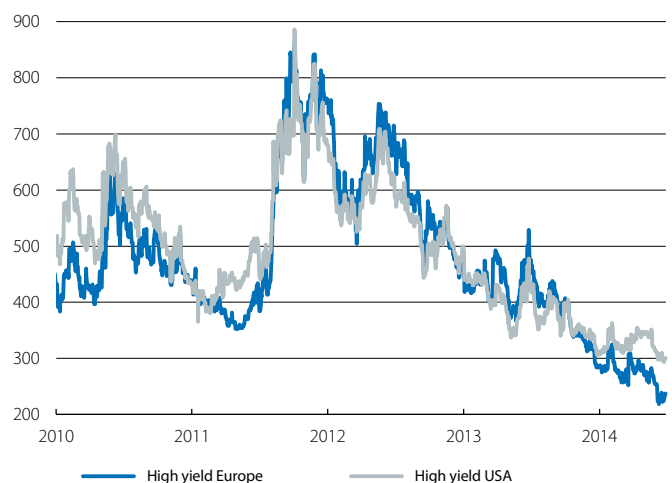
(January 2011 = 100)



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

Corporate bonds: CDS premia

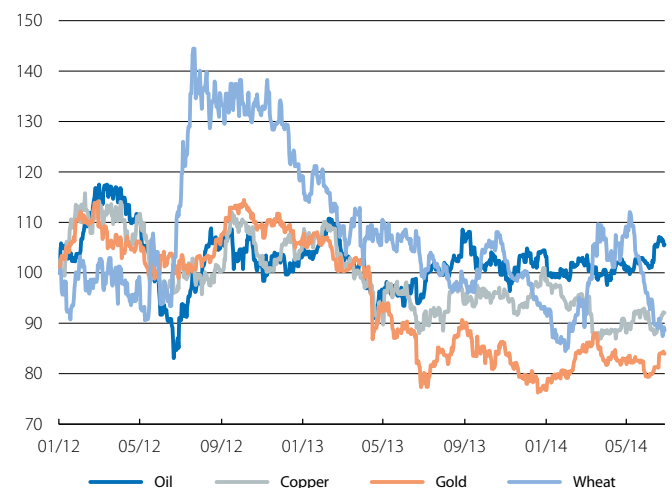
(BP)



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

Trends in commodities

(January 2012=100)



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

FOCUS · The ECB makes a move

After several months postponing the inevitable, at its June meeting the ECB decided to launch a new package of monetary stimuli. Mario Draghi's repeated comments insisting that he was prepared to act had created huge expectation and the announcement did not come as a disappointment. The number and variety of measures give credibility to the words of the ECB President. We will now describe these briefly to analyse their potential impact.

The range of instruments chosen by the ECB has been extensive. The most conventional measure was the reduction in the Refi rate from 0.25% to 0.15%, a new historical low level, but more important are the reductions in the interest rate on the deposit facility (from 0.00% to -0.10%) and the interest rate on the marginal lending facility (from 0.75% to 0.40%). These reductions have two broad aims: to narrow the range of fluctuation of the EONIA interest rate (the overnight interbank interest rate) and therefore its volatility; and to penalise surplus liquidity kept by some banks in the ECB and thereby boost lending. Another measure implemented is the extension of the main refinancing operation as fixed rate tender procedures with full allotment until December 2016. Lastly, also in this category of somewhat conventional measures, the President announced that the ECB would suspend the weekly fine-tuning operation sterilising the liquidity injected under the SMP, which should inject more liquidity into the markets.

In the category of less orthodox measures, the ECB President announced the start-up of long-term refinancing operations targeted on credit (TLTROs). Specifically, quarterly TLTROs will be held from September 2014 to June 2016, all at a very low fixed interest rate (the Refi rate plus a spread of 10 basis points) and with maturities of up to four years (September 2018). The first two TLTROs will be subject to a maximum entitlement equivalent to 7% of total loans to the private sector¹ at 30 April 2014. In these two auctions, the ECB expects to inject a maximum of 400 billion euros. The procedure is a little more complex for the subsequent TLTROs: all counterparties will be able to borrow up to three times the amount of their net lending² to the private sector during the months leading up to the auction. The ECB also announced that it will set the minimum growth in lending required for those counterparties wishing to access these TLTROs to ensure the liquidity injected reaches SMEs. These requirements

1. Private sector is understood as non-financial firms and households (excluding mortgages).

2. Net lending is understood as new loans minus loans redemptions.

have to be analysed very carefully as the success of this measures depends on them.

In general, therefore, the measures announced guarantee a source of financing at a low price for a long period of time, which will undoubtedly strengthen the recovery in lending over the coming years. But we should remember that, in order to improve the economy's lending capacity, it is still vital to reduce regulatory uncertainty, a particularly important factor this year in which asset quality reviews and stress tests are being carried out on banks. Any growth in lending is also still limited by solvent demand for credit, an aspect which the top monetary authority can do little about.

There can be few doubts, however, that Mario Draghi's press conference in June was yet another sign of the ECB's firm commitment to economic recovery and price stability. In fact, in addition to the aforementioned measures Mario Draghi also announced that the ECB is preparing itself to consider, if necessary, purchasing ABS with underlying assets of loans to SMEs, something that had been unthinkable until very recently. As happened in the summer of 2012 with the famous «whatever it takes», renewed confidence in financial markets has been noticed and the cost of financing, especially public debt, has fallen. Over the medium to long term, however, it is vital for the most backward countries in this respect to continue carrying out structural measures to underpin their growth, and for governance of the euro area to get stronger. If this does not happen, whatever the ECB does will be of little use.

Reaction of financial markets to the ECB's measures *

Percentage, unless otherwise specified

	May	6 June	Average 24-30 June
Refi rate	0.25	0.15	0.15
EONIA interest rate	0.26	0.07	0.09
3-month Euribor	0.33	0.27	0.21
12-month Euribor	0.59	0.53	0.49
German 10-year public debt	1.40	1.36	1.27
Spanish 10-year public debt	2.94	2.70	2.67
Spanish risk premia (bps)	154	134	140
Euro exchange rate (in \$)	1.373	1.364	1.364
Inflation expectations **	1.37	1.39	1.33

Notes: * The ECB announced the package of expansionary measures at the meeting on 5 June.

** Calculated as the spread between the German 10-year bond and the German 10-year inflation-indexed bond.

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

FOCUS · Low interest rates and little volatility: a double-edged sword

On the whole, the trend for international financial markets has been very positive over the first half of the year. In fact, perhaps too positive in some areas, insofar as the right conditions could be brewing for subsequent episodes of instability.

Signs of escalation can initially be seen in the drop in risk-free interest rates and in risk premia and, consequently, in rising share prices. But the incredibly low level of volatility in derivatives, both recorded and implicit, is even more striking. Trading is also vigorous and fluid in both primary and secondary markets. As a result, the indices measuring the degree of market stress have returned to the all-time low levels of 2007. The main reasons for this situation are well-known: less likelihood of extreme risks (such as the breaking up of the euro, etc.), moderate but resilient growth, low inflation and expansionary monetary policies, with this last factor being particularly important. One of the medium-term goals of current monetary policy in developed countries is precisely to achieve buoyant financial markets. But it is advisable to avoid excesses which, should they go too far, would have a boomerang effect. The guardians of financial stability are vigilant, as well they might be. Several warnings can be deduced from reports published on this area over the last three months by organisations such as the IMF, ESRB, ECB and FSOC, but none is as categorical as that of the Bank for International Settlements (BIS) which, in its recent annual report, classifies the climate in financial markets as euphoric and detached from economic reality.

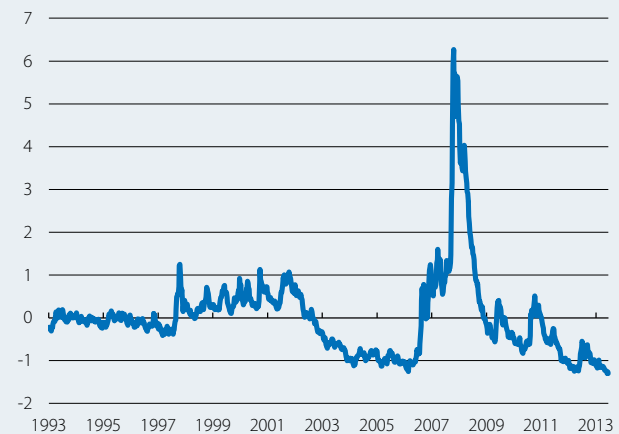
The BIS attributes a dominant and almost exclusive role in this financial scenario to central bank policies. Firstly, causing a two-fold effect on the sovereign debt markets of advanced countries: very low and very stable yields, with hardly any volatility. These two effects combine and reinforce each other to produce a third: more risk-taking and more leveraging by investors in their search for yield. It is easy to spot examples of this phenomenon; for example, and with particular relevance, the boom in junk bonds, a market that is currently in vogue among investors and has an increasing number of issuing companies. By way of anecdote, of note is the rise in issuances and narrowing of spreads of so-called cat bonds, instruments that transfer the risk of natural catastrophes such as hurricanes and earthquakes to the bond holder. Also revealing is the proliferation of carry trade strategies in foreign exchange markets.

Should low interest rates and imperceptible volatility go on for too long, this might encourage a false sense of security or excessive complacency among investors, leading them to increase their debt burden in order

to invest in risk assets. This would make the system vulnerable to any upset likely to increase volatility, insofar as it might (through the same channel as risk-taking) reverse the direction of the market spiral from upward to downward.

St. Louis Fed financial stress index *

(Index)



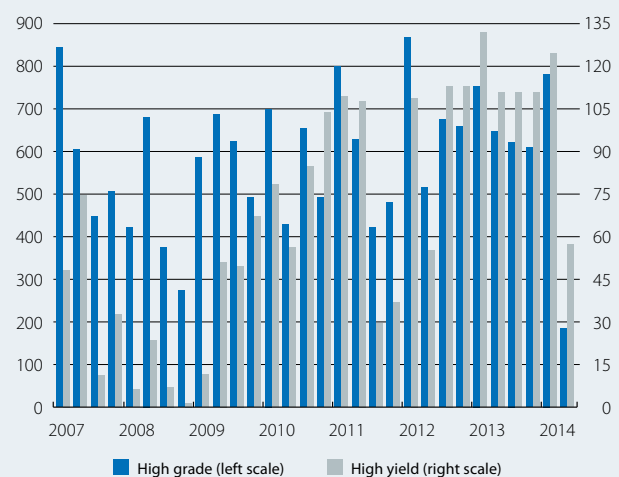
Note: * This index measures the degree of financial stress in the markets and is constructed from the following indicators, among others: interest rates, volatility, credit spreads and inflation expectations.

Source: "la Caixa" Research, based on data from the Federal Reserve Bank of St. Louis.

Global corporate bond issuance *

(Billion dollars)

(Billion dollars)



Note: * Includes bonds issued by financial companies.

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

KEY INDICATORS

Interest rates (%)

	30-June	30-May	Monthly change (b.p.)	Year-to-date (b.p.)	Year-on-year change (b.p.)
Euro					
ECB Refi	0.15	0.25	-10	-10.0	-35.0
3-month Euribor	0.21	0.31	-10	-8.0	-1.1
1-year Euribor	0.49	0.57	-8	-6.8	-3.9
1-year government bonds (Germany)	0.02	0.08	-6	-15.4	-7.3
2-year government bonds (Germany)	0.03	0.06	-3	-18.8	-17.1
10-year government bonds (Germany)	1.25	1.36	-11	-67.6	-46.7
10-year government bonds (Spain)	2.66	2.85	-19	-148.2	-193.5
10-year spread (b.p.)	142	150	-8	-80.6	-162.3
Dollar					
Fed funds	0.25	0.25	0	0.0	0.0
3-month Libor	0.23	0.23	0	-1.5	-4.2
12-month Libor	0.55	0.53	2	-3.8	-14.1
1-year government bonds	0.10	0.09	1	-1.5	-4.1
2-year government bonds	0.46	0.37	9	8.1	10.9
10-year government bonds	2.53	2.48	5	-48.6	6.6

Spreads corporate bonds (p.b.)

	30-June	30-May	Monthly change (b.p.)	Year-to-date (b.p.)	Year-on-year change (b.p.)
Itraxx Corporate	62	66	-4	-8.0	-52.4
Itraxx Financials Senior	68	73	-5	-20.2	-97.1
Itraxx Subordinated Financials	103	112	-9	-27.0	-142.6

Exchange rates

	30-June	30-May	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
\$/euro	1.369	1.364	0.4	-0.4	4.8
¥/euro	138.740	138.740	0.0	4.1	-6.3
£/euro	0.800	0.814	-1.6	3.7	7.2
¥/\$	101.330	101.770	-0.4	3.7	-1.8

Commodities

	30-June	30-May	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
CRB Index	496.4	498.0	-0.3	8.8	6.0
Brent (\$/barrel)	112.1	110.7	1.3	0.9	8.8
Gold (\$/ounce)	1,327.3	1,249.7	6.2	9.9	5.8

Equity

	30-June	30-May	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
S&P 500	1,960.2	1,923.6	1.9	6.1	21.4
Eurostoxx 50	3,228.2	3,244.6	-0.5	4.2	23.5
Ibex 35	10,923.5	10,798.7	1.2	10.5	38.6
Nikkei 225	15,162.1	14,632.4	3.6	-5.9	10.6
MSCI Emerging	1,050.8	1,027.7	2.2	4.8	11.6
Nasdaq	4,408.2	4,242.6	3.9	5.5	28.4

CURRENT SITUATION · The recovery has left behind the period of setbacks of the first six months

Global growth gains momentum for the second half of the year. The US, Japan and China have managed to withstand their obstacles quite well, these being of a different nature in each case. The situation also looks encouraging for the emerging economies albeit with some notable exceptions. The prospect of normalisation for US monetary policy is the biggest challenge for global expansion to consolidate.

UNITED STATES

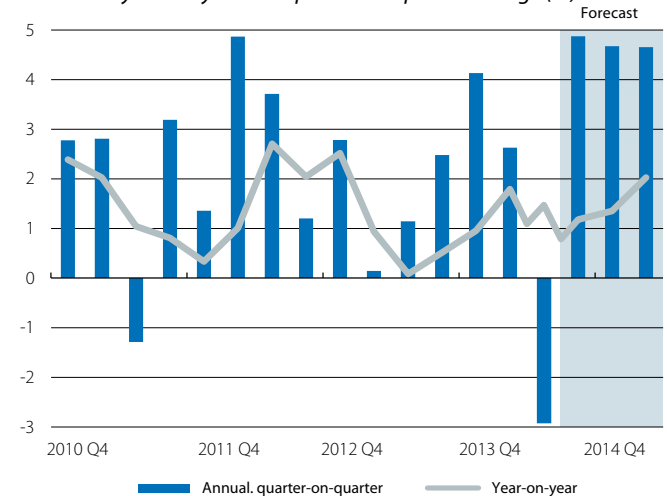
The first quarter's contraction in GDP was extensive but has not altered the underlying trend of recovery. GDP fell by 2.9% annualised quarter-on-quarter in 2014 Q1 and not by the 1.0% initially calculated, and by 1.5% in year-on-year terms. The base effect of this first quarter, strongly influenced by the bad weather and other temporary factors, has led us to revise downwards our forecast for 2014 as a whole from 2.6% to 2.2%, in line with the revisions carried out by the Fed and IMF. However, the latest indicators point to the recovery continuing and the outlook is one of robust growth for the remainder of 2014 and for 2015 (the year in which we predict growth of 3.1%).

In addition to the adverse weather, this setback can also be explained by the delay in the implementation of Obamacare. This factor, affecting private expenditure on healthcare, accounts for two thirds of GDP's downward revision. Due to deferments until April of the implementation of the Affordable Care Act (the law that makes it mandatory to have medical insurance but has lowered the cost for people on low incomes), consumers postponed their doctor visits waiting for this health coverage to come into force and thereby save on their bills. After such temporary effects, we expect private consumption to pick up steam in line with the improved expectations, as shown by the rise in the Conference Board Consumer Confidence index which, in June, reached 85.2 points, its highest level since the Great Recession. May's increase in retail sales, up by 0.3% month-on-month (after being revised upwards in April) and the qualitative indicators contained in the Fed's Beige Book also point towards slightly more solid consumption in Q2 and the following quarters.

