

MR09

MONTHLY REPORT • ECONOMIC AND FINANCIAL MARKET OUTLOOK

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ECONOMIC & FINANCIAL ENVIRONMENT

FINANCIAL MARKETS

Frontier markets: a fast-growing investment option

INTERNATIONAL ECONOMY

Should we be concerned about China's property market?

EUROPEAN UNION

Securitisation: a key role in stimulating credit?

SPANISH ECONOMY

The improvement in the current account balance comes to a halt

DOSSIER: LOW REAL INTEREST RATES AND ECONOMIC STABILITY

Real interest rates and growth prospects

The temperature is rising in international financial markets: bubble or just a hot spell?

Are international property markets overheating?

Macroprudential tools, the great unknown

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September 2014

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Rock bottom interest rates: a blessing or a curse?

The latest decisions taken by the European Central Bank have placed all the main advanced economies in a situation of extremely low nominal interest rates. This phenomenon has not only influenced monetary interest rates of under one year but has also affected the whole interest rate curve, to such an extent that yields for high quality 10-year government bonds are now between 1% and 2.5%, indicating that investors are expecting money market interest rates to remain low for quite some time.

If we deduct inflation expectations for the corresponding period from these nominal rates we get the real interest rate. Although inflation expectations are minimal, the low level of nominal interest rates means that real rates are in negative terrain, especially for the shorter terms.

This *Monthly Report's* Dossier examines the main reasons as to why this situation has occurred as well as what it means for some of the key asset markets. Such debate is of huge importance since, without a good diagnosis, it is very difficult or even impossible for the right economic policies to be implemented.

There are essentially two opposing views in the controversy regarding the causes. The first, proposed by Keynesian economists, argues that excessive global savings have led to a situation where the equilibrium in western economies (seen as the existence of enough demand to achieve full employment) is only possible if real interest rates are negative. As this equilibrium is not easy to achieve by monetary policy alone (nominal interest rates do not go below zero and it is both complicated and dangerous to generate higher inflation expectations), these economists argue that the solution is through fiscal policy. They also claim that a low interest rate environment makes it easier to finance the resulting deficit which, on the other hand and in their opinion, would not be very large as the expansion achieved by the economy would also result in more revenues.

The alternative view is provided by so-called neo-classical economists. They believe that such extremely low interest rates, with which conventional monetary policy has used up all its room to manoeuvre, are the result of many years, at least two decades, of excessively accommodative monetary policy that has encouraged economic growth above the true potential of economies, as well as resulting in worrying levels of debt. According to this analysis, improvements in the population's living standards have been based on growing debt and not on the generation of more production and wealth. On the one hand, such policies have led to recurring speculative bubbles and financial crises, the last with a huge impact on the real economy. And, on the other hand, they have led monetary policy into a dead end, forcing it to enter the uncertain terrain of unorthodox monetary policy with central banks directly purchasing public debt, something that would have been intolerable a few years ago.

This second view warns of the effect of demand-based economic policies which, it believes, lie at the root of the problem. From this perspective, the political system of modern democracies is incapable of withstanding the long period of low growth and deleveraging required by the current situation and the injection of further stimuli, or the continuation of existing ones, would sow the seed for future episodes of serious economic and financial instability. In short, exceptionally low interest rates propose a huge dilemma for economic policy. They are both a blessing and a curse.

Jordi Gual
Chief Economist
31 August 2014

CHRONOLOGY

JULY 2014

- 15** The sixth BRICS summit establishes the ground rules of the **New Development Bank for development projects and the creation of a Contingent Reserve Arrangement** allocated 100 billion dollars.

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**.

AGENDA

SEPTEMBER 2014

- 2** Registration with Social Security and registered unemployment (August).
4 Governing Council of the European Central Bank.
10 Industrial production index (July).
16 Quarterly labour cost survey (second quarter).
17 International trade (August).
 Fed Open Market Committee.
18 Loans, deposits and NPL ratio (July).
29 Economic sentiment index of the euro area (September).
 Flash CPI (September).
30 State budget expenditure (August).

OCTOBER 2014

- 2** Registration with Social Security and registered unemployment (September).
 Governing Council European Central Bank.
8 Industrial production index (August).
15 International trade (September).
 Net international investment position (second quarter).
 Financial accounts (second quarter).
 Balance of payments (July).
16 Household savings rate (second quarter).
17 Loans, deposits and NPL ratio (August).
23 Labour Force Survey (third quarter).
24 European Council.
28 State budget expenditure (September).
29 Fed Open Market Committee.
30 Economic sentiment index of the euro area (October).
 GDP flash estimate of Spain (third quarter).
 Flash CPI (October).
31 Balance of payments (August).

Recovery endures

The world economy is weathering the geopolitical uncertainty. The macroeconomic data published during the summer have confirmed that the world economy is still on its predicted course with growth gradually getting stronger in spite of flare-ups in armed conflicts in the Ukraine, Iraq and the Middle East, leading to some episodes of volatility in financial markets. Nonetheless, contrasting situations can be seen within this overall trend of activity gaining traction. While the US is speeding up, Japan is slowing down more than expected, hindered by its VAT hike in spring. Among the emerging economies, China is holding firm and inflationary imbalances are easing in the rest of Asia, unlike the situation in Russia, Turkey and Brazil. In the euro area, Spain's good figures stand out against the continued decline of Italy and France and the unexpected drop in German GDP.