The outlook for investment is steadily improving. The ISM index for business sentiment and activity rose again in May, both for manufacturing and services, and the activity index produced by Markit suggests this improvement will continue in June with levels corresponding to growth in GDP of close to 4% annualised quarter-on-quarter. Since the end of the Great Recession, investment has seemed reluctant to confirm these positive expectations with a recovery that is lagging behind the rest of the economy. But a series of favourable factors

USA: GDP

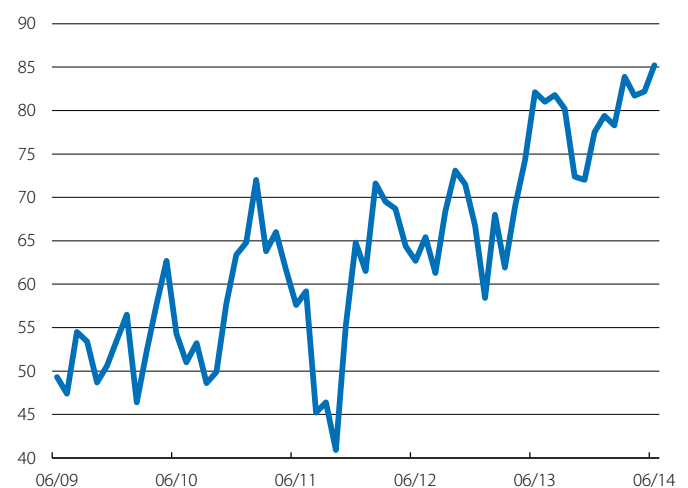
Annualised year-on-year and quarter-on-quarter change (%)



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

USA: consumer confidence

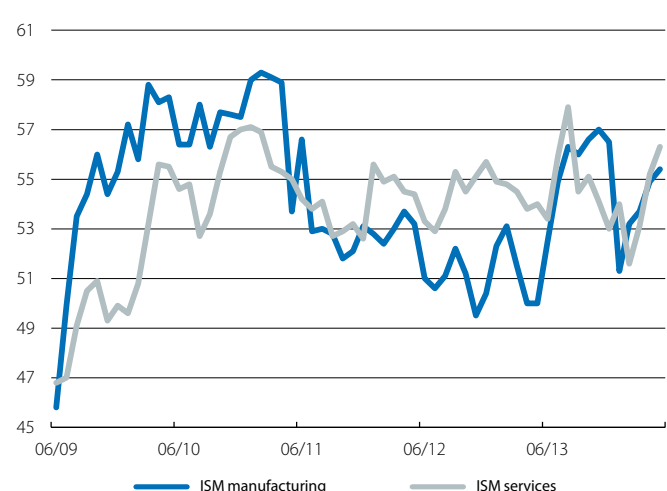
(Index)



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

USA: activity indicators

(Index)



Source: "la Caixa" Research, based on data from the Institute for Supply Management.

(see the Focus «A return to investment in the US: better late than never» in this issue) should help investment to finally take off in the second half of 2014.

Housing has recovered from its slump and is back on the road to growth, albeit at an understandably more moderate rate than in 2012 and 2013 when it was starting from very low levels. Real estate sales picked up in May and new houses started in the same month reached 66% of their 1995-2000 level; i.e. before the bubble (in November 2009 this bottomed out at a meagre 35%). The Case-Shiller index for house prices, which covers 20 metropolitan areas, also confirms the good tone being shown by the real estate market with an increase in April that was modest but continuing the upward trend. The index has recovered by 25.2% since May 2009 (in absolute terms close to half what was lost in the Great Recession).

The CPI continues to moderate but not to such a great extent. Prices are not showing any worrying inflationary tensions although April and May saw surprising increases. May's year-on-year rate stood at 2.1%, above 2% for the first time since April 2012, while the rate was 1.9% for the core CPI, without energy or food. It should be noted that the Fed's target (2% in the long term, somewhat higher in the current phase of the cycle) does not refer to the CPI but to the deflator for personal consumption expenditures (PCE) whose rate is a little lower, specifically 1.8% year-on-year (1.5% without energy or food).

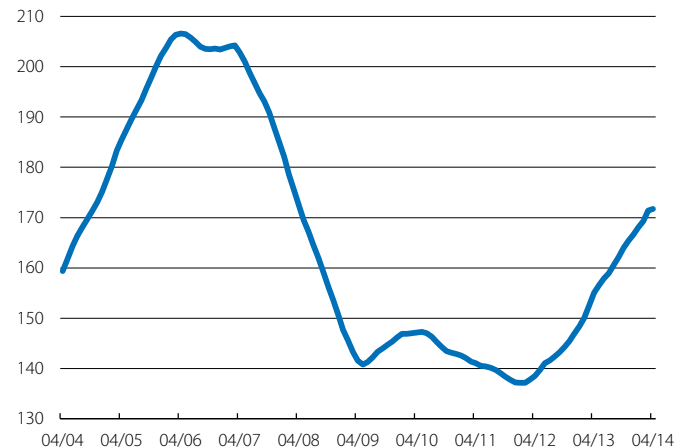
The labour market provided another pleasant surprise with 217,000 new jobs in May, above the average of 150,000 seen over the three winter months. The unemployment rate held steady at 6.3% but the persistently low participation rate (62.8%) continues to suggest the labour market is far from being fully recovered.

The Fed repeats its commitment to a slow monetary normalisation strategy. The Committee meeting on the 19 June agreed a new step in tapering: a reduction of 10 billion dollars, leaving monthly bond purchases at 35 billion, while also insisting that official interest rates will remain low for some time. The dynamics observed in the labour market and inflation, however, could raise doubts as to whether this will actually be the case. Moreover, the Fed will also have to consider the overheating of some financial markets. In other words, the attention of investors and the rest of the economic agents will once again be focused on US monetary policy.

JAPAN

Japan's economy suffers a jolt but does not derail. April's VAT hike (from 5% to 8%) seems to have affected it more than expected. In Q1 the economy grew by 1.6% quarter-on-quarter (2.8% year-on-year) boosted by the strength shown by private consumption and investment due to expenditure being brought forward to avoid the VAT hike in force as from 1 April. But just as GDP grew more than normal in Q1, the consensus of analysts predict a sharp contraction in Q2 because of the same distortion, clearly seen in the latest

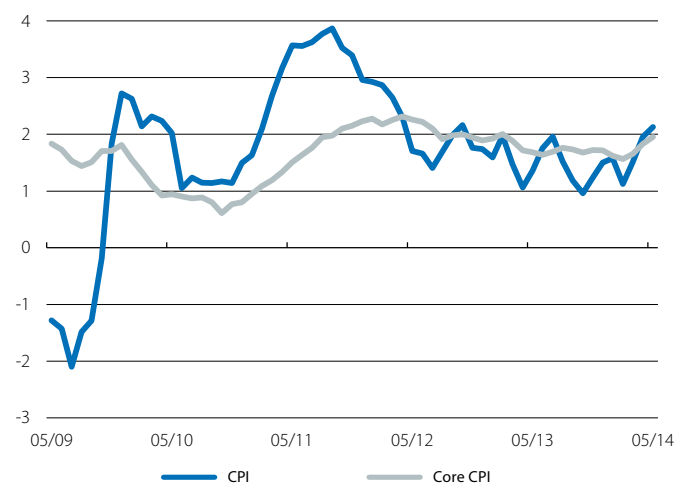
USA: Case-Shiller index of house prices (Index)



Source: "la Caixa" Research, based on data from Standard & Poor's.

USA: CPI

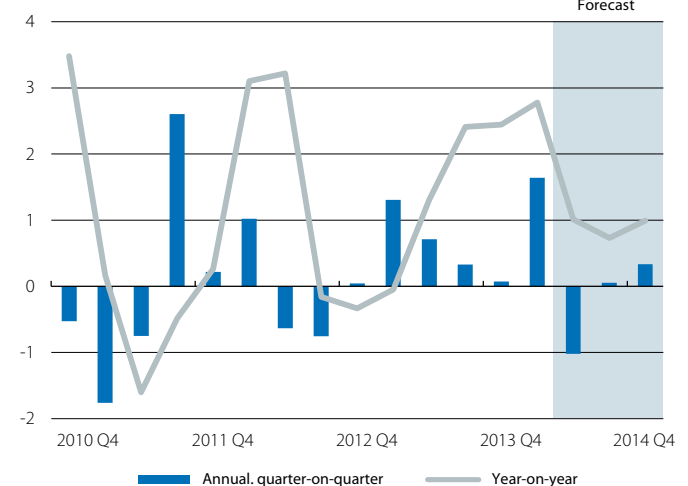
Year-on-year change (%)



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

Japan: GDP

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



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

business indicators. Industrial production, which had picked up by 7.6% year-on-year in March, slowed up in April to 3.8% and it was the same situation for retail sales, down by 13% in April after outdoing expectations in March. However, in spite of these fluctuations in indicators, other elements suggest the expansion is still on track: the latest data for the PMI activity and business sentiment index and the good figures for automobile sales in May are promising signs. Nevertheless, the real measure of the effect of the VAT hike on the activity will be provided by the figures in Q3.

Regarding prices, deflation has been left behind although inflation may have peaked. The CPI rose by 3.7% year-on-year in May (3.4% in April) boosted by energy prices and the VAT effect, while the core CPI, without food or energy, repeated April's figure of 2.2%. However, the month-on-month drop in prices for the Tokyo area in June points to inflation being somewhat more moderate over the coming months.

EMERGING ECONOMIES

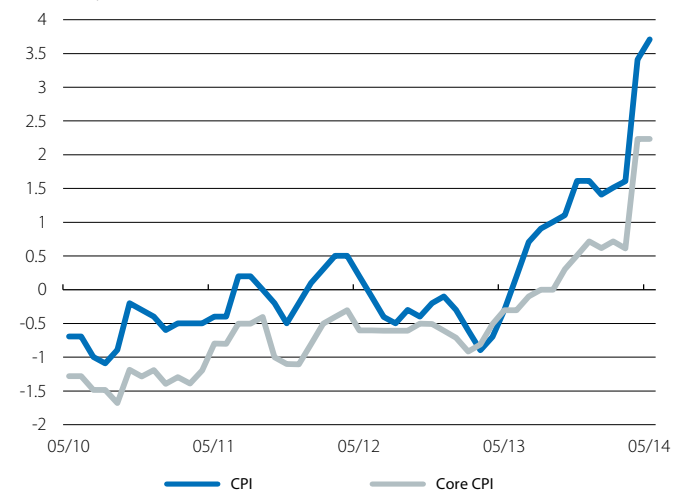
Activity in China consolidates and a soft landing looks likely. Industrial production advanced by 8.8% in May, noticeably more than April's figure and the official PMI posted a slight rise in May (from 50.4 to 50.8) supported by new orders (Markit's PMI also rose, although remaining just below the 50-point threshold). Looking at demand, retail sales accelerated, growing by 12.5% year-on-year, while new bank lending also intensified, encouraged by the government's policies to boost growth (which are also being implemented through fiscal and monetary measures). Inflation is still moderate (May's slight increase to 2.5% year-on-year was due to food prices), leaving room for such expansionary policies.

The correction of imbalances is coming to a halt in some emerging countries considered as vulnerable. The persistence of a current account deficit and high inflation high in Brazil and South Africa (6.4% and 6.1%, respectively) provides no leeway for expansionary policies while their economies are slowing down (GDP growth in 2014 Q1 of 1.9% and 1.8%, respectively). Turkey grew by a healthier 4.3% year-on-year but its high inflation (9.7%) and current account deficit (7.4% of GDP) imply a slowdown is on the cards.

India is also experiencing rising inflation but Narendra Modi's success at the general election has fuelled expectations that growth will speed up to 5%. The likelihood of a stable government and Modi's desire for changes augur genuine reform of the public sector, a more energetic labour market and greater investment in infrastructures. May's 6% upswing in the wholesale price index (India's measure for inflation) was largely expected while the outcome of the elections should bolster the anti-inflationary stance taken by India's Reserve Bank.

Japan: CPI

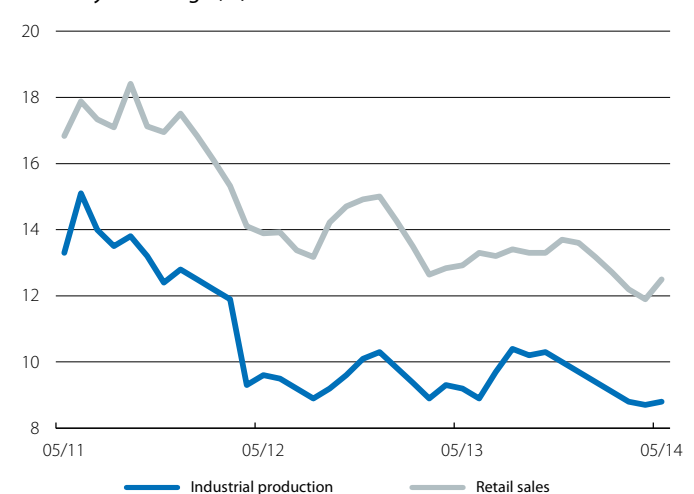
Year-on-year change (%)



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

China: industrial production and retail sales

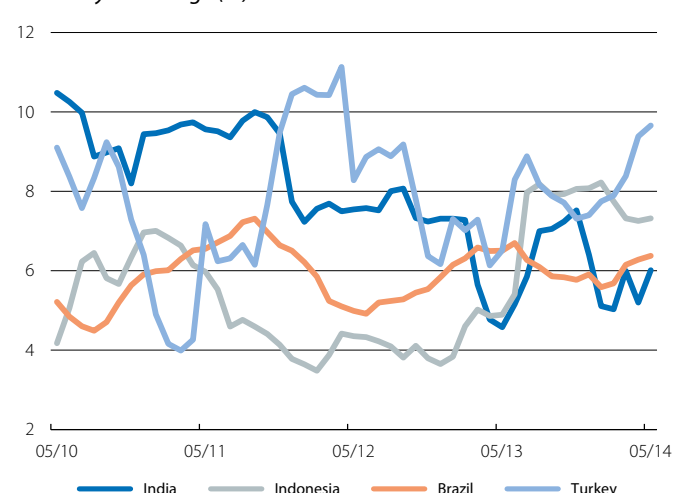
Year-on-year change (%)



Source: "la Caixa" Research, based on data from the National Bureau of Statistics of China.

Emerging countries: CPI

Year-on-year change (%)



Source: "la Caixa" Research, based on data from the respective national statistics offices.

FOCUS · Is the trend in world trade changing?

International trade was one of the hardest hit during the years of crisis but it soon recovered, providing an important source of growth for the world economy. However, in the last few quarters trade figures have started to weaken, which is slightly puzzling since the main developed countries are busy consolidating their recovery and in the emerging economies, although the situation is very different for each country, a widespread slowdown is not expected.

This slowdown in trade is not alarming but it is certainly noticeable and widespread: it can be seen both in the main developed countries and in the emerging economies. Of note is the slowdown in exports taking place in the US although adverse weather conditions are largely to blame in this case. Between 2010 and 2013, the average quarter-on-quarter growth rate for exports of goods and services stood at 1.3% while in 2014 Q1 it fell by 2.3%.

The trend in exports is quite volatile in the short term and the figures from the last few months may merely be part of the erratic movements that often occur. However, in some countries the growth rate of exports has altered its usual pattern over the last few quarters. Historically, the growth rate for exports, in real terms, has always been higher than for GDP. Gains in efficiency provided by the greater integration of a country's production in the global value chain were crucial to sustain growth in activity. However, in 2012 and 2013, at a global level, the growth rate for exports was almost the same as for GDP, an almost unprecedented phenomenon in the last 30 years.

The main reasons for this change in trend lie particularly with the US and China (the world's second and first exporters, respectively). In the case of the United States, this has been interpreted as a temporary situation as it is due to the strong upswing in domestic demand in the last few years once confidence in the economy's growth capacity improved. In the case of China, however, we might be looking at a longer-term phenomenon: the change in model being promoted by the new government to rebalance sources of growth, with a greater emphasis on domestic demand. According to IMF forecasts, this will mean that China's growth in exports will be very similar to its growth in GDP or even lower over the next few years.

Apart from China, and the temporary ups and downs typical of the series of international trade, it is hard to believe that international trade will stop being one of the main ways via which global gains in productivity, and therefore growth, are achieved. But we should keep a close eye on developments.

Trends in exports of goods and services *

Quarter-on-quarter change (%)

	Average 2000-2007	Average 2008-2009	Average 2010-2013	2014**
USA	1.1	-0.2	1.3	-2.3
Euro area	1.4	-1.3	1.3	0.3
United Kingdom	1.2	-0.7	0.9	-1.0
Japan	1.9	-1.6	0.9	3.2
China	5.1	1.1	2.1	0.7
India	5.6	0.8	3.2	0.2
Brazil	2.7	-0.2	2.0	-0.1
Russia	2.0	0.1	1.0	-5.1

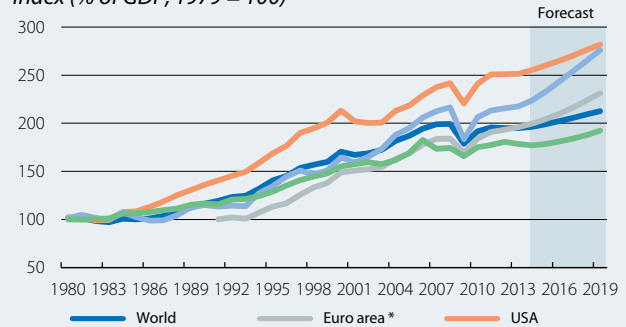
Notes: * Data in real terms.

** Average in 2014 up to latest figure available.

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

Developed countries: trend in the trade of goods and services relative to GDP

Index (% of GDP; 1979 = 100)

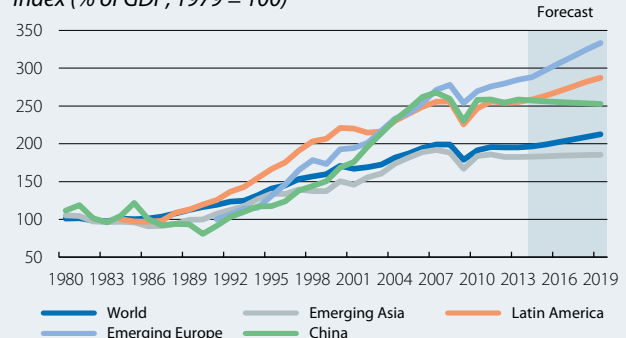


Note: * For the euro area 1991 = 100.

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

Emerging countries: trend in the trade of goods and services relative to GDP

Index (% of GDP; 1979 = 100)



Note: For Latin America 1984 = 100, and for Emerging Europe 1991 = 100.

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

FOCUS · A return to investment in the US: better late than never

The US economy has yet to fully recover from the Great Recession, an exceptionally large crisis in many different ways: intensity, duration and geographical scope, all plunged into financial dysfunctions the like of which had not been seen since the beginning of the last century. Such circumstances not only affected the recessionary period *per se* (between the end of 2007 and mid-2009) but have also lasted into the recovery stage. After almost five years, the pace of growth in the US is still shy compared with other post-recession periods and, to a large extent, this is due to the weakness seen in corporate investment. After a recession, companies with reduced inventories and rising demand normally increase their capital expenditure. This initial action is generally accompanied by improved confidence levels, both among businesses and consumers, accentuating and spreading the desire to invest through a self-perpetuating process. However, in the current cycle the engine of investment did not get off to a quick start nor has it been able to gather speed subsequently. A comparison with the cycle in the 1980s is revealing: this time round, it has taken twice as long to get back to the pre-crisis volume of investment. Such a poor performance has significant implications both in the short term (for job creation) and in the long term (for potential growth).

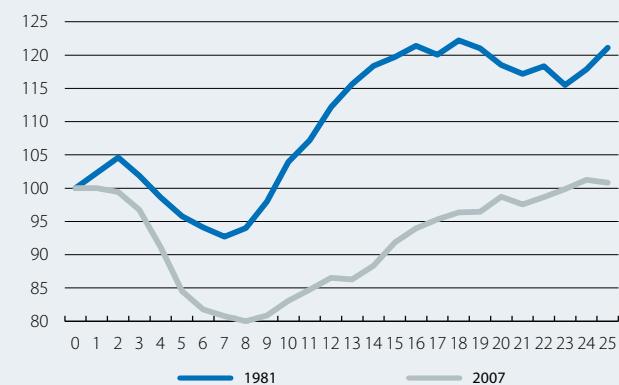
This lacklustre investment has surprised everyone, particularly given the theoretically encouraging conditions: incredibly low interest rates (even reaching negative terrain), totally recovered corporate earnings and healthy company balance sheets. One factor that has hindered investment is uncertainty, firstly due to the complexity of the crisis and then to economic policy responses that have been as aggressive as they are innovative (from monetary to fiscal and including regulatory) and therefore full of uncertainty. Another explanation is that, during this recovery, the US economy has generally provided much more excess capacity than in previous cycles, reducing the need for investment in the midst of generalised economic lethargy.

Nonetheless 2014 looks like being the year when investment will pick up steam. This revival is supported by four basic factors. Firstly, the improved economic outlook for the country as a whole. Having overcome the first quarter slump due to adverse weather conditions, most business sentiment and consumer confidence indicators are pointing in this direction. Secondly, less economic and political uncertainty, the latter thanks to the Republicans and Democrats reaching certain minimal agreements in the area of budget policy and as the big changes in financial regulation come in to play. Thirdly, the ageing of capital, precisely because of the lack of investment in the

last few years, forcing companies to replace it, particularly in a favourable context for industry located within the US to recover, thanks to phenomena such as the energy revolution of petroleum and shale gas. And fourthly, the continuation of favourable financial conditions. Based on these factors, our main scenario predicts that investment will pick up over the coming quarters, placing its growth rate at a strong 8% *saar* in the second half of 2014 and around 6% in 2015.

USA: trend in non-residential investment

Index, base 100 at the level of investment at the start of the crisis

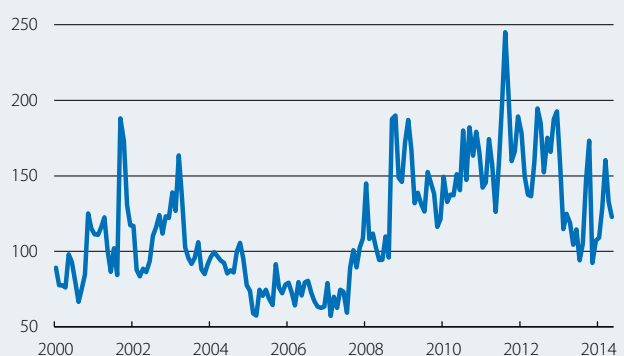


Note: The horizontal axis corresponds to the number of quarters since the crisis began. Base quarters: 1981: 1981 Q2 = 100; 2007: 2007 Q4 = 100.

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

USA: economic policy uncertainty

Monthly index



Source: "la Caixa" Research, based on data from Scott Baker, Nicholas Bloom and Steven J. Davis in www.PolicyUncertainty.com.

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	06/14
Activity									
Real GDP	2.8	1.9	1.6	2.0	2.6	1.5	–	...	–
Retail sales (excluding cars and petrol)	4.2	3.6	3.7	3.7	3.6	2.3	3.7	3.2	...
Consumer confidence (value)	67.1	73.2	75.1	81.0	74.0	80.5	81.7	82.2	85.2
Industrial production	3.8	2.9	2.5	2.7	3.3	3.4	3.8	4.3	...
Manufacturing activity index (ISM) (value)	51.8	53.9	50.8	55.7	56.7	52.7	54.9	55.4	...
Housing starts (thousands)	784	930	865	882	1,025	925	1,071	1,001	...
Case-Shiller home price index (value)	141	158	156	161	165	170	172	...	...
Unemployment rate (% lab. force)	8.1	7.4	7.5	7.2	7.0	6.7	6.3	6.3	...
Employment-population ratio (% pop. > 16 years)	58.6	58.6	58.7	58.6	58.5	58.8	58.9	58.9	...
Trade balance ¹ (% GDP)	–3.3	–2.8	–3.0	–2.9	–2.8	–2.8	–2.9	...	...
Prices									
Consumer prices	2.1	1.5	1.4	1.6	1.2	1.4	2.0	2.1	...
Core consumer prices	2.1	1.8	1.7	1.7	1.7	1.6	1.8	2.0	...

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	05/14
Activity								
Real GDP	1.4	1.5	1.3	2.4	2.4	2.8	–	...
Consumer confidence (value)	40.0	43.6	44.7	44.0	41.7	38.8	37.0	39.3
Industrial production	0.2	–0.6	–3.0	2.0	5.8	8.3	3.8	2.1
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	3.5
Trade balance ¹ (% GDP)	–1.4	–2.4	–1.9	–2.1	–2.4	–2.8	–2.8	–2.8
Prices								
Consumer prices	0.0	0.4	–0.3	0.9	1.4	1.5	3.4	3.7
Core consumer prices	–0.6	–0.2	–0.4	0.0	0.5	0.6	2.2	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	05/14
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	12.5
Industrial production	10.0	9.9	9.1	10.1	10.0	0.0	8.7	8.8
PMI manufacturing (value)	50.8	50.8	50.5	50.8	51.3	50.3	50.4	50.8
Foreign sector								
Trade balance ¹ (value)	230	260	269	252	260	234	235	250
Exports	8.0	7.9	3.8	3.9	7.4	–3.4	0.9	7.0
Imports	4.3	7.3	4.9	8.4	7.1	1.7	0.8	–1.6
Prices								
Consumer prices	2.7	2.6	2.4	2.8	2.9	2.3	1.8	2.5
Official interest rate ² (value)	6.00	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	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 · Moderate inflation encourages the ECB to act

The euro area's recovery is continuing according to script: gradually and with differences between countries. In 2014 Q1, GDP grew by 0.9% year-on-year and most leading indicators for activity and confidence point to this rate of growth remaining steady in Q2 and perhaps even improving slightly. Nevertheless, it is important to stress that the recovery is still uneven among the region's different countries. Germany leads the field with stronger and more balanced growth, as well as the periphery countries whose recovery is consolidating. But this positive note is still marred by uncertainty regarding France's economic recovery. For the region as a whole, although the recovery is underway domestic demand is still weak in some areas and this, together with a labour market that has yet to fully recover, means that inflation has remained at unusually low levels. This situation has forced the ECB to act, announcing a package of monetary stimuli whose aim is to anchor inflation expectations and boost the region's recovery.

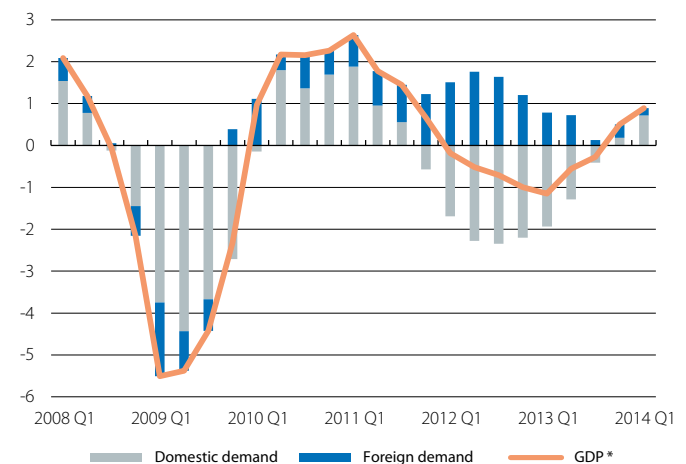
GDP growth in Q1 was driven by domestic demand with a year-on-year contribution to growth of 0.7 percentage points. Of note is the trend in investment, up by 1.9% year-on-year compared with -0.1% in 2013 Q4. Investment in machinery and capital goods, growing by 2.9% year-on-year, is still one of the mainstays for this performance. By country, Germany continues to head the ranking with 6.6% growth in investment. Although exports' contribution to the region's growth was 0.2 percentage points, the upswing in imports particularly stands out, up by 4.1% year-on-year (2.5% in Q4), boosted by the improvement in domestic demand.

Confidence indicators are encouraging for Q2. Although the composite PMI for the euro area fell slightly in May and June from 54.0 points to 53.5 and 52.8 points, respectively, it is still clearly in expansionary terrain, above 50 points. This decline has only slightly offset the increase achieved in April (its highest level in the last three years) so Q2 is still higher than Q1 in average terms. This slight correction is therefore still in accordance with a recovery is that gradually picking up steam. Along the same lines, the European Commission's economic sentiment indicator fell slightly by 0.6 percentage points in June, affected by the decline in the confidence of industry and consumers. The rate of this expansion still varies from country to country. In France indicators are still weak, fuelling doubts regarding the French economy. However, the trend is opposite in the rest of the European countries and most data suggest that activity is continuing to grow at a good rate.

Business indicators endorse the slight improvement in Q2. The figures for industrial production and retail sales available to date seem to confirm what the confidence indicators

Euro area: GDP growth

Contribution to growth (p.p.)

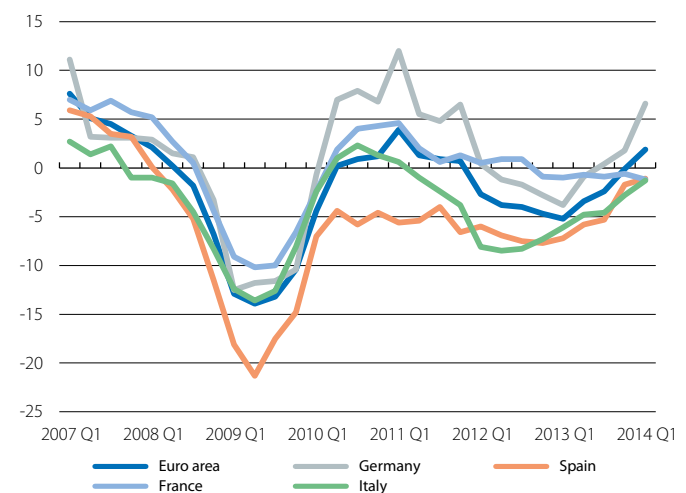


Note: * Year-on-year change (%).

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

Gross fixed capital formation

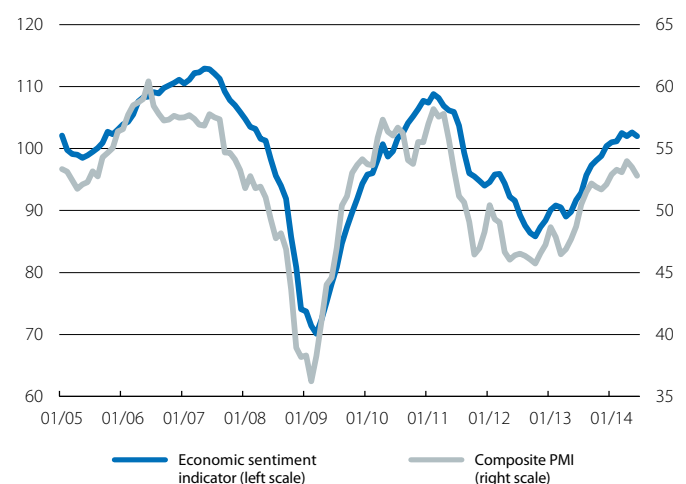
Year-on-year change (%)



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

Euro area: activity indicators

(Index)



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

had suggested. Regarding the former, in April industrial production grew by 1.2% year-on-year (compared with 0.5% in March), above the average for Q1 and boosted by the increased production of non-energy manufacturing, maintaining its upward trend. With regard to demand, retail sales rose in April by 2.4% year-on-year (compared with 1.0% in March), suggesting that domestic demand will continue to support GDP growth in the region as a whole thanks to the greater confidence of households and more stable labour market. There are still marked differences between countries, however, with France lagging behind the majority.

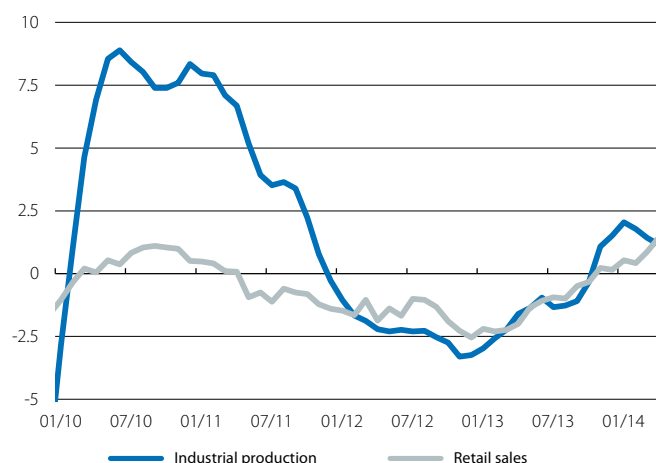
The export sector is weakening. Exports of goods had a good start to the year but this positive trend cooled down in March and April. Specifically, in April exports fell by -0.7% year-on-year (compared with -0.8% in March) and leading indicators do not point to any substantial change in trend. The European Commission's indicator for expected volumes of exports over the next three months decreased slightly in Q2 while the indicator for new orders for exports also fell. This weakness in leading indicators therefore points to Q1's slump in exports continuing in Q2. Nevertheless, given that April's contraction in the imports of goods was more pronounced than for exports, foreign demand is likely to continue contributing positively to GDP growth for the region as a whole.

The labour market is starting to show signs of improvement. For the whole of the euro area, employment grew slightly by 0.1% quarter-on-quarter in Q1, this being the second consecutive quarter with positive figures since 2011 Q2. Nevertheless, there are still big differences between the four main powers in Europe: Germany saw the largest rise in employment at 0.3% quarter-on-quarter, followed by Spain with 0.2%. However, France remained at the same level as the previous quarter and Italy continued with job losses, with employment falling by -0.1%. Given this weak growth for the region as a whole, unemployment is therefore still high (11.7% in April). Another factor underlining the sluggish labour market is labour costs which are still moderate, rising slightly in 2014 Q1 in general but by more in France and Germany, helping the periphery countries to gain competitiveness.