Accommodative monetary policy overcomes the summer's outbreaks of volatility. Episodes such as that of the Banco Espírito Santo and trade reprisals between Moscow and the EU countries has resulted in localised, contained outbreaks of volatility during the summer months. Nonetheless, the markets' underlying tone is still positive with stock market indices around their maximum and risk-free interest rates at a minimum. The messages being issued by the Federal Reserve and ECB in favour of prolonging the already highly accommodative monetary conditions are still a powerful support for this upward trend. At July's meeting of the Federal Open Market Committee, Janet Yellen approved the broad lines of its monetary policy and conveyed a message that suggests a slight shift towards a gradually more restrictive position. Meanwhile, at the annual central bank symposium in Jackson Hole, her European peer repeated, even more explicitly, the ECB's commitment to resort to additional expansionary measures to combat the risk of deflation should this become necessary (inflation in the euro area fell by 0.1 percentage points in August with a cumulative drop of 0.6 percentage points for the year to date).

The US continues to grow. Thanks to improved consumption and investment, as well as an upswing in stock, in Q2 the US economy grew by 1.0% in quarter-on-quarter terms (2.5% year-on-year), data that contrast with the 0.5% quarter-on-quarter decline in Q1. On the whole, data from the National Accounts system show a pattern of growth in which domestic demand is gaining strength and all the evidence points to investment and

consumption continuing to perform well in Q3. This is also suggested by the good trend in ISM business indicators and the upswing in consumer confidence in July and August, something not seen since before the crisis. The continued strength being shown by the labour market is also notable, and has not translated yet into a rise in inflationary tensions.

A disparate, middling recovery in the euro area. The weakening signs suggested by activity indicators in the last quarter have materialised with the euro area's economy standing still in Q2, putting an end to four quarters of growth at an average rate of 0.2% quarter-on-quarter. Although the breakdown in GDP by component has yet to be published, the drop in industrial confidence points to a decline in investment and exports are suffering from the weakness of world trade at the beginning of the year, as well as stronger geopolitical tensions, especially in the Ukraine. The performance of the French and Italian economies is also hindering the progress of European activity although Germany is expected to recover some of its energy after its bad patch in Q2. These data, together with the deterioration in sentiment, PMI and consumer confidence indices in Q3, paint a rather gloomy picture for the second half of the year.

Spain's domestic demand boosts growth. The Spanish economy has ended the summer in a stronger position, managing to avoid the disappointing growth figures in Europe as a whole. Its recovery is gradually building up steam and this is starting to be felt in the labour market, with the number of employed people rising by 402,400 and the unemployment rate falling by 1.45 p.p. in Q2. Domestic demand is also looking healthier: household consumption has grown at an average rate of 0.6% quarter-on-quarter for the last four quarters and investment has recovered strongly, particularly boosted by capital goods (+2.1% quarter-on-quarter). However, this dependence of the recovery on domestic demand is affecting the external balance. The strong upswing in imports, combined with exports losing steam, has pushed the current account balance back into negative terrain. Nor should we forget that part of this upswing in activity is being supported by temporary factors (such as decisions to consume and invest that were postponed during the crisis), and that the Spanish economy's ability to withstand a weak Europe has its limits. So our incipient optimism regarding Spain's recovery should be tinged with some caution.

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	3.0	3.4	3.9	3.4	3.3	3.3	3.5	3.9	3.9
Developed countries										
United States	2.3	2.2	2.2	3.1	1.9	2.5	2.3	2.3	3.6	3.2
Euro area	-0.6	-0.4	0.8	1.4	0.9	0.7	0.9	0.9	1.1	1.5
Germany	0.6	0.2	1.5	1.5	2.2	1.3	1.3	1.2	0.9	1.6
France	0.4	0.4	0.4	1.0	0.8	0.1	0.4	0.5	0.7	1.0
Italy	-2.4	-1.8	-0.2	0.8	-0.4	-0.2	-0.1	0.0	0.3	0.8
Spain	-1.6	-1.2	1.2	1.7	0.5	1.2	1.5	1.8	1.9	1.7
Japan	1.5	1.5	1.1	1.2	2.7	0.0	0.6	1.0	-0.1	2.1
United Kingdom	0.3	1.7	2.9	2.1	3.0	3.2	2.8	2.6	2.3	2.0
Emerging countries										
Russia	3.4	1.3	0.3	1.1	0.9	0.8	0.0	-0.3	0.7	0.8
China	7.7	7.7	7.5	7.4	7.4	7.5	7.3	7.6	7.8	7.5
India ²	4.5	4.7	5.5	6.4	4.6	5.7	5.2	5.4	5.7	6.3
Brazil	1.0	2.5	0.7	1.4	1.9	-0.9	1.0	0.8	1.2	1.5
Mexico	4.0	1.1	2.6	3.8	1.9	1.6	3.1	3.7	3.7	3.8
Poland	2.1	1.6	3.3	3.5	3.5	3.3	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	3.4	3.3	3.5	3.5	3.6	3.6	3.4
Developed countries										
United States	2.1	1.5	1.9	1.9	1.4	2.1	2.0	2.1	2.0	1.8
Euro area	2.5	1.4	0.7	1.3	0.7	0.6	0.5	1.1	1.2	1.3
Germany	2.1	1.6	1.1	1.7	1.0	0.9	0.9	1.4	1.5	1.6
France	2.2	1.0	0.9	1.5	0.9	0.8	0.9	1.1	1.3	1.4
Italy	3.3	1.3	0.5	1.3	0.5	0.4	0.2	0.9	1.2	1.3
Spain	2.4	1.4	0.2	1.1	0.0	0.2	-0.2	0.7	0.9	1.1
Japan ³	0.0	0.4	2.8	1.7	1.5	3.6	3.2	2.9	3.1	0.8
United Kingdom	2.8	2.6	1.8	2.1	1.7	1.7	1.8	2.0	2.0	2.0
Emerging countries										
Russia	5.0	6.8	7.2	5.8	6.4	7.6	7.5	7.3	6.9	6.2
China	2.7	2.6	2.3	2.7	2.3	2.2	2.2	2.6	3.0	3.2
India ⁴	7.3	6.4	5.6	6.5	5.4	5.7	5.2	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	0.7	1.7	0.9	0.5	0.5	0.8	1.5	1.5
Turkey	8.9	7.5	8.7	6.7	8.0	9.4	8.7	8.6	7.2	6.6