Inflation has remained low, forcing the ECB to act. After the ups and downs in the latest figures for inflation due to the calendar effects of Easter, June's figure stood at 0.5% year-on-year (0.5% in May), confirming the weak growth in prices. This situation led ECB to act via a package of monetary stimuli with the aim of achieving its mandate of price stability and keeping inflation expectations anchored. Particularly of note in this package, made up both of conventional and non-conventional measures, are refinancing operations with the condition of credit being granted to the private sector (see the Focus «The ECB makes a move» for a more detailed discussion). In spite of the current weakness in prices, over the coming months a

Euro area: industrial production and retail sales

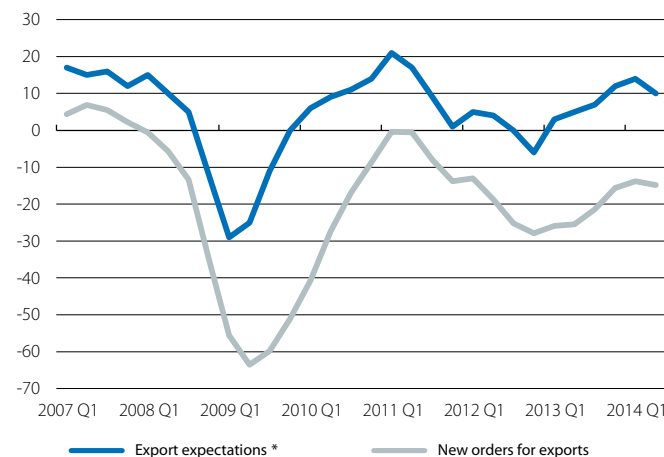
Year-on-year change (%), average 3 months



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

Euro area: foreign sector

(Index)

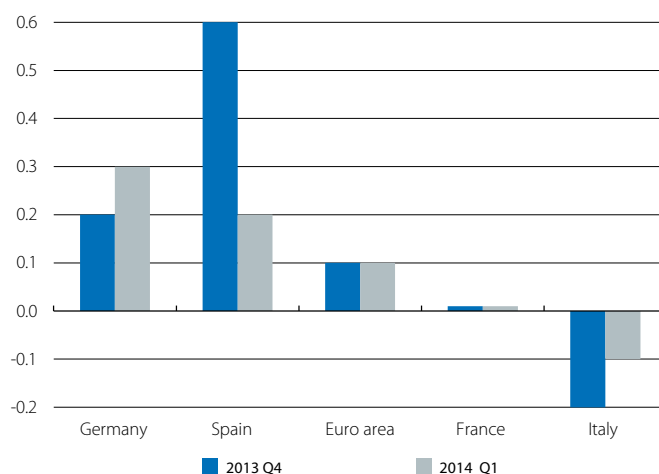


Note: * Indicator that forms part of the economic sentiment index, representing the expected volume of exports over the next 3 months.

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

Employment

Quarter-on-quarter change (%)



Note: Seasonally-adjusted figures.

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

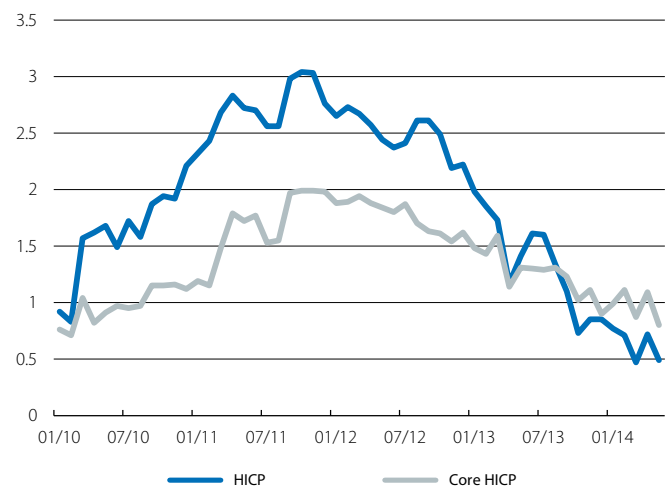
change in trend will appear in the inflation rate as confidence in growth capacity recovers and domestic demand builds up. In the short term, the upswing in oil prices due to geopolitical tensions in Iraq and the Ukraine will also support a change in trend for inflation. Given this situation, we expect the inflation rate to be slightly above 1% by the end of 2014 and to remain around 1.5% in 2015, a figure more in line with the euro area's economic situation as a whole. Any significant deviation from this scenario could force the ECB to introduce more monetary stimuli.

Looking at individual countries, there is notable uncertainty regarding France's economic recovery.

The French economy stalled in 2014 Q1 with zero growth compared with the previous quarter. In fact, GDP only managed to avoid a negative growth rate thanks to an increase in stocks, as exports made a negative contribution to growth and household consumption and investment both declined (−0.5% and −0.9%, respectively). Business and confidence indicators for Q2 are not encouraging either. Industrial production fell by 2.0% year-on-year in April (compared with −0.2% in Q1) as did goods exports, down by −6.4% year-on-year, although in this case the larger fall in imports could mean that the foreign sector ends up contributing positively to GDP growth. Confidence indicators are equally pessimistic: the composite PMI remains below 50 points and, even more worrying, below the average figure for Q1.

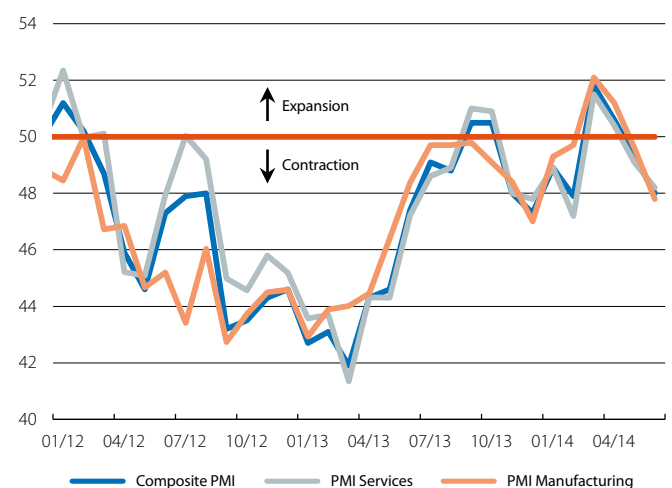
A slight setback for the Portuguese government. The Constitutional Court annulled some of the measures that had been approved by the government to reduce the public deficit. The measures annulled are valued at 800 million euros, including permanent wage cuts for the civil service. This means that Portugal has ended the Troika's bail-out programme without the last payment of financial aid being made, forcing the Portuguese Treasury to resort to the markets to offset the loss of this source of financing. Although the measures annulled by the Constitutional Court were meant to cover one fourth of the fiscal adjustment budgeted for 2014, the government's total commitment to fiscal consolidation, the good pace of growth in Portugal's economy and the breadth of the structural reforms already implemented are helping the market to remain confident in Portuguese sovereign debt.

Euro area: harmonised index of consumer prices
Year-on-year change (%)



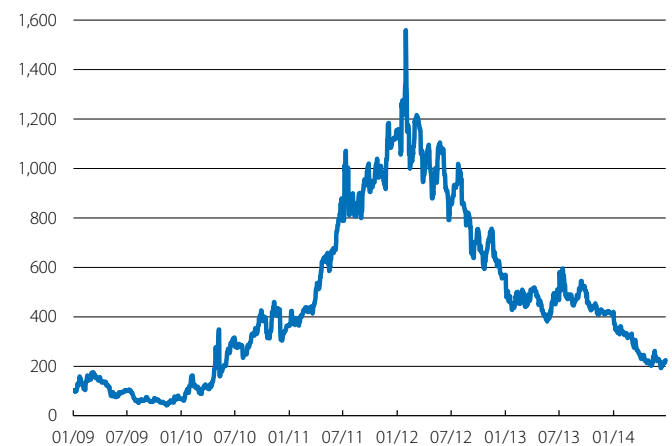
Source: "la Caixa" Research, based on Eurostat data.

France: trend in the PMI
(Index)



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

Portugal: risk premium on 10-year sovereign debt
(bps)



Note: Spread between 10-year Portuguese and German sovereign debt.

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

FOCUS · The Bank of England: new measures for new times

During the crisis, the central banks of the main advanced economies have taken charge of providing the necessary conditions to create an accommodative environment in the markets via official interest rates close to zero and unconventional monetary policies. As the economic recovery consolidates, this easy situation should change. Doubts are therefore starting to emerge as to when the turning point will come for monetary strategy and which country will be the first to take this step.

Some of these questions are starting to be answered by the statements made by Mark Carney, governor of the Bank of England (BoE). He has warned that interest rates might start to rise earlier than the markets anticipated, which had expected the first official interest rate hike in 2015 Q2. The markets reacted immediately to his declarations and are now forecasting the first rise at the end of the year. This different tone taken by the governor's discourse is based on a more encouraging macroeconomic environment than expected and on favourable prospects for GDP growth. That is why risks of inflation might start to appear, as well as bubbles in certain assets, especially in the real estate market. Let's look at this step by step.

With regard to price stability, in May inflation was at 1.5%, far from the levels that might concern the central bank. The consensus of analysts, however, expects inflation to end the year at around 2.0%. Price containment will chiefly depend on how quickly the labour market continues to recover. The unemployment rate had already fallen to 6.6% in May and looks like improving further, ending the year at 6.4% and down to 5.7% in 2015, levels very close to those prior to the crisis. Although this could be taken as a sign that the United Kingdom is close to full employment, the salary trend rules out such a hypothesis since, at present, no upward pressure can be observed on wages which are still growing at a much slower rate than before the crisis (an average of 1.1% year-on-year since the start of the year compared with 4.3% between 2001 and 2007). This might be an indication that the surplus capacity available in the labour market is larger than suggested by the unemployment rate. For example, the percentage of part-time employees is still above its pre-crisis level (27% in 2013 compared with 25% historically) and, in turn, the percentage of these part-time employees who do not want to work part-time has risen to 17.8% compared with 9.6% before the crisis.

Another factor lying behind the governor's change in tone is the growing unease about a potential real estate

bubble. House prices are shooting up again, in April growing by 9.9% year-on-year although this trend is not widespread throughout all the regions but particularly intense in the capital. Taking this risk into account, and before starting to normalise monetary policy, the BoE has decided to use macroprudential instruments that limit household mortgage debt and thereby reduce households' vulnerability. One particularly important instrument is the condition that no more than 15% of British banks' new mortgages can be loans of more than 4.5 times a borrower's annual income and that lenders must also impose stricter tests on whether their customers can repay their loans at higher interest rates. The effectiveness of these new instruments and developments in the labour market will largely depend on the timing and pace of the interest rate hikes.

United Kingdom: labour market



United Kingdom: trend in house prices and mortgages



FOCUS · Hungary: a recovery that is running out of steam

After contracting by 1.7% in 2012, the Hungarian economy grew by 1.2% in 2013 and this recovery in activity continued in Q1 this year, when growth reached 3.2% year-on-year. However, this figure must not be extrapolated as GDP is expected to grow more slowly in the coming quarters, resulting in a gentle economic expansion with growth of around 2% in 2014 and 2015. This trajectory will leave Hungary lagging behind its neighbours in the region, which are progressively looking more dynamic. Should the forecasts be accurate, in 2015 the Czech Republic will grow by 2.5%, Slovakia and Romania close to 3% and Poland by 3.5%. So why has the Hungarian recovery, which had barely started, run out of steam so quickly?

The essential problem for Hungary is that its recovery critically depends on two factors: stimulus from fiscal policy (to a large extent based on increased public investment, co-financed by the European Union) and from monetary policy (by lowering interest rates and injecting liquidity) and the recovery in exports (especially automobiles). On the other hand, domestic demand, and especially private investment, will remain subdued. In short, there is a worrying absence of private domestic drive. This situation should come as no surprise, seeing as Hungary has been suffering from a heterodox economic policy that has damaged the perception of investors and business people regarding the quality of the country's environment to do business.

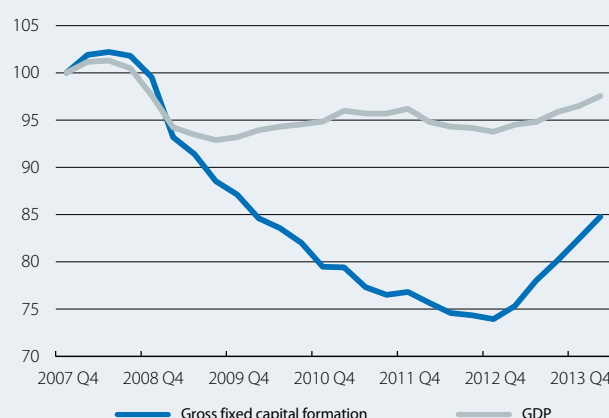
In fact, since 2010 Hungary has adopted an economic policy that is, to say the least, questionable. With the aim of short-term growth and reducing its fiscal deficit, it has prioritised exceptional measures that will therefore not be repeated or sustainable over time, very often erring on the side of populist. Among others, it was decided to tax sectors with an extensive proportion of foreign ownership, such as banks and retail chains, while financial institutions were forced to exchange loans in currencies other than the Hungarian forint at favourable rates for the debtors and part of the private pension system was also renationalised.

In spite of many warnings, particularly from international organisations, regarding the limitations and ill-advisedness of this type of practice, there are no signs of change on the horizon. The outcome of the legislative elections last April, which allowed the government to remain in power with ample parliamentary majority, also endorsed the electoral success of these populist measures and the prospect that economic policy will remain unchanged and not become less unorthodox. Some of the proposals announced are indeed along these lines: the aim to bring 50% of banks under Hungarian ownership and the state's

intervention in the energy industry. Given this situation, atypical compared with the lines followed by the economic policy of advanced countries, the country has fortunately kept a tight rein on its budget, partly because this is an unavoidable requirement to guarantee European financing of public investment, one of the few internal pillars of growth.

However, in the medium and long term it will not be possible to improve potential growth if the country does not restore a business-friendly regulatory framework and orthodox economic policy. And it is quickly losing competitiveness. Between 2009 and 2014, the World Bank's Doing Business indicator, which reflects the ease of doing business in different countries, shows that Hungary has dropped 13 places in the ranking, going from the 41st best country for business to 54th. A worrying trend that endorses the economy's loss of international appeal and reflects the toll being paid by business in the country. Without a significant boost from the private sector, this situation (remember: Hungary is moving away from its neighbours' rate of growth) could even become more the rule than the exception in 2015.

Hungary: investment fails to keep up with GDP Index (2007 Q4 = 100)



Source: "la Caixa" Research, based on data from the Hungarian National Statistics Office.

Key economic indicators

	2013	2014 (f)	2015 (f)
Real GDP growth (%)	1.2	2.1	2.2
Inflation CPI (%) (y)	0.4	2.7	3.0
Exchange rate forint/€ (y)	297.1	303.0	295.0
Current account balance (% GDP)	3.1	2.7	2.2
Fiscal balance (% GDP)	-2.4	-2.9	-2.9
Public debt (% GDP)	79.2	80.3	79.5

Note: (f) Forecast; (y) Year-end figure.

Source: "la Caixa" Research, based on data from Thomson Reuters Datastream, IMF, AMECO and IIF.

KEY INDICATORS

Activity and employment indicators

Values, unless otherwise specified

	2012	2013	2013 Q2	2013 Q3	2013 Q3	2014 Q1	04/14	05/14	06/14
Retail sales (year-on-year change)	-1.6	-0.9	-1.1	-0.5	0.2	0.9	2.4	...	...
Industrial production (year-on-year change)	-2.5	-0.7	-1.0	-1.1	1.6	1.2	1.4	...	...
Consumer confidence	-22.1	-18.6	-20.8	-15.9	-14.4	-11.2	-8.6	-7.1	-7.5
Economic sentiment	90.8	93.8	90.2	95.3	99.1	101.6	102.0	102.6	102.0
Manufacturing PMI	46.2	49.6	47.9	50.9	51.9	53.4	53.4	52.2	51.9
Services PMI	47.6	49.3	47.5	50.9	51.3	52.1	53.1	53.2	52.8
Labour market									
Employment (people) (year-on-year change)	-0.6	-0.8	-1.0	-0.8	-0.4	0.1	-	...	-
Unemployment rate: euro area (% labour force)	11.3	12.0	12	12.0	11.9	11.8	11.7	...	...
Germany (% labour force)	5.5	5.3	5.3	5.3	5.2	5.2	5.2	...	...
France (% labour force)	9.8	10.3	10.3	10.3	10.2	10.4	10.4	...	...
Italy (% labour force)	10.7	12.2	12.1	12.3	12.5	12.7	12.6	...	...
Spain (% labour force)	24.8	26.1	26.2	26.1	25.8	25.3	25.1	...	...