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	2.1	1.6	1.7	2.4	2.2	2.1	1.8	1.5
General government consumption	-4.8	-2.3	-0.1	-1.8	-0.2	1.1	-1.5	0.2	-3.1	-3.4
Gross fixed capital formation	-7.0	-5.0	0.7	4.3	-1.2	1.2	1.2	1.5	3.2	3.9
Capital goods	-3.9	2.3	8.8	7.7	11.0	8.7	7.9	7.6	7.0	7.0
Construction	-9.7	-9.6	-4.0	2.4	-8.6	-3.4	-2.3	-1.7	2.1	2.0
Domestic demand (contr. Δ GDP)	-4.1	-2.7	1.3	1.3	0.7	1.8	1.3	1.5	1.1	0.9
Exports of goods and services	2.1	4.9	4.0	4.8	7.4	1.7	2.9	3.8	5.8	5.4
Imports of goods and services	-5.7	0.4	4.6	4.0	8.6	3.9	2.3	3.4	3.7	3.3
Gross domestic product	-1.6	-1.2	1.2	1.7	0.5	1.2	1.5	1.8	1.9	1.7
Other variables										
Employment	-4.8	-3.4	1.1	1.6	-0.4	0.8	1.6	2.2	2.2	1.8
Unemployment rate (% labour force)	24.8	26.1	24.6	23.3	25.9	24.5	23.9	24.1	24.2	23.0
Consumer price index	2.4	1.4	0.2	1.1	0.0	0.2	-0.2	0.7	0.9	1.1
Unit labour costs	-3.0	-1.5	-0.5	0.1	-0.9	0.0	-0.4	-0.6	0.5	-0.6
Current account balance (cum., % GDP) ¹	-1.2	0.8	0.3	0.8	0.2	-0.2	0.1	0.3	0.4	0.6
Net lending or borrowing rest of the world (cum., % GDP) ¹	-0.6	1.5	0.9	1.4	1.0	0.5	0.7	0.9	1.0	1.2
Fiscal balance (cum., % GDP) ¹	-10.6	-7.1	-5.6	-4.2						

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	0.25	0.71	0.24	0.23	0.24	0.30	0.36	0.58
12-month Libor	1.01	0.68	0.59	1.15	0.56	0.54	0.57	0.68	0.80	1.04
2-year government bonds	0.27	0.30	0.50	1.45	0.36	0.40	0.51	0.75	1.07	1.31
10-year government bonds	1.78	2.33	2.77	3.63	2.75	2.61	2.61	3.12	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	0.52	0.53	0.56	0.57	0.48	0.48	0.49	0.50
2-year government bonds (Germany)	0.08	0.13	0.08	0.25	0.14	0.11	0.03	0.06	0.13	0.21
10-year government bonds (Germany)	1.55	1.62	1.47	1.94	1.68	1.43	1.22	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	138.42	138.84	140.98	140.11	136.71	135.89	136.80	138.21
£/euro	0.81	0.85	0.81	0.85	0.83	0.82	0.80	0.80	0.80	0.80
OIL										
Brent (\$/barrel)	111.38	108.47	107.17	109.43	107.74	109.65	105.16	106.13	108.63	109.12
Brent (euros/barrel)	86.61	81.67	79.63	84.88	78.61	79.96	78.77	81.22	83.78	84.48

Note: 1. Four quarter cumulative.

Forecasts

CURRENT SITUATION · The geopolitical conflicts fail to change accommodative monetary policy

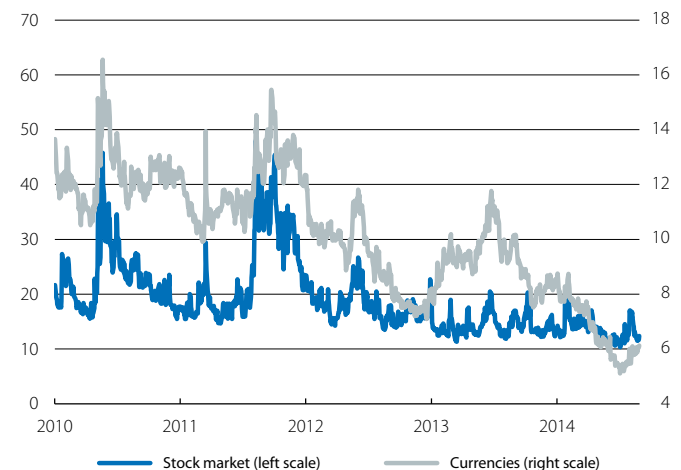
Localised, contained outbreaks of volatility during the holiday period. After months of relative calm in the financial markets, towards the end of July and in the early days of August some unstable episodes occurred with a variety of origins and natures. These events were either geopolitical (the crisis between Russia and the Ukraine and the Middle East conflict) or specific to a country (Portugal) or sector (banking). But it should be added that any disturbance has been limited in scope. Perhaps the most notable factors have been the trade reprisals between Moscow and EU countries, together with problems for Portugal's bank Banco Espírito Santo (BES). Both affected the stock markets on the Old Continent, already damaged by poor economic data. Nonetheless, the international markets' underlying tone is still positive: stock market indices are within their maximum range and risk-free interest rates at a minimum. The messages being issued by the Fed and particularly the ECB in favour of extending accommodative monetary policy are still a powerful support for this upward trend. But while the ECB's actions are effectively expansionary, it is not so clear that this is the case of the Fed. Monetary normalisation in the US is still the key challenge in the medium term.