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	2014 Q1	04/14	05/14
Current balance: euro area	1.6	2.7	2.3	2.4	2.7	2.8	2.9	...
Germany	7.4	7.5	7.5	7.4	7.5	7.5	7.5	...
France	-2.1	-1.3	-1.5	-1.6	-1.3	-1.2	-1.3	...
Italy	-0.3	1.0	0.4	0.7	1.0	1.4	1.5	...
Spain	-1.2	0.8	0.4	0.8	0.8	0.4	0.3	...
Nominal effective exchange rate¹ (value)	97.8	101.6	100.8	101.9	103.1	103.8	104.5	103.8

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	2014 Q1	04/14	05/14
Private sector financing								
Credit to non-financial firms ¹	-0.3	-2.3	-2.2	-2.8	-2.9	-3.1	-2.8	-2.5
Credit to households ^{1,2}	1.2	0.3	0.3	0.3	0.3	0.3	0.4	0.5
Interest rate on loans to non-financial firms ³ (%)	2.4	2.2	2.2	2.2	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	2.7	...
Deposits								
On demand deposits	4.1	7.9	9.3	7.6	6.6	5.9	5.2	4.9
Other short-term deposits	2.0	0.0	0.1	0.3	-1.5	-2.5	-2.4	-1.9
Marketable instruments	0.5	-14.8	-15.5	-17.2	-16.8	-13.6	-15.3	-13.4
Interest rate on deposits up to 1 year from households (%)	2.8	2.0	2.1	1.8	1.6	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 · The recovery is gaining momentum, helped by domestic demand

The composition of growth is shifting towards national demand. The progress made by the latest indicators for consumption, investment and the labour market point to domestic demand continuing as the mainstay for the Spanish economy's increasing dynamism. This advance in domestic demand has led to a notable upswing in imports, acting as a brake on the correction in the trade deficit. Although we expect exports to see much better growth rates over the coming months thanks to the excellent performance by tourism, we have revised slightly downwards our forecast for the current surplus for 2014 and 2015.

Supply indicators continue to improve and the revival in industrial activity is increasingly evident. Industrial production rose by 4.3% year-on-year in April (0.9% March) while the good performance by the production of capital goods and consumer durables (9.0% and 4.1% year-on-year, respectively) points to further advances in investment and consumption. Similarly, the PMI's for manufacturing and services are still at levels in line with a growth rate similar to the one seen in 2014 Q1 or even slightly higher.

Household consumption continues its upward trend.

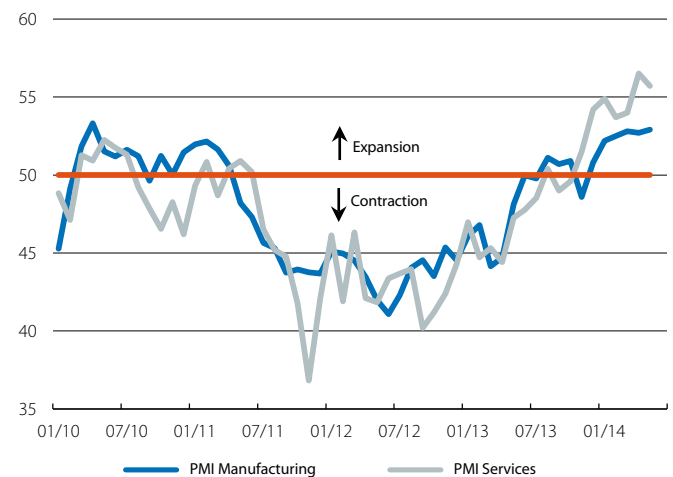
A sustained recovery in private consumption is essential to ensure similar GDP growth rates to the beginning of the year and it is therefore a good sign that the various consumption indicators continue to improve at a good rate. Consumer confidence is on a clearly upward track and is already above pre-crisis levels. Retail sales also reflect the gradual improvement in household consumption, with May seeing an advance of 0.5% year-on-year. The figures are therefore still showing growth in household spending.

The recovery in the labour market is picking up its pace.

In May the number of registered workers affiliated to Social Security increased for the ninth consecutive month (56,600 people, seasonally adjusted). This improvement in the labour market has generally been concentrated in the services sector although industry and construction also contributed positively to employment growth that month. Employment contract figures also reflect the upturn in the labour market. Specifically, the total number of new contracts between January and April this year was 16.5% higher than the figure for the same months in 2013. Although the vast majority were temporary, as is to be expected, it is worth noting that permanent contracts grew faster in March and April after the commencement of new incentives to give permanent employment contracts. If this tone continues over the coming months, it should have a positive effect on stable employment and, in turn, this should boost private consumption. This situation should also be helped by the fact

Activity indicators

(Index)

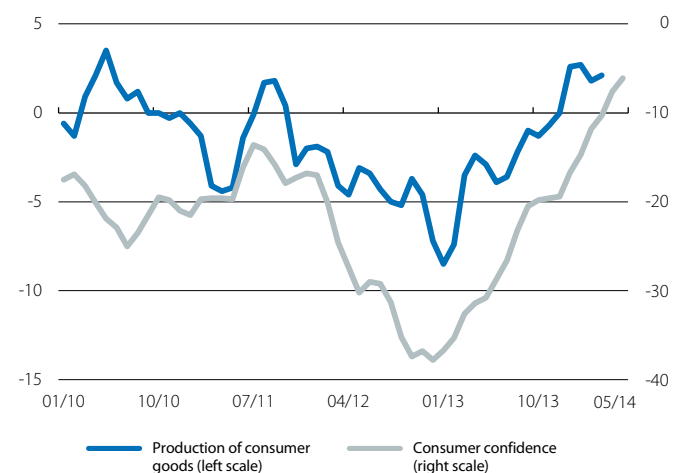


Note: Values above 50 points are usually related to positive GDP growth rates.
Source: "la Caixa" Research, based on Markit data.

Consumption indicators

Year-on-year change (%)

(Index)

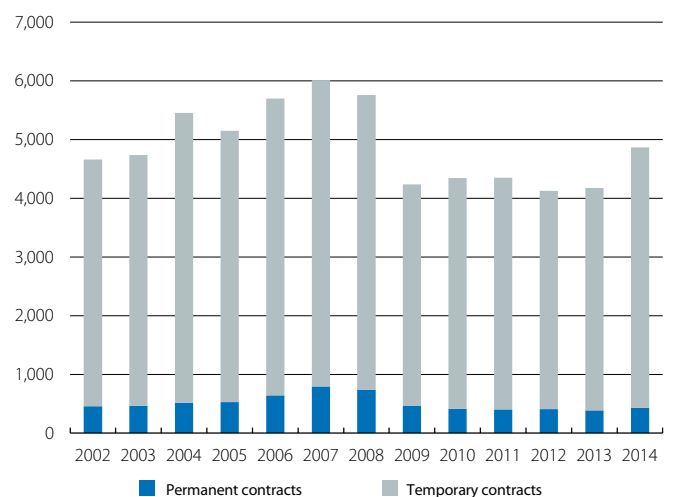


Note: Moving 3-month average.

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

Hiring contracts registered

Cumulative figures from January to April (thousands)



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

that, in 2014 Q2, the expectations for unemployment over the next 12 months are at very low levels not seen since 2000, namely -3.1 points.

Wage moderation continues. In 2014 Q1, labour costs increased by 0.5% year-on-year (0.1% quarter-on-quarter) according to the harmonised index of labour costs, a lower rate than the euro area as a whole which was 1.0%. This means that Spain continued to gain in competitiveness but there are notable differences in wage trends between sectors. In Q1, the wage adjustment was concentrated in the private sector as the public sector posted a rise of 0.4% quarter-on-quarter. It was also noted that those sectors whose activity has recently improved, such as hotels and restaurants, recorded positive rates of growth in wage costs. The wage increases contained in new agreements (0.5% year-on-year in May) suggest that labour costs will remain contained. Nonetheless, workers' purchasing power should not decrease while inflation remains at a low level, important for the revival in domestic demand.

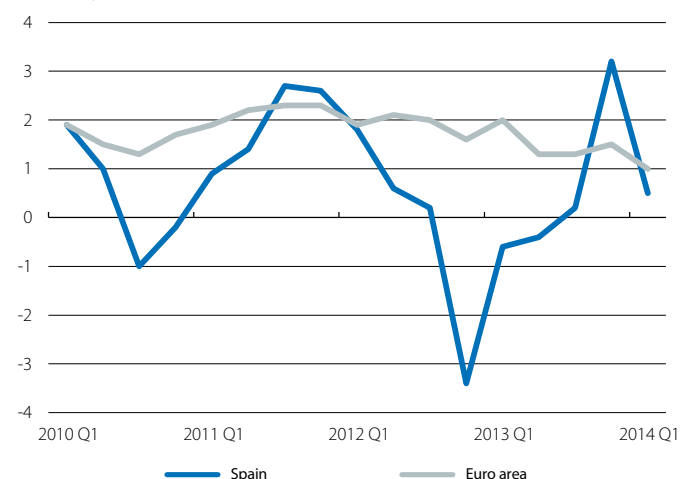
The inflation rate is still close to zero. In June, the inflation rate fell by 0.1 percentage points to 0.1%. The components with most impact were food and non-alcoholic beverages and electricity. However, the upswing in oil prices due to geopolitical tensions in Iraq and the Ukraine, as well as the gradual recovery in domestic demand, will bring about a change in trend over the coming months. We therefore predict the year will end with inflation at 0.9% in December (0.4% for the whole of 2014). For 2015 we expect the inflation rate to be around 1.1% albeit with a very high degree of uncertainty. So far the recovery in inflation is being slower than initially expected. This is particularly surprising as the gains being made by activity and the labour market are slightly better than forecast. Given this situation, it is important to highlight the ECB's commitment to price stability. In addition to specific measures (discussed in the Focus «The ECB makes a move») and their potential effects, in the press conference given by Mario Draghi last June he repeated that, if necessary, the ECB would again take action to ensure inflation returns to levels in line with its mandate.

The recovery in domestic demand boosts imports. During the first four months of the year, imports gained 4.9% year-on-year (compared with -3.5% in the same period of 2013), with particularly high growth in imports of consumer goods (12.6%), automobiles (23.6%) and capital goods (12.5%). The advance made by exports, however, was more modest (1.4% year-on-year) although the upward trend in sales to the euro area, at 4.8% year-on-year, suggests the outlook is favourable. This slight increase in the trade imbalance, together with the deterioration in capital income, lie behind the slight reduction in April's current account surplus from 0.39% to 0.34% of GDP (cumulative figures over 12 months).

The good performance by tourism will help the foreign sector in 2014 Q2. The main indicators show that tourism has started the high season in excellent shape. 6.1 million foreign

Labour cost per hour

Year-on-year change (%)



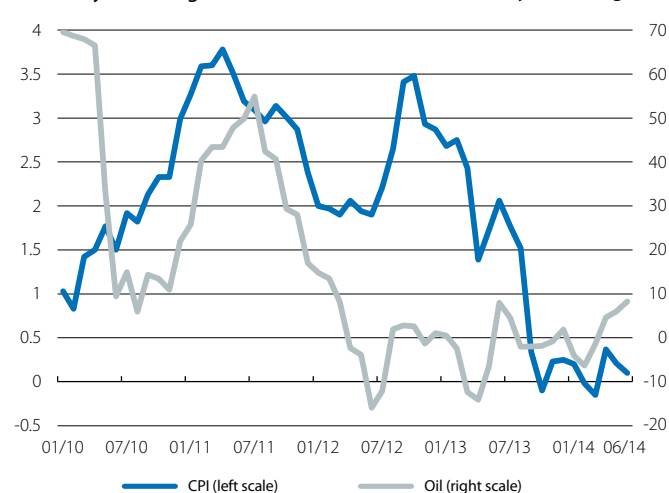
Note: Data seasonally adjusted.

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

Trend in the CPI and oil prices

Year-on-year change (%)

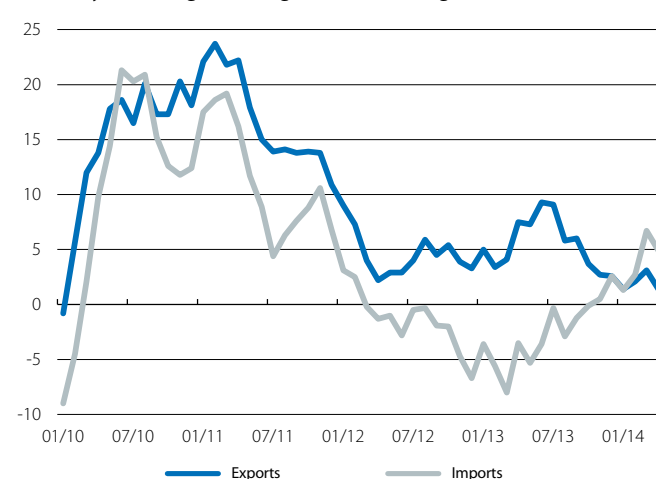
Year-on-year change (%)



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

International trade

Year-on-year change, moving 4-month average (%)



Note: Data seasonally adjusted.

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

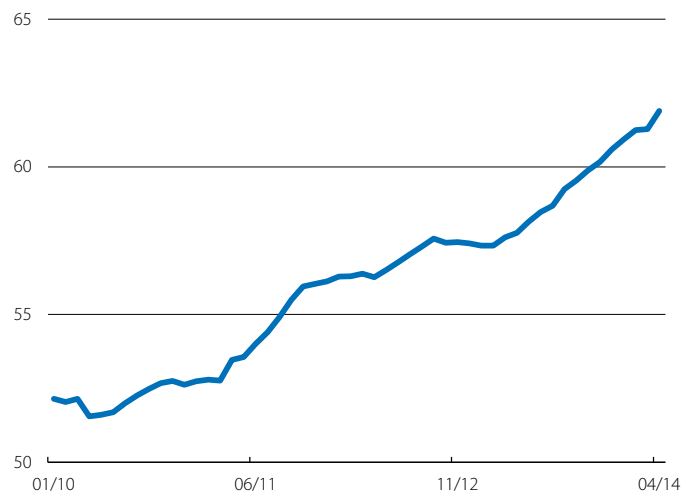
tourists came to Spain in May (62.3 million in cumulative figures over 12 months), particularly tourists from Europe, with all the evidence pointing to this trend increasing in the summer months, so that 2014 should see new records being set. It is also positive that the expenditure by international tourists is continuing to rise (3.5% year-on-year in May). Recently, moreover, there have been signs of domestic tourism starting to pick up. In May, the number of resident travellers in Spain grew at a very similar rate to that of foreign tourists (close to 5% year-on-year). This revival in tourism expenditure is yet another sign of the improved tone in consumption by Spanish households.

More credit is gradually being granted to households and SMEs. The completion of banking restructuring and the consolidation of economic growth are helping to support the recovery in credit. For example, new loans to SMEs continued to rise compared with last year. Specifically, during April 2.8% more credit was granted than in the same month in 2013. This revival in new loans helped to soften the rate of contraction in April's outstanding credit balance to 7.2% year-on-year (7.6% in March). The recovery in new loans is expected to take hold over the coming months as confidence in the Spanish economy's capacity to grow becomes stronger and as the asset quality review (AQR) and stress tests carried out by the ECB endorse the solvency of Spanish banks.

The public deficit is adjusting slowly, increasing to 2.5% of GDP in May, 0.1 percentage points less than the deficit in 2013. This slight improvement is due to tax revenue supported by the improvements seen in economic activity although expenditure increased, especially in intermediate consumption and subsidies. Having approved the tax reform for 2015, for which more details are provided in the Focus «Tax reform and public deficit adjustment», contained public expenditure will be crucial to ensure deficit targets are met. As with the state deficit, the trend in the deficit of the autonomous regions is turning out to be very similar to that of 2013. In this case, April's deficit was 0.1 percentage points more than in 2013. Given that the deficit target for 2014 is 5.5% of GDP, 1.1 percentage points less than the deficit of 2013, we should see some acceleration in the adjustment over the coming months.

Foreign visitor arrivals

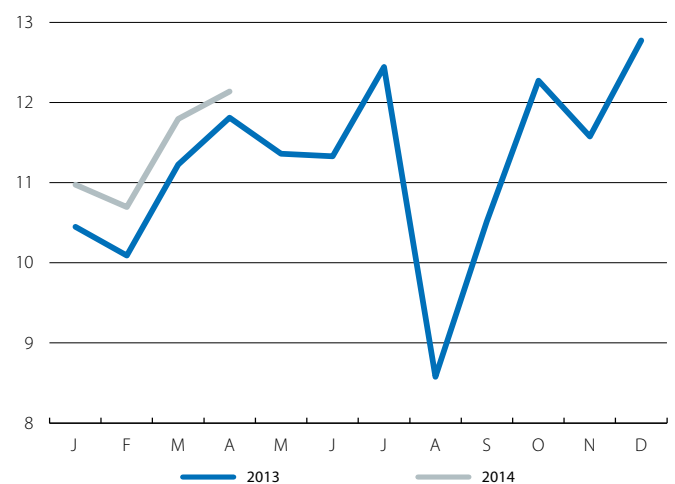
Cumulative figures over 12 months (millions)



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

New loans granted to SMEs

(Billion euros)

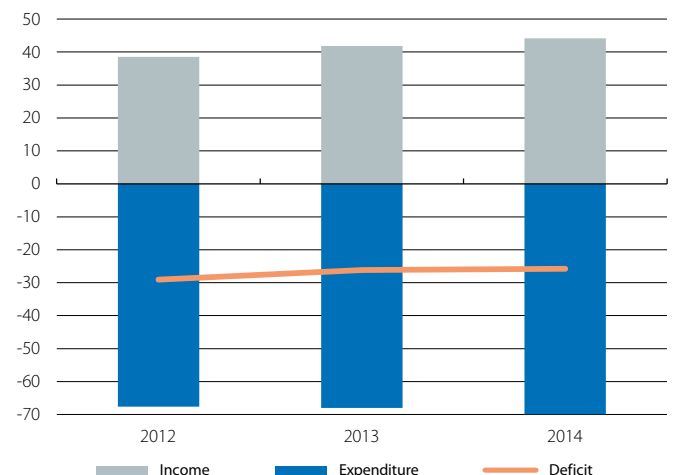


Note: Under 1 million euros.

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

Trend in the state deficit

Cumulative figures up to May (billion euros)



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

FOCUS · Investment in Spain: quantity, but quality?

Investment was one of the hardest hit by the economic crisis in Spain. Between 2007 and 2013, gross fixed capital formation (GFCF) fell by close to 40% in real terms, a clearly much larger drop than the one in GDP, namely 8%, and the relative weight of investment with regard to GDP went from 31% to 18%. Now that investment is starting to show signs of recovering, it is a good time to weigh up the situation.

In spite of this slump in investment, its current relative weight with regard to GDP is not any lower than in the main developed countries. However, what does seem to be an anomaly is its relative importance during the years prior to the crisis, as a result of the housing boom, with investment in construction accounting for 80% of GFCF. And it is precisely investment in construction that adjusted the most between 2007 and 2013: in 2014 Q1 it accounted for just 50% of all GFCF. Investment in capital goods and intangible assets, the other two large components, still have a similar relative weight with regard to GDP as the main developed countries. For example, in Spain this rose to 7.9% of GDP in 2014 Q1 while in Germany and the euro area as a whole its relative weight was 7.4% and the 7.6%, respectively.

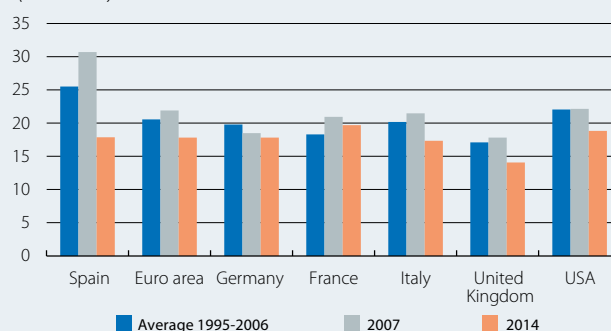
Consequently, the volume of investment does not seem to be Spain's main problem, at least when compared with the main developed countries. The quality of investment, however, is just as important. Although it is difficult to measure quality directly, the competitiveness indicators published by the World Economic Forum are useful as they help to identify where there is room for improvement. As can be seen in the table, Spain's ranking produced by the main indicators determining an economy's capacity to direct its resources towards the most efficient uses is not very good when compared with the main advanced countries.

Another determining factor of investment quality and quantity is the distribution of company size. Big companies normally invest a larger proportion of their resources than smaller companies and this difference is particularly noticeable with regard to R&D investment. According to data from the SEPA foundation for Spain's industrial sector, companies with more than 200 workers invested 1.3% of their revenue between 2008 and 2011, double what firms with fewer than 200 workers invested. Similarly, the quality of the investment carried out also seems to be better in general. According to the same source, large firms normally monitor innovation projects more thoroughly and their success rate is usually higher.

The evidence therefore seems to suggest that Spain could improve the quality of its investment. Competitiveness indicators offer key aspects in which the Spanish economy could improve. It also seems that larger company size would be a great help.

Gross fixed capital formation

(% of GDP)



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

Competitiveness indicators *

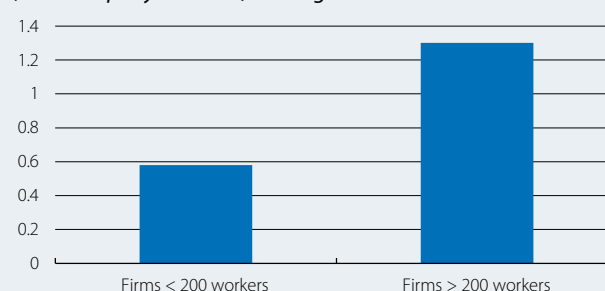
	Spain	Germany	USA	UK	France	Italy
Global competitiveness index	4.6	5.5	5.5	5.4	5.1	4.4
- Institutions	4.1	5.3	4.6	5.4	4.8	3.5
- Infrastructures	6.0	6.2	5.8	6.1	6.2	3.5
- Goods market efficiency	4.3	4.9	4.9	5.1	4.4	4.2
- Financial market development	3.7	4.7	5.3	5.0	4.6	3.3
- Innovation factors	4.1	5.6	5.4	5.2	4.8	4.2
Capacity for innovation	3.7	5.6	5.6	5.2	4.8	4.2
Quality of scientific research institutions	4.6	5.8	6.0	6.2	5.6	4.4
Company spending on R&D	3.4	5.5	5.4	4.7	4.7	3.6
University-industry collaboration in R&D	4.0	5.4	5.7	5.6	4.5	3.7
Government spending on R&D	3.2	4.3	4.3	3.6	3.6	2.7
Availability of scientists and engineers	5.2	4.9	5.3	4.8	4.8	4.7
Patents per million inhabitants	39.2	214.6	141.1	90.6	109.2	51.6

Note: * Index between 1 and 7 except the indicator for the number of patents. A higher figure indicates a better ranking.

Source: "la Caixa" Research, based on data from the Global Competitiveness Report 2013-2014.

Investment in R&D *

(% of company turnover). Average 2007-2011



Note: * Data from the Business Strategy Survey for industrial firms.

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

FOCUS · The improvement in Spain's household consumption is in full swing

The long expected recovery in the Spanish economy that started last year and has gradually built up steam has been accompanied by a considerable and somewhat surprising improvement in household consumption. Between 2013 Q3 and 2014 Q1, household consumption grew at a rate of 0.5% quarter-on-quarter on average, clearly more than the figure of -0.3% recorded between 2007 and 2012 and approaching the figure of 0.8% from 2000-2006.

This recovery in household consumption is closely related to a substantial rise in the consumption of durables. Consumption of this kind of product decreased the most during the recession, by almost 25% in real terms but now that confidence in the economy's ability to recover has once again taken root among the population, it is starting to make up the ground it lost. However, according to OECD estimates, between 2000 and 2006 an average of 10% of household consumption was on durables, similar to this type of consumption in the euro area or US. The share reached is just 6% at present, so there is still some way to go before it returns to its pre-crisis level.

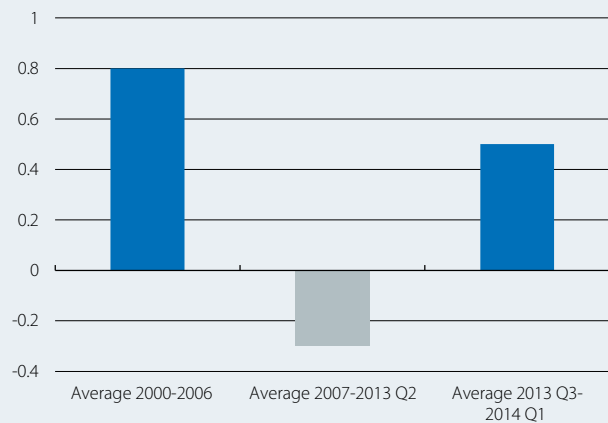
Automobile purchases are one of the main factors supporting the recovery in the consumption of durables. During the first six months of the year, 225,000 cars were sold to individuals, up by 23% compared with 2013. The government's approval of the PIVE 6 plan, with a budget of 175 million euros, and the continuing improvement in consumer confidence suggest this good rate of growth in sales will carry on over the coming months. The automotive industry, including all activities related to automobiles such as insurance and dealerships, represents 6% of GDP and employs almost 7% of Spain's labour force, so these recent consumption figures are particularly encouraging.

However, this sharp increase in the consumption of durables, and vehicles in particular, is resulting in a notable upswing in imports. As the proportion of goods imported in durables is higher than that for non-durables, it comes as no surprise that this recovery is being accompanied by higher growth in imports. For example, between January and March this year the increase in vehicle imports accounted for 22.8% of the total increase in goods imports.

The current account balance ended 2013 with a historical surplus of 0.7% of GDP but part of the improvement posted over the last few years was due to the fall in domestic demand and, in particular, to the slump in the consumption of durables. All this reminds us of just how important it is for the Spanish economy that its agents continue their efforts to improve competitiveness.

Growth in household consumption

Quarter-on-quarter change (%)

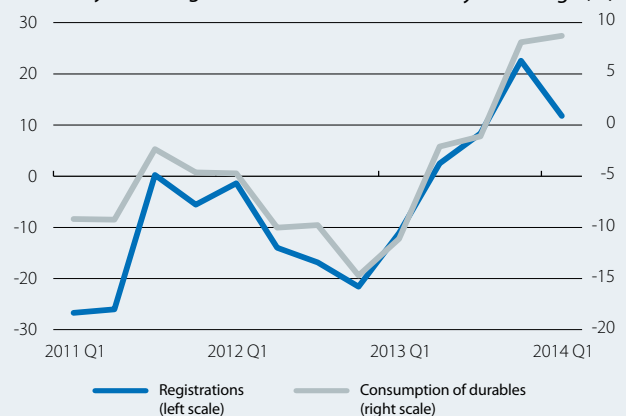


Source: "la Caixa" Research, based on INE data.

Consumption of durables and vehicle registrations

Year-on-year change (%)

Year-on-year change (%)



Source: "la Caixa" Research, based on data from the OECD and ANFAC.

External balance of vehicles *

Cumulative over 12 months (index 100 = January 2011)



Note: * In nominal terms.

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

FOCUS · Tax reform and public deficit adjustment

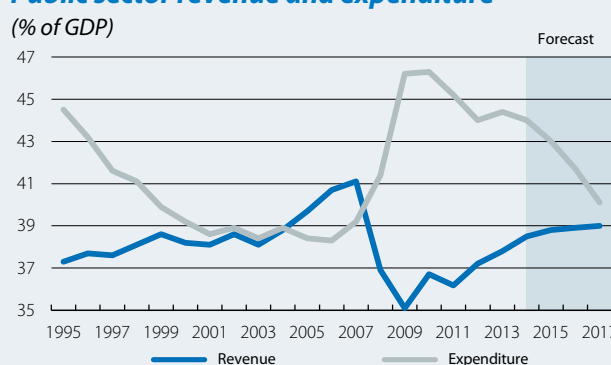
Although the correction in the public deficit over the last few years has been considerable, it is still only half the way there. Since 2009, when the deficit stood at 11.1% of GDP, it fell by 4.0 p. p. to 7.1% by the end of 2013. Consequently, it needs to fall a further 4.1 p. p. to reach at least the level of 3% agreed with Brussels. In this second part of the correction that has yet to be achieved, one of the questions that needs to be answered is how most of the pending fiscal adjustment should be distributed, by increasing revenue or reducing public spending.

A comparison at an international level provides no clear clues as to the appropriate level of public revenue and expenditure. In Spain, revenue for general government as a whole stood at 37.8% of GDP in 2013. This figure is clearly lower than Germany's, at 44.7%, and France's, at 51.8%, but is similar to the 37.7% of the United Kingdom and clearly higher than the 30.7% of the US. An international comparison provides no clues as to the appropriate level of public expenditure either: some countries spend more, others less. In a nutshell, the decision consists of determining what level of fairness and provision of public goods each country aspires to and how efficiently its public system can provide this. It is therefore necessary for decisions that alter this framework to any great extent or period of time to be accompanied by top rate public debate.

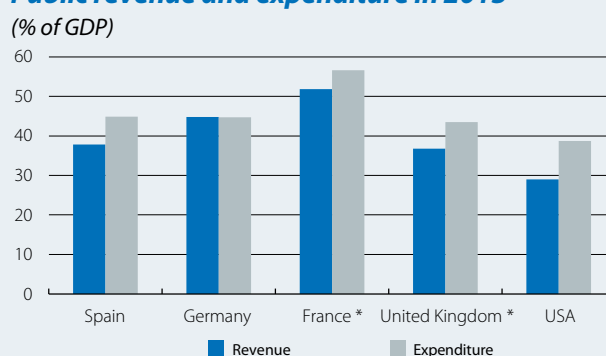
Given this situation, Spain's tax reform is facing a huge challenge: balancing traditional, long-term targets (related to the efficiency and fairness of the system as a whole, already potentially conflictive *per se*) with other short-term targets (increasing revenue at the same time as stimulating economic growth). The tax reform presented by the government has been extensive, substantially altering almost all the big taxes (see the table for a brief description of the main measures announced). Broadly speaking, the objectives pursued are to achieve a simpler and more transparent system that thereby improves its efficiency as well as to reduce fiscal pressure on people and companies to stimulate the recovery in activity and employment. According to the government's estimates, the reform presented will increase GDP by 0.55 p. p. between 2015 and 2016.

As part of the whole fiscal consolidation process, according to the government's calculations, revenue will increase by about 1% of GDP up to 2017 and will reach 39.0% of GDP. The leading light of this pending adjustment will therefore be public spending, which is planned to fall to 40.1% of GDP the same year. This is vital for the adjustment in the public deficit to continue on the right track.

Public sector revenue and expenditure



Public revenue and expenditure in 2013



Tax reform

Main measures

Income tax	<ul style="list-style-type: none"> Minimum rate: from 24.75% to 20% in 2015 and to 19% in 2016 Maximum rate: from 52% to 45% in 2016 Number of tranches: from 7 to 5
	<ul style="list-style-type: none"> General tax rate: from 30% to 27.5% in 2015 and to 25% in 2016
	SMEs: incentives that can reduce the rate to 20%
Corporate tax	Eliminating some deductions (reinvestment of extraordinary profit, etc.)
	New incentives linked to increase in net assets
	Rate of 30% maintained for financial institutions
VAT	<ul style="list-style-type: none"> Rate for sanitary products: from 10% to 21%
Earnings on savings	Generalised reduction, also in two phases (2015 and 2016)
	In 2016, the minimum rate will be 19% and the maximum 23%
	New €8,000 limit for exemptions due to pension plans
Combating tax fraud	Incentives for savings over more than 5 years for contributions under €5,000
	Publication of a bad debtor list

Source: "la Caixa" Research, based on data from the Tax Ministry and from the public administrations.

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	06/14
Industry									
Electricity consumption	-2.2	-2.1	-2.3	-2.4	0.1	-0.4	-0.5	1.6	...
Industrial production index	-6.6	-1.5	-2.5	-0.7	1.1	1.5	4.8	...	...
Indicator of confidence in industry (<i>value</i>)	-17.5	-13.9	-15.4	-12.8	-11.6	-9.1	-9.3	-8.0	-7.4
Manufacturing PMI (<i>value</i>)	43.8	48.5	47.6	50.5	50.1	52.5	52.7	52.9	...
Construction									
Building permits	-42.7	-21.4	-27.2	-24.0	-6.5	-8.9	13.9	...	...
House sales	-8.7	-2.7	0.7	-9.7	-9.8	-9.3	5.3	...	...
Services									
Foreign tourists	2.0	5.7	5.3	4.9	10.8	8.1	13.2	5.7	...
Services PMI (<i>value</i>)	43.1	48.3	46.5	49.3	51.8	54.2	56.5	55.7	...
Consumption									
Retail sales	-7.1	-3.7	-5.0	-1.8	0.4	-0.1	1.0	1.0	...
Car registrations	-13.5	5.6	2.5	8.3	22.6	11.8	28.7	16.9	...
Consumer confidence index	-31.7	-25.3	-28.7	-20.5	-19.4	-11.8	-7.8	-6.7	-3.9

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	04/14	05/14
Registered as employed with Social Security¹								
Employment by industry sector								
Manufacturing	-5.3	-4.3	-5.1	-3.9	-2.5	-1.3	-0.3	0.1
Construction	-17.0	-12.1	-13.8	-10.8	-7.9	-5.3	-3.0	-2.3
Services	-1.7	-2.0	-2.5	-2.1	-0.4	1.1	2.0	2.3
Employment by professional status								
Employees	-3.8	-3.8	-4.4	-3.9	-1.8	0.1	1.0	1.4
Self-employed and others	-1.4	-0.6	-1.1	-0.5	0.4	1.4	2.1	2.3
TOTAL	-3.4	-3.2	-3.8	-3.3	-1.4	0.4	1.2	1.6
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	24.7	20.9
Temporary	-4.0	6.4	6.0	7.1	15.0	19.4	11.3	13.1
TOTAL	-1.6	4.0	2.0	2.7	13.5	18.2	12.4	13.7
Unemployment claimant count³								
Under 25	4.5	-6.2	-6.1	-6.4	-8.0	-9.4	-12.4	-11.0
All aged 25 and over	11.7	3.7	5.2	2.3	-1.2	-3.7	-5.5	-6.1
TOTAL	10.9	2.7	4.0	1.5	-1.8	-4.2	-6.1	-6.5

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	06/14
General	2.4	1.4	1.7	1.2	0.1	0.0	0.4	0.2	0.1
Core	1.6	1.5	1.9	1.3	0.3	0.1	0.3	0.0	...
Unprocessed foods	2.3	3.6	4.3	6.0	0.7	0.7	-0.5	-2.7	...
Energy products	8.8	0.1	-1.1	-2.1	-1.1	-1.0	1.6	3.0	...