The Federal Reserve maintains its course but internal debate is livening up. At July's meeting of the Federal Open Market Committee, the Fed approved the broad lines of its monetary policy and conveyed a message suggesting a slight shift towards a gradually less accommodative position. In the announcement made after the meeting, it applauded the progress made by the US economy during Q2 and also pointed out the progress being made by the labour market, albeit noting that there was still a large amount of idle resources. This last point has become the crux of the Fed's strategy to justify highly lax conditions after the end of tapering (planned for October). With regard to inflation, and given the improvement in the economic situation, the authority estimates that prices are now less likely to remain below the target of 2% in the medium term. However, the publication of the meeting's minutes in August hinted at growing divergence within the Fed when the first interest rate hike should occur. For the time being, the view of the dovish wing (with Yellen at its head) is prevailing over those advocating an earlier hike although, as admitted by the institution itself, this will all depend on the activity and inflation figures over the next few months.

Mario Draghi, the star of the annual central bank symposium at Jackson Hole. Unlike previous years, no important announcements were made regarding US monetary

Implied volatility in the financial markets

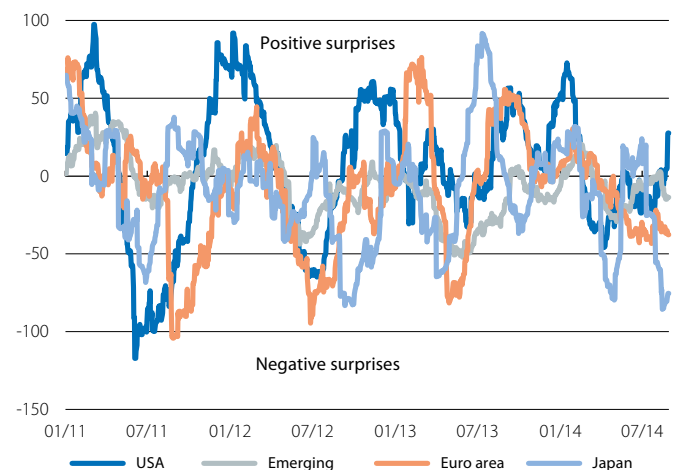
(Stock market: VIX index. Currencies: JPMVXYGL index)



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

USA: index of economic surprises

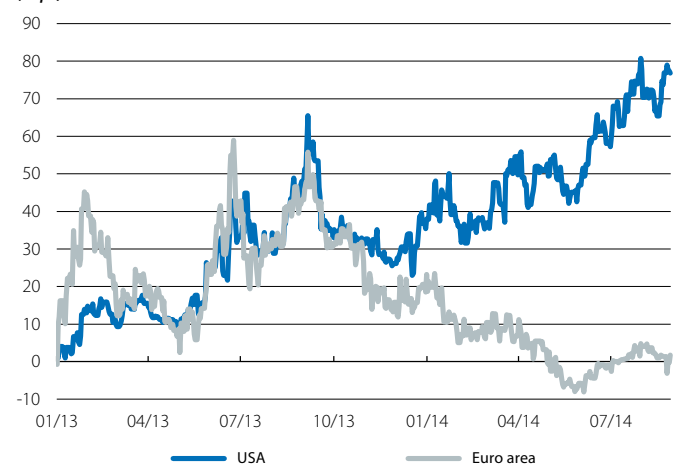
(Positive surprise: better figures published than expected by the consensus)



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

Interbank market: 1-year forward and spot spreads

(b.p.)



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

policy and Yellen's speech focused on an empirical analysis of the US labour market. Draghi, however, surprised participants with the tone of his statements. On the one hand the ECB President was very explicit, repeating the commitment to resort to additional expansionary measures to combat the risk of deflation should it be necessary (including a possible asset purchase programme). A direct reference to the reduction in inflation expectations in the short and medium term helped to reinforce his message. On the other hand Draghi moved away from the ECB's usual mantra regarding fiscal policy, declaring that the potential of this tool to boost growth must be reconsidered and duly used.

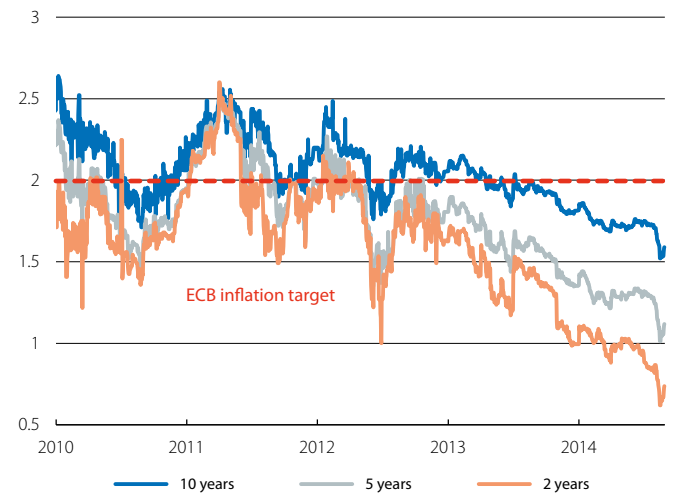
All eyes are once again on the ECB. With the full implementation of June's package of expansionary measures still incomplete, both Draghi's statements and current trends have once again placed the ECB centre stage, although the authority is most likely to reinforce its more accommodative messages before carrying out any new actions. Along these lines, the ECB expects the two targeted longer-term refinancing operations (TLTROs) in September and December to be well received by the banks in the euro area. Meanwhile, preparations have intensified to design a programme to purchase «simple and transparent» asset-backed securities (ABS). The two big sources of risk (inflation and geopolitical tensions) will largely condition the ECB's future steps although a third factor has also come into the fray, related to the normalisation of monetary conditions in the US. As the Fed provides more specific and explicit information on its first interest rate hike, there is the risk that the euro area's sovereign debt curves and monetary rates will be pushed up.