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 Q2	2013 Q3	2013 Q4	2014 Q1	03/14	04/14
Trade of goods								
Exports (year-on-year change)	3.8	5.2	11.9	4.4	0.8	3.2	1.7	-3.7
Imports (year-on-year change)	-2.8	-1.3	0.6	-0.6	2.0	7.0	15.4	-1.1
Current balance	-12.4	8.0	4.0	7.7	8.0	4.0	4.0	3.5
Goods	-27.8	-11.6	-14.5	-11.5	-11.6	-13.9	-13.9	-14.3
Services	37.6	40.9	38.7	39.3	40.9	41.6	41.6	42.1
Income	-17.9	-15.3	-15.0	-14.6	-15.3	-17.2	-17.2	-18.0
Transfers	-4.3	-6.0	-5.2	-5.5	-6.0	-6.4	-6.4	-6.3
Net lending (+) / borrowing (-) capacity	-5.8	15.8	12.1	15.6	15.8	12.5	12.5	11.7

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	04/14	05/14
Net lending (+) / borrowing (-) capacity	-10.6	-7.1	-3.0	-4.6	-7.1	-0.5	-	...
Central government ¹	-8.1	-4.9	-3.5	-4.0	-4.9	-0.9	-1.4	-2.5
Autonomous regions	-1.9	-1.5	-0.8	-1.0	-1.5	-0.3	-0.4	...
Local government	0.2	0.4	0.2	0.5	0.4	0.2	-	...
Social Security	-1.0	-1.2	0.8	-0.3	-1.2	0.3	0.5	...
Public debt (% GDP)	86.0	93.9	92.2	93.3	93.9	96.8	-	...

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	2014 Q1	04/14	Balance 04/14 ¹
Financing of non-financial sectors²								
Private sector	-4.0	-7.8	-8.2	-8.1	-7.4	-6.1	-5.9	1,820.5
Non-financial firms	-4.1	-9.8	-10.5	-10.2	-8.7	-6.4	-6.3	1,048.9
Households ³	-3.8	-4.9	-4.8	-5.0	-5.5	-5.6	-5.3	771.6
General government ⁴	14.9	17.0	18.5	17.5	13.1	8.6	7.4	982.8
TOTAL	0.6	-0.9	-0.9	-0.9	-1.4	-1.4	-1.6	2,803.3
Liabilities of financial institutions due to firms and households								
Total deposits	-4.5	2.1	1.8	4.7	2.2	0.2	-1.0	1,162.4
On demand deposits	0.2	4.2	3.2	4.6	8.1	7.4	4.5	285.8
Savings deposits	-2.8	-0.1	-1.1	-0.2	1.4	3.8	5.0	204.0
Term deposits	-6.7	1.7	1.6	5.7	0.2	-3.6	-5.0	652.3
Deposits in foreign currency	-4.0	16.8	22.7	24.1	-0.1	-1.1	2.2	20.3
Rest of liabilities ⁵	-13.2	-16.8	-19.2	-15.3	-12.7	-11.1	-11.1	125.3
TOTAL	-5.7	-0.2	-0.9	2.3	0.5	-1.1	-2.1	1,287.7
NPL ratio (%)⁶	10.4	13.6	11.6	12.7	13.6	13.4	13.4	-
Coverage ratio (%)⁶	73.8	58.0	65.8	63.8	58.0	58.6	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.

COMMODITIES: A SOURCE OF GROWTH

The trend in commodities: a long-term view

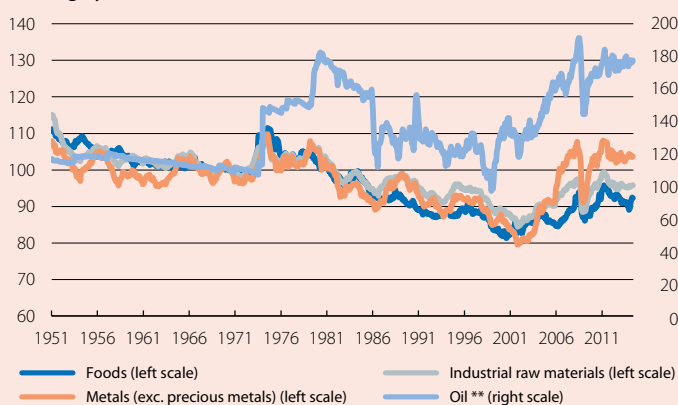
Over the last few decades the trend in commodity prices has been the object of recurring debate in international academic, financial and political circles although the intensity of this discussion has been intermittent: greater during periods of sharp rises or falls in prices and less so at more stable times. Round about the financial crisis of 2008 there was therefore a highly agitated period due to the dramatic rise and slump experienced simultaneously by numerous commodity prices. The last two years have been much calmer, helping to evaluate the medium and long-term dynamics without the distortions, and particularly the short-sightedness, inherent in volatile periods getting in the way. The overriding view in 2008, still very widespread today, is that we are witnessing abnormally high prices in historical terms for commodities in general. However, an analysis of the series of prices in real terms shows that this impression is misleading. Price increases over the last fifteen years have converged towards the average long-term level for commodities as a whole while there is also a notable discrepancy in patterns between different products when these are examined in perspective.

Certainly, since the start of the 21st century, the rise in prices in real terms (deducting the general inflationary component) has been acute in almost all commodities. But we must remember that, in the previous period between the middle and end of the 1990s, these products recorded their lowest prices in decades and in some cases were at an all-time low. Two questions spring immediately to mind: what causes such long-term fluctuations in commodity prices, and is this behaviour likely to be repeated after a specific period? Several academic studies have attempted to answer these questions, identifying the presence of long and short-lived cycles caused by the dynamics of supply and demand in each market. These, in turn, have been heavily influenced by the episodes of accelerated economic growth occurring throughout history: the industrial revolutions of the 19th and 20th century, the (re)urbanisation in western countries after the Second World War and the vigorous expansionary cycle of emerging economies starting at the end of the last century. In fact, the economist D. Jacks documents that long-term commodity cycles, in the jargon known as «supercycles»,^{1,2} are periods lasting between 30 and 35 years on average, whereas short-term cycles generate fluctuations around the long-term component, lasting between approximately 4 and 5 years, and are thereby fundamental to explaining volatility and bubbles forming and bursting.

In supercycle terms, not all commodities have evolved in the same way, in accordance with the patterns of supply and demand specific to each market. Commodities are normally divided into four broad categories: energy (oil, gas, coal, etc.), metals (copper, steel, zinc, tin, gold, silver, etc.), industrial raw materials (rubber, resin, cotton, leather, etc.) and foods (cereals, oils, animal fats and meat, etc.). Energy products, dominated by crude oil, and metals are the groups recording the highest rises in real prices from a long-term perspective while, at the other end of the scale, we find industrial raw materials and foods, which have experienced a notably downward trend. Two important determining factors help to explain this divergence. In terms of demand, the composition of global growth has pushed up the price of energy and metals over the last 20 years and enhanced differences. In particular, since the middle of the 20th century the countries that today make up the so-called developed block have based most of their growth on an expansion and extension of the services sector, as well as manufacturing with a high technological component. This contrasts with the strong expansionary cycle undertaken by emerging countries at the end of the 1990s, characterised by the intense use of production factors related to energy, metals and their derivatives. For its part, the demand for agricultural

Trend in the real price * of commodities

(Average year 1970 = 100)



Notes: * Series deflated by the USA consumer price index (USA CPI Urban Consumers Index).

** Barrel of crude WTI (West Texas Intermediate).

Source: "la Caixa" Research, based on data from Bloomberg, Thomson Reuters Datastream and the St. Louis Federal Reserve.

1. For a detailed, thorough explanation of supercycle theory see Jacks, D. (2013) «From Boom to Bust: A Typology of Real Commodity Prices in the long Run», National Bureau of Economic Research, Working Paper Series no. 18874, and Cashin, P. and C.J. McDermott (2002), «The Long-Run Behavior of Commodity Prices: Small Trends and Big Variability.» IMF Staff Papers 49(2): 175-199.

2. See Pedreira, J. and Canela, M.A., (2012) «Materias primas: ¿Qué cambió en la última década?» Working Document 06/2012, Research Department, "la Caixa", for an analysis and comparison of commodity cycles.

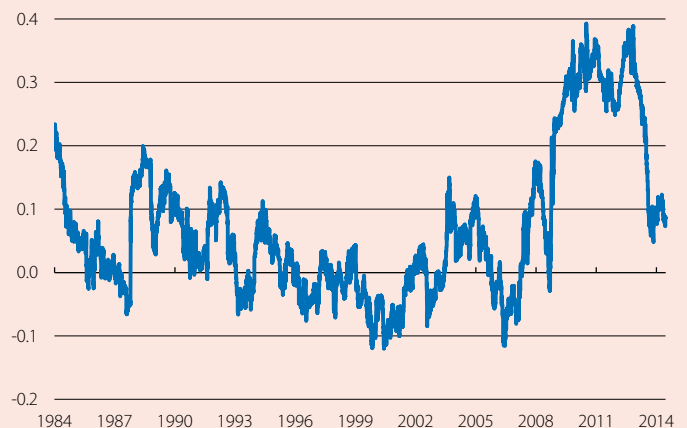
commodities has seen slightly smaller rises than the aforementioned cases as the tendency to consume these products tends to decrease as a country leaves behind the initial stages of economic development and progress. Regarding supply factors, the rising cost of extracting and exploiting energy and mineral resources, often located in regions with considerable geopolitical conflict, helps to keep prices at higher levels, in turn making them less able to adjust when faced with sudden changes in the patterns of demand (or, which is the equivalent, making supply relatively inelastic). Conversely, the supply of food products and crops (cotton, etc.) is generally better able to adapt to fluctuations in demand due to lower fixed costs and greater flexibility in intermediate factors of production. In addition, the strong gains in productivity made by agriculture after a wave of technological and organisational innovations from the Green Revolution have consolidated these products' weakness in price terms over the last few decades.

Notwithstanding these differences in the dynamics of supercycles, the beginning of the new century also saw the start of a period of greater correlation between prices.³ One possible explanation lies in the technological changes in processes leading to an increasing use of common inputs (especially energy itself) in extracting or producing different commodities.⁴ But a more plausible explanation for this greater correlation is commodity «financialisation». Professional portfolio managers and institutional investors have always tried to allocate part of their funds to acquiring commodities, attracted by the low correlation that, historically, has been observed between these and traditional financial assets (equity and bonds), thereby helping to diversify the risk of their portfolios. Since the mid-2000s, this possibility to diversify has become available to retail investors thanks to some innovations such as derivatives (futures and options) and ETFs (exchange-traded funds) for commodities. Paradoxically, correlations have increased precisely due to the growth and popularity of these instruments. Indeed, «financialisation» has led to even greater volatility and correlation in commodity prices over the last few years due to contagion from other parts of the financial markets, sometimes distorting the normal functioning of the mechanisms of end supply and demand.⁵ Many empirical studies show that such pseudo-financial flows affect the conditions of commodity markets in the short term but are not conclusive when establishing a cause and effect relationship between the degree of «financialisation» of commodities and the medium to long-term level of prices. Moreover, some of the recent reforms made to the international financial system have reduced the links between commodities and financial markets. For example, the new rules regarding operations in derivative markets and restrictions to proprietary trading by banks. Some signs are already pointing in this direction: according to data from the BIS, the outstanding balance of over-the-counter (OTC) derivatives on commodities at the end of 2013 totalled 2.21 trillion dollars, below the figures of 2.6 trillion at the end of 2012, 2.9 trillion in 2009 and the peak of 8.5 trillion reached in 2007.

In summary, both from the point of view of supercycle dynamics and the effect of «financialisation», the forces expected in the coming years point to much more stable prices (in real terms) than those observed over the last fifteen years, in line with the historical averages.

Correlation between commodities and stock markets

Correlation coefficient of daily gains in the S&P 500 and CRB commodity index



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

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3. McKinsey Global Institute (2013), «Resource Revolution: tracking global commodity markets».

4. The planting of corn or sugar cane to make bioethanol is a good example. According to data from McKinsey, between 15% and 30% of the total cost of producing corn corresponds to the energy factor.

5. Cheng, Ing-Haw & Xiong, Wei (2013), «The Financialization of Commodity Markets», National Bureau of Economic Research, Working Paper No. 19642. The authors argue that the positive effects associated with better risk sharing resulting from commodity derivatives can be offset by problems of asymmetrical information in futures markets.

The curious case of rare earth: a non-crisis

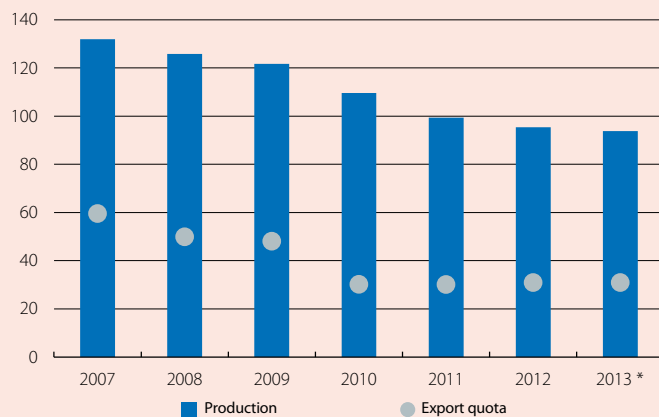
In your new mobile phone, the chips of your computer, the LED light bulbs in your house and the engine of your next electric or hybrid car (depending on how ecological you are): no matter how surprising it may seem, «rare earth», a group of singular metals, already forms part of your everyday life. Apart from their growing importance for industrial applications, rare earth elements are affected by another remarkable fact: to date, mining has been confined to very specific locations, dominated by China. Even so, and in spite of the media frenzy, we are unlikely to see a rare earth «fever» or «war».

Scandium, yttrium and another 15 metals from the family of lanthanides make up the group of chemicals known as «rare earth elements». However, despite their name they are not earth and neither are they particularly rare as there is a large supply of them in the earth's crust and most had already been discovered and classified by the end of the 19th century. But, unlike other metals such as gold or silver which form independent minerals, rare earths are found in very low concentrations inside other

minerals and are often mixed together, making them more difficult to extract and refine. In particular, these processes require large amounts of toxic acids, generating radioactive waste that is hard to control. Nor were these elements extensively used outside the laboratory until well into the second half of the 20th century but, in the last few decades, most rare earths have become essential inputs (albeit in minuscule amounts) of numerous high tech devices. Three areas particularly stand out: latest generation consumer electronics; the defense industry, especially communication systems related to missiles and drones; and the clean energy sector as they form part of the magnets used in engines for hybrid cars and in wind turbines.

China: rare earth production and export quotas

(Thousands of tonnes)



Note: * Estimate.

Source: "la Caixa" Research, based on data from The Economist and Bloomberg.

Although the presence of rare earths in a large number of everyday products worldwide is a fact, their extraction is almost totally limited to a single country, China, with more than 90% of the world's production. This is a relatively recent supremacy since, at the beginning of the 1980s, the US was

the main producer of rare earth thanks to Mountain Pass, a mine on the sunny Californian coast. However, growing competition from the Asian giant and a large amount of criticism regarding environmental safety led to the US mine being closed down in 2002. China's permissiveness in environmental terms is precisely what has given the country a firm advantage in mining rare earth elements since, as we have already mentioned, this is extremely toxic for the environment. In addition to this permissiveness there is also the fact that China's reserves of rare earth are very large (around 40% of the world's total), as well as having a public policy that has extensively supported the development of mining with huge investment and also low labour costs. In addition to being the main producer, China is also the world's biggest consumer of these elements, accounting for 70% of the total. Undoubtedly this is closely related to the leading role played by the country in «Factory Asia», one of the most integrated and extensive global manufacturing chains in the world, made up of numerous countries in South East Asia and specialising, precisely, in electronic products (see the article «China, at the heart of "Factory Asia"», in the Dossier in June's Monthly Report, 2014).

Given this dominant situation and the country's own strong demand, China has often been accused of abusing its position. In March 2012, Japan, the US and the EU jointly filed a complaint with the World Trade Organization (WTO) as a result of the rare earth export restrictions imposed by the Chinese government since 2010 (see the first graph), restrictions that, initially throughout 2011, led to a surge in the price of many of these metals in the international market. This was caused by stockpiling due to fears of subsequent (and perhaps tougher) restrictions by the Asian country (see the next graph). It should be noted, however, that China constantly justified its actions by the need to reduce the toxic emissions produced by extracting rare earth elements and to protect its environment. Certainly the country's dominance over the production of rare earth was based on numerous medium-sized and small mines that did not sufficiently meet the safety conditions to guarantee the toxic substances they produced were under control and should therefore be forced to close down. Whatever the exact, detailed reasons for these restrictions and although, this March, the WTO ruled on behalf of the plaintiffs, what is true is that, for four

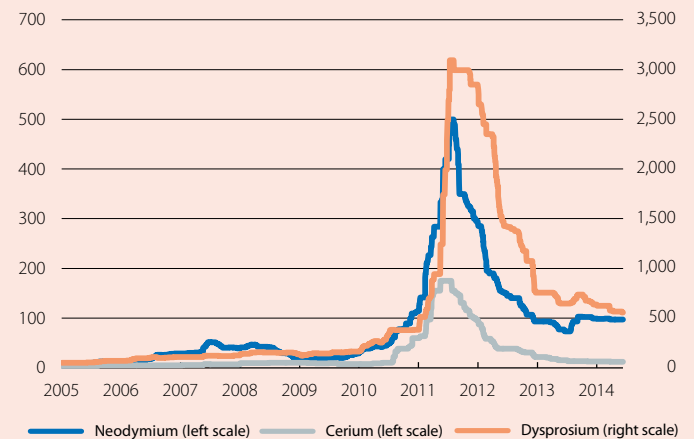
years now China and in particular its electronics manufacturers have benefitted from a lower price for rare earths (one of their production inputs), providing them with an edge over their foreign competitors.