The reappearance of geopolitical risk is pushing up demand for US public debt. Fluctuations in participants' appetite for risk have been accentuated by events in the Middle East and the Ukraine. Treasury yields have started to fall, albeit still within a narrow range. So far the affect of such factors has been modest and offset by the good performance of economic indicators. Paradoxically, the overriding sense of calm in the US bond market calls for even greater caution. Solid indications from US macroeconomic and labour market figures suggest the Fed may toughen up its position. Should this happen, the currently low levels of volatility in the sovereign debt market may give way to a more unstable and erratic environment.

Currently weak macroeconomic indicators in the euro area and conflict in the Ukraine are flattening out the German sovereign curve. The geopolitical disturbances between Russia and the Ukraine and the expected effects of trade sanctions by Moscow on the EU have helped to push down German yields. Specifically, yield on the 2-year Bund has gone into negative terrain while the 10-year yield is below 1%. Confirmation of the German economy's poor performance between April and June (-0.2% quarter-on-quarter) has helped to reinforce this pattern among the country's bonds.

Euro area: inflation expectations

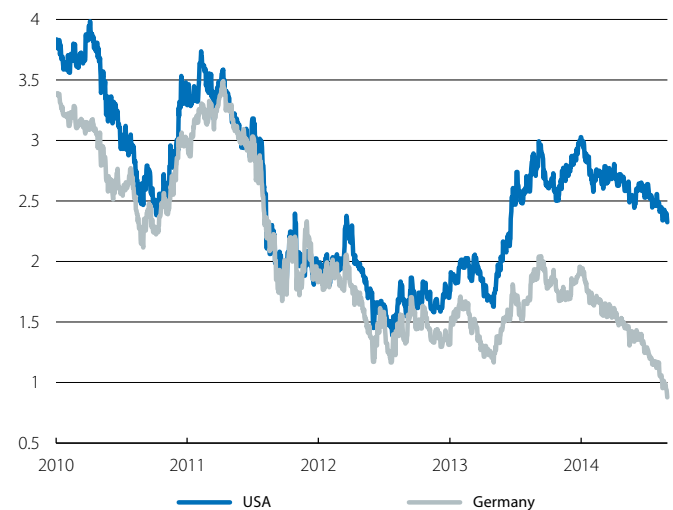
Inflation swaps (%)



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

Yields on 10-year public debt

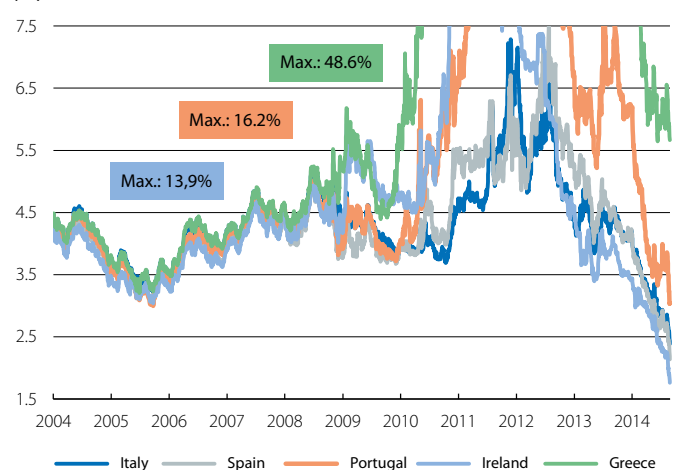
(%)



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

Euro area: yields on 10-year public debt

(%)



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

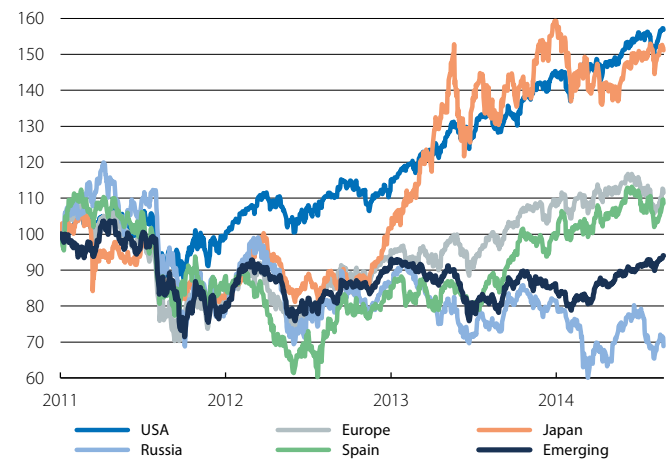
Periphery sovereign debt is showing favourable signs. The outbreak of the crisis for the Portuguese Banco Espírito Santo, later cut short by the government in collaboration with the European authorities, and Italy's relapse into recession resulted in a brief period of nervousness among investors in periphery bonds. In fact, the yield on Spanish 10-year bonds did not take long to start falling again, setting a new all-time low (2.15%) by the end of August. One factor stands out behind this positive trend in periphery sovereign debt: growing market expectation that the ECB will announce further expansionary measures in September. However, we should not forget the risks still facing the EMU economies. On the one hand, the loss of steam observed in Germany, France and Italy could have repercussions on the performance of other EU countries. On the other, the upcoming stress tests on European banks could result in a less benign climate for periphery sovereign debt.

Ups and downs in the stock markets. The fluctuations were quite pronounced in the equity markets in July and August but still far from the tensions seen during the crisis. The disparities between countries have been reflected in their stock markets with the succession of geopolitical tensions and the nature of the economic figures from each one highlighting their differences. US indices, such as the S&P 500, reached new all-time highs thanks to the improvement in the economy and the recovery in corporate earnings. In Europe, equity suffered from the BES crisis, Russia's reprisals and the slump in growth for the region. Interrupting the upward trend started in spring, European indices lost ground between July and mid-August and the modest earnings season for European companies failed to sustain investor optimism. However, the second half of August saw an upswing in European indices, as well as the Ibex, thanks to their US peers and Draghi's messages. The prices of risk assets from the emerging block reported solid gains. The stock markets of some of these countries, such as India, Indonesia and Turkey, with gains close to 20%, are benefitting from increased capital inflows. The other side of the coin is provided by the Russian stock market, a victim of the deterioration in the country's macrofinancial environment.

The euro is weakening. Since the ECB announced its package of unconventional measures in June, the euro-dollar exchange rate has shifted in favour of the US currency. With monetary policy moving in different directions on both sides of the Atlantic, the euro has gradually but continually lost value, falling to 1.311 dollars, its lowest value for the last 12 months. The good activity figures for the US, unlike the weak data posted by the main European economies, has helped the dollar to appreciate. The underlying trend will be for the euro to continue depreciating. Regarding commodities, of note is the sizeable fall in Brent oil due to the increase in production capacity and poor performance figures from Europe.

Trends in the main international stock markets

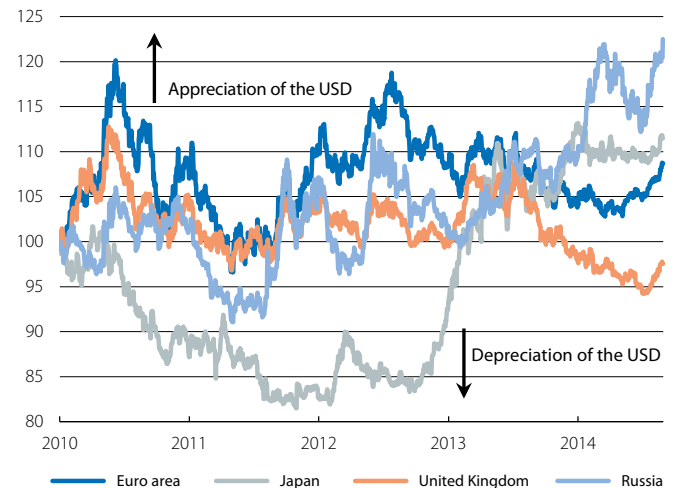
(January 2011 = 100)



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

Value of the USD against different currencies

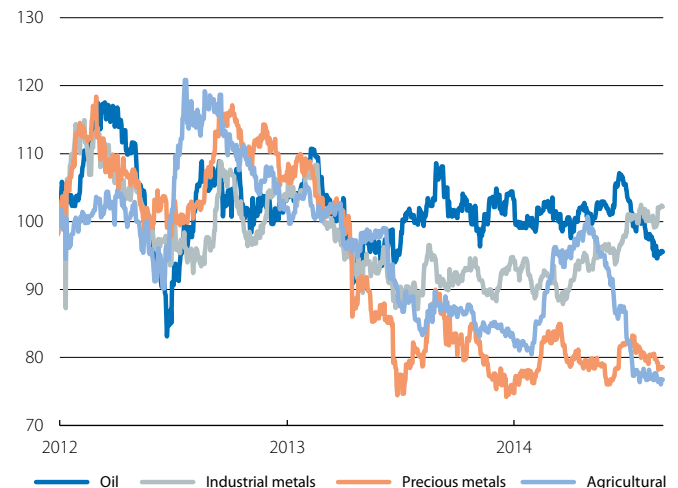
(January 2010 = 100)



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

Trends in commodities

(January 2012 = 100)



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

FOCUS · MAB, the SME stock market: teething problems

More than 99% of Spanish firms are small or medium-sized (SMEs) and their business accounts for around 65% of GDP. In the past they've encountered considerable obstacles to securing good quality financing precisely because of their size: they have limited capital as well as few assets that can be used as collateral. In the last decade, and particularly during the years of crisis, it has become clear that such firms require alternative sources of financing to traditional bank loans. Early attempts were aimed at increasing their capital. In fact, although used to a lesser extent than in large companies, SMEs can also opt to increase their share capital via business angels, seed capital and venture capital, or through capital increases in organised markets, especially stock markets.

In 2008, attending to the particular needs of such firms and given the success of specific spaces for this kind of company in other countries' stock markets, the Alternative Stock Market (*Mercado Alternativo Bursátil* or MAB) was set up in Spain, run by the company that deals with the organisational aspects of Spain's stock exchanges and financial markets (*Bolsas y Mercados Españoles* or BME). The MAB is a segment of the market devoted to small cap firms looking to expand, with its own set of regulations and costs and procedures tailored to the companies' particular characteristics. In comparison with the rules for firms listed on the continuous market, the requirements to access the capital market via the MAB are more flexible. But this does not mean they are any less thorough: SMEs applying to join the MAB must be suitably transparent and supply good quality information. Two figures have been created to this end: a registered advisor and a liquidity provider. The registered advisor has the mission to help companies meet these information requirements, as well as the duty to support such firms while they are listed on the MAB. The liquidity provider is an intermediary responsible for ensuring a minimum frequency of counterparty trading in order to achieve efficient share price setting for the company, as well as providing liquidity. The supervision of these actions and control of regulatory compliance falls to the Spanish Securities and Investments Board (CNMV).