A few months after the start of restrictions by China, prices returned to more moderate levels once it was realised that these limitations were not excessive. Nonetheless, the reactions came thick and fast. The US reopened Mountain Pass at the end of 2010, Australia started to increase its production in the west of the country and Canada has carried out numerous prospection projects, proving that the geographical distribution of the world's rare earth reserves extends beyond China's borders. For its part, Japan has strongly promoted the recycling of these metals, as well as research into their potential replacements; support that, last May, took an important step forward with the presentation of new batteries that, in addition to being economical, recyclable and high performance, did not contain rare earth.

In short, and although the future is still uncertain, we are unlikely to see further episodes of volatility in rare earth prices such as those observed in 2011. This argument is based on three conclusions. Firstly, China has shown no sign of insisting on restrictions to rare earth exports. Ultimately, some kind of understanding with the US, Europe and Japan is essential for the Asian country's own welfare as its high tech exports are consumed, precisely, by the citizens from these three markets. New mines opened far and wide across the globe will also help to stabilise prices. Lastly, technological breakthroughs look like reducing today's dependence on rare earth in producing advanced electronics and developing renewable energies.

Rare earth prices

Dollars per kilo



Note: Some of the most plentiful or common rare earth elements.

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

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Could Latin America withstand a downturn in commodities?

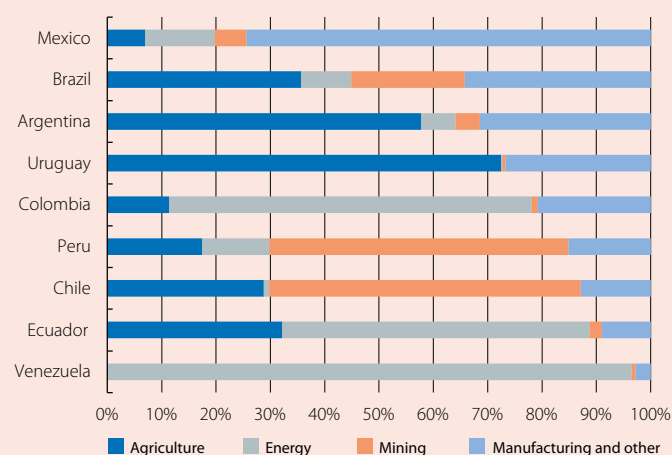
On the whole, Latin America has benefitted from a boom in commodity prices over the last few years. The region is an important supplier of a large number of products for the agricultural, mining and energy industries that make up the basket of international commodities, whose nominal value almost doubled between 2003 and 2013. The real rise (discounting inflation) reached 50%, thereby helping to improve these countries' real terms of trade. The prospect of prices softening (see the article «The trend in commodities: a long-term view» in this Dossier) raises the question of to what extent the region's main economies can withstand this new scenario, as well as the responses that might be made by economic policy.

To analyse this issue, a good starting point is by taking a look at the most important countries' dependence on commodities. A recent report by the IIF combines an overall view of the situation with details to draw some revealing conclusions.¹ The first is that Mexico does not seem to be very vulnerable: while in most of Latin American countries exports of commodities represent between 97% and 66% of all international sales, in Mexico they only account for 26%.

But the other countries analysed –Argentina, Brazil, Chile, Colombia, Ecuador, Uruguay and Venezuela– do show a high dependence on commodity exports. Moreover, it is possible to analyse these vulnerabilities even further if we consider that concentrating exports in just a few products is an added risk factor. The general tone observed is that, unfortunately, a small number of product categories concentrate most exports at a national level. With the exception of Brazil, which benefits from a relatively diversified product portfolio, between 60% and 70% of each country's exports are of only one type of commodity: Argentina and Uruguay specialise in agriculture; Venezuela, Colombia and Ecuador in oil and other energy products; and Chile and Peru in mining (see the graph).

Exports by product type

(% total exports)



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

Having reached this point in our analysis, the next step is to quantify the possible impact on economic growth of any price changes in commodities, an exercise that has actually been carried out by another recent study, this time by the IMF.² The Fund has analysed the relationship between commodity prices and economic growth in Chile, Peru, Ecuador, Uruguay, Brazil, Colombia and Bolivia under three different scenarios. The first is where «stable prices» dominate, with commodity prices remaining constant at their 2013 average levels. The second, in which the IMF assumes a moderate decrease, is based on the market prices of commodity futures at the time of the study (February 2014). Lastly, the third adverse scenario assumes that all commodity prices fall by 10% more than those implied by the «futures» scenario. The general conclusion drawn from this analysis is that, even in the most benign scenario (namely «stable prices»), projected growth for 2014-2019 would be lower than that recorded in 2003-2013. Specifically, it would be 1.2 percentage points lower in the «stable prices» scenario, 2 points lower in the «futures» scenario and 2.5 points lower in the adverse scenario, as shown in the graph.

To throw some light on different countries' sensitivity to commodity trends, the IMF also provides explicitly individualised information on projected growth under the «stable prices» scenario. Even under this scenario, all the countries analysed would see a slowdown in growth in 2014-2019 compared with their average in 2003-2013. Specifically, the order of countries, from the most to the least affected, is as follows: Peru, Ecuador, Bolivia, Uruguay, Brazil, Colombia and Chile.

Taken as a whole, the results of the IMF study show that South America is relatively sensitive to commodity price shocks and, should the most adverse scenario take place, it would see its growth reduced to less than half that recorded in 2003-2013. However, the Fund itself admits that the model used for its estimates may be magnifying the negative impact to some degree since it does not take into account the improvements made over the last few years in the framework of economic policy in many of the region's countries.

1. Institute of International Finance (2014), «Latin America: We're Not In Kansas Anymore».

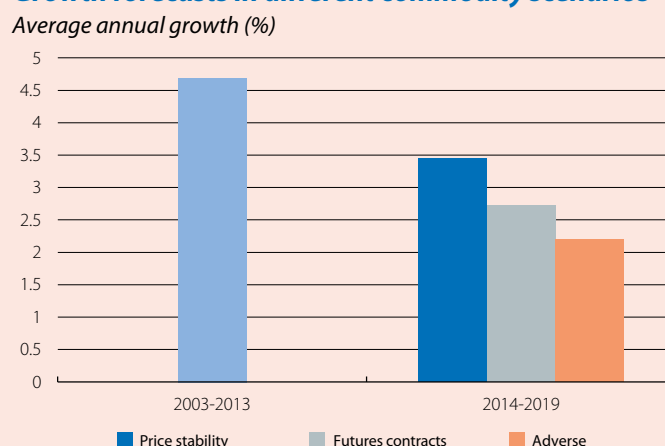
2. International Monetary Fund (2014), «Regional economy outlook. Western Hemisphere».

This issue has been tackled by a third study, in this case by the BIS.³ Traditionally, emerging countries have been less able to implement contracyclical policies than developed countries with a more solid economic policy framework. Many Latin American economies, as well as emerging economies in other regions, would typically have highly procyclical policies, accentuating very volatile growth profiles. The classic pattern was one of fiscal policy managing to gain leeway during boom periods with monetary policy often subordinated to the former. This situation has been gradually changing as many emerging economies, including Latin America, have built up a much stricter fiscal framework, strengthening their central banks with the aim of controlling inflation.

The BIS confirms that, since 2000, numerous emerging economies have been able to successfully adopt contracyclical policies. In fact, in some cases they have even achieved the intensity seen in advanced economies. The BIS estimates are based on data from 2000 to 2011 for Brazil, Mexico, Colombia, Peru and Chile. One initial conclusion is that the degree of countercyclicity in the monetary policy of the first three countries is similar to that shown in many countries within the euro area. The case of Chile stands out, however: its fiscal policy has the most active role in compensating the ups and downs of the cycle, to an extent that is actually greater than that observed in most euro area countries. This is the positive result of gradually building up what is probably the best economic policy in Latin America to guarantee macroeconomic stability.

In short, and going back to our initial question, could Latin America withstand a downturn in commodities? The answer is that, in general terms, the impact of a sharp drop in prices would also be seen on their growth rates. Fortunately, this hypothetical situation would occur at a time when many of these countries are benefitting from significantly more solid economic policy frameworks than in previous decades. Even if there is no sharp drop in commodities, which is a more likely scenario, they clearly have a lot of leeway to take countercyclical action, which will be crucial in the future.

Growth forecasts in different commodity scenarios



Note: Simple average for GDP growth in Bolivia, Brazil, Chile, Colombia, Ecuador, Peru and Uruguay.

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

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3. Takáts, E. (2012), «Countercyclical policies in emerging markets», BIS Quarterly Review, June.

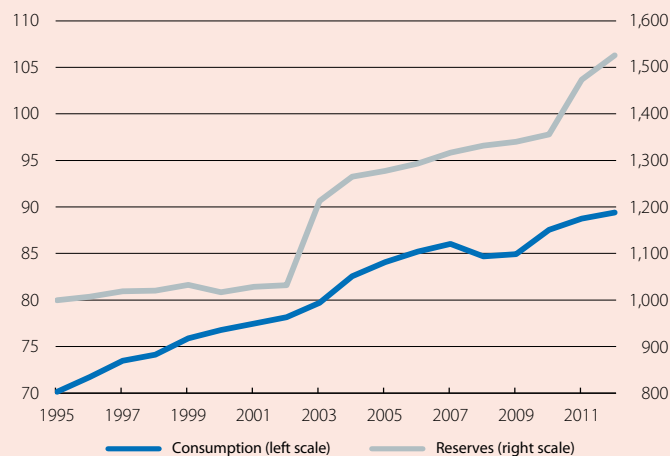
Oil: stability has a price

The resurgence of conflict in Iraq has set off alarm bells in the international oil market. The possibility of military escalation in the heart of such a critical region as the Middle East has led to fears of another episode of tensions for crude. And rightly so: Iraq is the world's eighth largest producer of petroleum (3.4% of global production) and provided most of the increase in OPEC's crude production between 2008 and 2013. However, it is also true that, over the same period, the increase in oil extracted in the

US and Canada was five times greater than in Iraq. Perhaps for this reason the Brent's rise from 108 to 114 dollars in the third week of July could be considered moderate compared with the spectacular upswings occurring in past conflicts. Although the Iraqi conflict may cause oil prices to fluctuate for the remainder of 2014, the underlying trend points to a relatively calm evolution over the coming years. This does not mean we expect cheap petroleum: Brent is still close to its all-time high, both in nominal and real terms, and will stay there. In other words, we expect oil to still be expensive but without any huge fluctuations. The reasons for this stability, unprecedented in the last few decades, lie in the changes occurring both in supply and demand. On the supply side, the last few years new oil fields have appeared outside the scope of OPEC while the transformations occurring in China and India, both heavy consumers of energy, are key to demand, particularly their increasing use of other sources of energy such as hydroelectricity and natural gas.

Oil: consumption and global reserves

(Millions of barrels a day)

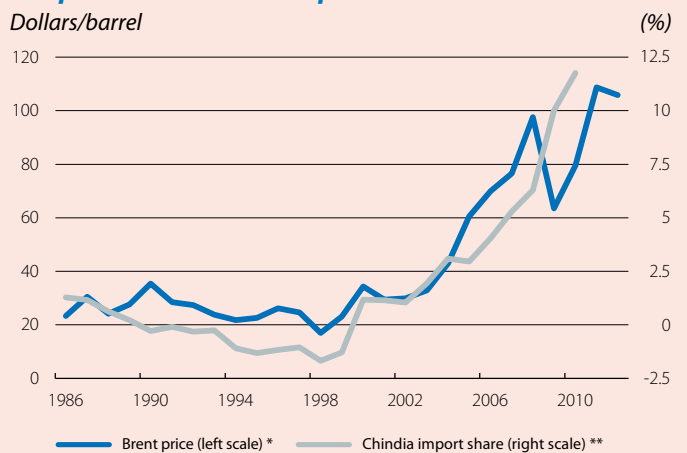


Source: "la Caixa" Research, based on data from the EIA (Energy Information Administration).

The technical viability of extracting oil from alternative sites to those in the Middle East means that reserves are growing faster than consumption. Whereas the world's consumption of oil rose by 17% between 2000 and 2012, reserves grew by more than 60% (consumption accounted for 7.6% of global reserves in 2002 but just 5.9% in 2012). However, this increase in reserves has not brought down the price of Brent, as the average in 2013 was three times greater than in 2000 (deflated by the US GDP deflator). Why? Because, in order to extract petroleum from these new sites, expensive and contaminating techniques have to be used such as fracking, which obtains petroleum and gas trapped within layers of shale in the subsoil. This high extraction cost compared with traditional methods means that it is only profitable to exploit such sites if oil is expensive. Should prices fall, extraction is no longer worthwhile and supply shrinks, giving oil a relatively high floor price. But when oil prices rise, extraction becomes profitable. Consequently, supply increases and this places a ceiling on prices.

The geographical diversity of the sites also helps to contain prices as it reduces geopolitical risk. The US and Canada are the prime example of this greater supply. Thanks to fracking, the two countries increased their crude production from 11.9 million barrels a day in 2008 to 16.4 million in 2013. These figures are extremely significant. On the one hand, this means that the US and Canada already provide 18.2% of the world's production in absolute terms; on the other, they contributed 80% to the growth in the world's supply over the same period. This makes them increasingly important as regulators of the international price of crude, a role which, until very recently, was reserved for Saudi Arabia (11.6 million barrels a day in 2013). Proof of this greater North American flexibility is the historically upward trend in the percentage of crude consumption covered by imports, which has been downward since 2008.

Oil: price and Chindia imports



Notes: * Brent spot (annual average) deflated by the USA GDP deflator.

** Difference compared with the trend of 1986-2004.

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

The patterns in global demand also point to stable oil prices. The factor affecting global demand for crude the most over the last decade has been the emergence of China and India (Chindia) as heavy consumers of energy due to their rapid economic growth. It is estimated that Chindia will contribute 60% to the increase in the world's consumption of petroleum between 2010 and 2020. Chindia's influence is not new: it has been a big net importer of oil for years and the explosive acceleration in its share of imports in relation to the world total since 2004 has occurred in parallel with the rises in oil prices between that year and 2011 (the exception is 2009, a time of deep crisis in international trade due to the Great Recession). This points to a strong link between Chindia's demand for oil imports and crude prices.

However, the changes being observed in Chindia's energy structure augur a calm evolution in crude prices thanks to a very powerful phenomenon: between 2010 and 2020 these countries' use of natural gas (requiring less investment to extract) and hydroelectric and nuclear energy (benefitting from technological advances in battery life and less environmental impact) will grow more than their consumption of oil. Admittedly, the reduction in the relative share of coal (a particularly dirty source of energy) from 65% of Chindia's energy needs in 2010 to 60% in 2020 will be partly covered by oil but the first effect is stronger than the second, so that the share of petroleum fuels will shrink (from 20.6% to 19.3% of the total) at the same time as an increase in natural gas (from 4.9% to 5.6%) and especially hydroelectric and nuclear energy (from 9% to 15%). These figures may seem modest but, in terms of implicit growth rates, they can lead to huge variations in the energy scenario.

In fact, these patterns of transformation in Chindia's energy structure will also be observed at a global level; to a lesser extent, certainly, but enough to support the scenario of relatively stable crude prices. Another contributing factor will be slower economic growth in the US and especially in Europe compared with that of the emerging economies. The US and Western Europe tend to use oil to meet their energy needs to a greater extent than in Asia (39% and 37% for the US and Western Europe in 2010 compared with 25%). Consequently, this relatively slower growth will mean that, on the whole, the demand for oil will rise more slowly than that for hydroelectric or nuclear energy and natural gas.

There are three key events that could upset our scenario of expensive but stable oil: one that would push prices up, the other pushing prices down and the third being somewhat ambiguous. Firstly, if tensions in the Middle East end up destabilising Saudi Arabia, the effect on supply would magnify and oil would become significantly more expensive. Secondly, although China has to import half the oil it consumes, if its on- and offshore extraction projects manage to increase production considerably, we might see crude coming down in price. And thirdly, albeit to a lesser extent, cyclical aspects such as a less gentle slowdown in the Chinese economy than expected or, on the other hand, an acceleration in activity in the advanced economies could also affect oil prices.

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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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