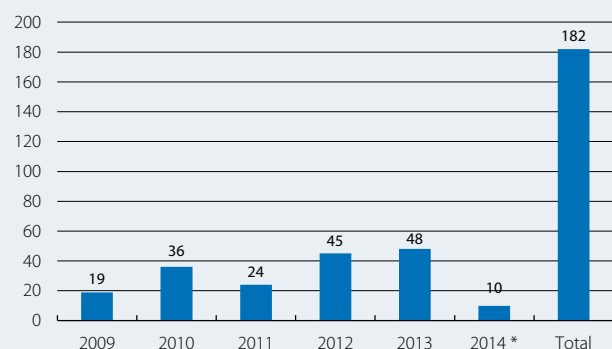
More than twenty firms are currently listed on the MAB, from a range of industries such as consumer goods, technology and telecommunications, industry, construction and consumer services. Considering the context of the financial crisis over the last few years, the overall experience of this market has been reasonable. From a quantitative point of view, the first firms to be listed on the MAB have improved their level of business,

their equity position and their international exposure. In addition to using their increased funds to grow and undertake expansion projects, a lot of companies have also improved their turnover and operating profits. In qualitative terms, the MAB represents a platform for firms to increase awareness and prestige among their clients and suppliers (both commercial and financial), as well as greater corporate transparency.

However, over the last few months the MAB's reputation has been damaged by a case of alleged fraud, curiously concerning the most capitalised company within the segment. The fact that SMEs may employ small-scale auditors of questionable reliability and excessively flexible reporting requirements have turned out to be weak points for the supervisory system. In order to make sure such events do not occur in the future, the Ministry of Finance and Competitiveness has announced changes to strengthen the control of companies by extending the supervisory role of BME and establishing new reporting requirements to the CNMV. Moreover, those firms whose stock market capitalisation exceeds 500 million euros will no longer be listed on the MAB and will move to the continuous market. Such reforms to the regulatory framework should be seen as positive: they form part of the learning and development process of a market that has only existed for six years and which, to date, has operated within an overall context of crisis but has huge potential for growth. In this respect, it should also be noted that the MAB still has a long way to go before reaching the level of its European peers such as the British AIM and the French Alternext. In short, the main challenge faced by the Alternative Market in the future is to tighten up its commitment to transparency and supervision.

Financing obtained by MAB firms *

Equity investments and capital increases
(billion euros)



Note: * First half of 2014.

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

FOCUS · Frontier markets: a fast-growing investment option

Frontier markets make up a large, diverse group of countries immersed in the earliest stages of economic development.¹ Recently, the share and bond prices of this group have performed very well, greatly exceeding the gains made by their older brothers, the traditional emerging markets (especially BRICS). Particularly commendable has been the resilience shown by the former during periods of global financial instability, such as the one occurring after the Fed announced its tapering program in May 2013 which hit the latter group of countries very hard. However, we should not forget the risks and vulnerabilities involved in this kind of market.

Frontier markets have great growth potential thanks to favourable demographic dynamics, low levels of public and private debt and a reasonable amount of macroeconomic stability. However, these regions are less financially developed than those countries in the traditional emerging block and such development is often precarious. In particular, there is a lot of room for improvement in their debt and equity markets due to the limited size and scope of liquidity. According to data from the IIF, the total capitalisation of these countries accounts for just 3% of global stock market capitalisation although they hold 20% of the world's population. In GDP terms, frontier stock market capitalisation was around 30% in 2012 compared with 55% in the traditional emerging countries and 85% in advanced countries.

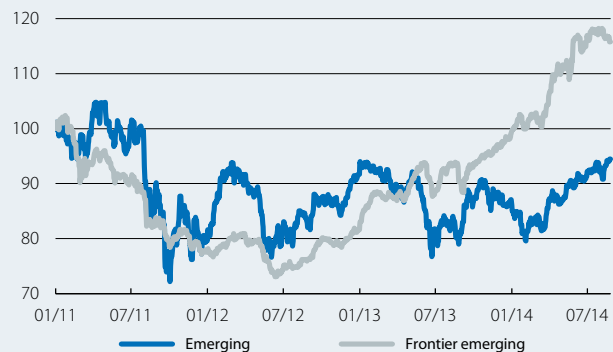
However, in spite of their limitations international investors have become more interested in such assets over the last year, attracted by these countries' strong growth and driven by a generally low level of risk aversion at a global level. This last element, together with the sharp gains of frontier stock markets, has set off some alarm bells regarding how sustainable these rises might be. But there is no reason to panic: earnings are strong and asset prices are at reasonable levels in line with their historical average. Sovereign debt is also a good example of the progress being made by frontier markets. This year, for example, Senegal placed 500 million dollars in ten-year bonds at 6.25% and the Ivory Coast issued 750 million dollars at ten years at 4.75%.

Nevertheless, in spite of such milestones being reached we should not forget the notable political, economic and liquidity risks inherent in these countries. One key aspect that needs to be monitored closely is actually the destination of the funds secured in the global capital market. The best purpose would be to finance specific projects in key areas such as infrastructures, as well as

encouraging a gradual diversification of the business sector. Laying down solid foundations in the frontier countries of today will set the course for the emerging countries of tomorrow.

International stock markets: trend by type

(January 2011 = 100; MSCI indices)



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

International stock markets: P/E ratios

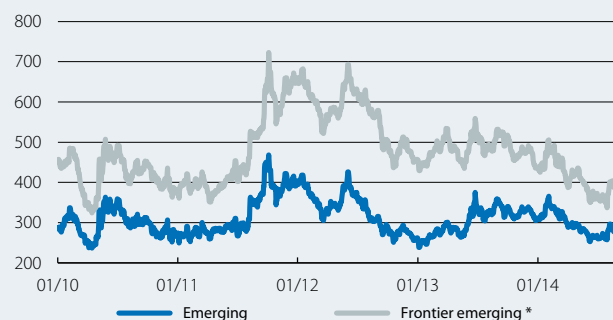
(P/E ratios calculated using earnings from the last 12 months; MSCI indices)



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

Emerging countries: sovereign debt risk premia

(Compared with a basket of US bonds; J. P. Morgan EMBI GD indices, in BP)



Note: * Average of the EMBI GD indices for Argentina, Lebanon, Pakistan, Sri Lanka and Vietnam, among others.

Source: "la Caixa" Research, based on data from Bloomberg and J.P. Morgan.

1. Bangladesh, Kazakhstan, Mozambique and Nigeria are some of the many countries included within this broad concept of frontier market.

KEY INDICATORS

Interest rates (%)

	29-Aug	31-July	Monthly change (b.p.)	Year-to-date (b.p.)	Year-on-year change (b.p.)
Euro					
ECB Refi	0.15	0.15	0	-10.0	-35.0
3-month Euribor	0.16	0.21	-5	-12.8	-6.5
1-year Euribor	0.43	0.49	-6	-12.8	-11.7
1-year government bonds (Germany)	-0.02	0.03	-5	-21.7	-14.2
2-year government bonds (Germany)	-0.03	0.03	-6	-25.2	-27.7
10-year government bonds (Germany)	0.89	1.16	-27	-104.0	-96.7
10-year government bonds (Spain)	2.23	2.51	-28	-190.7	-229.3
10-year spread (b.p.)	134	135	-1	-86.8	-132.7
Dollar					
Fed funds	0.25	0.25	0	0.0	0.0
3-month Libor	0.23	0.24	-1	-1.3	-2.8
12-month Libor	0.57	0.58	-1	-1.8	-10.2
1-year government bonds	0.08	0.11	-3	-3.0	-3.0
2-year government bonds	0.49	0.53	-4	10.8	9.0
10-year government bonds	2.34	2.56	-22	-68.5	-44.1

Spreads corporate bonds (p.b.)

	29-Aug	31-July	Monthly change (b.p.)	Year-to-date (b.p.)	Year-on-year change (b.p.)
Itraxx Corporate	60	65	-5	-10.3	-43.6
Itraxx Financials Senior	61	73	-12	-26.8	-84.3
Itraxx Subordinated Financials	84	103	-20	-46.2	-137.6

Exchange rates

	29-Aug	31-July	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
\$/euro	1.313	1.339	-1.9	-4.4	-0.4
¥/euro	136.690	137.650	-0.7	5.6	-4.4
£/euro	0.791	0.793	-0.2	5.0	7.4
¥/\$	104.090	102.800	1.3	1.0	-4.8

Commodities

	29-Aug	31-July	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
CRB Index	483.8	488.5	-0.9	6.0	2.3
Brent (\$/barrel)	101.3	103.9	-2.5	-8.0	-12.2
Gold (\$/ounce)	1,287.8	1,282.6	0.4	6.7	-7.8

Equity

	29-Aug	31-July	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
S&P 500	2,003.4	1,930.7	3.8	8.4	22.7
Eurostoxx 50	3,172.6	3,115.5	1.8	1.8	16.4
Ibex 35	10,728.8	10,707.2	0.2	8.0	29.2
Nikkei 225	15,424.6	15,620.8	-1.3	-5.0	15.6
MSCI Emerging	1,087.9	1,065.8	2.1	8.5	17.0
Nasdaq	4,580.3	4,369.8	4.8	9.7	27.6

CURRENT SITUATION · The recovery is consolidating in spite of the geopolitical risks

The world economy is weathering the geopolitical uncertainty. In spite of the escalation in armed conflicts (Ukraine, Iraq and Gaza), the macroeconomic figures published during the summer confirm that the world economy is still on its expected course of growth becoming gradually stronger, although there are several different situations within this overall trend. The US is speeding up but Japan has suffered more than expected from its VAT hike while, among the emerging economies, China is holding firm and inflationary imbalances are easing in the rest of Asia.

UNITED STATES

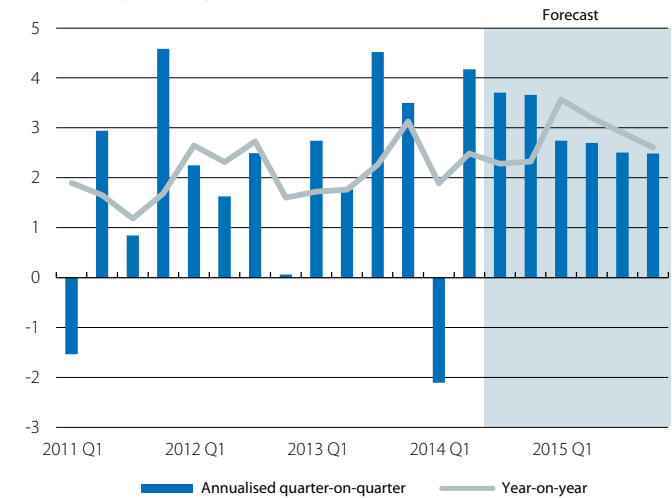
The economy steps up its pace in Q2. The US grew by 4.2% in Q2 in annualised quarter-on-quarter terms (2.5% year-on-year), a figure that contrasts with the decline of 2.1% annualised quarter-on-quarter in Q1. This growth is larger than expected, due basically to improved consumption and investment, as well as the upswing in stocks. The historical GDP series has also been revised and, as a result, 2012's growth is lower (2.3% compared with 2.8% previously) but 2013's figure has increased (2.2% compared with 1.9% previously). Taken as a whole, the data from the US National Accounts system show a pattern of growth in which domestic demand is steadily getting stronger.

In Q3 this expansion has not lost steam, as shown by the good ISM activity indicators, both for services and manufacturing, which rose in July. This trend suggests that investment will continue to perform well and the dynamic pace of consumption also seems sustainable, thanks to July's and particularly August's notable improvements in consumer confidence. After the increase of the last few months, this indicator has reached values not observed since before the crisis (specifically its highest figure since November 2007). One last figure certifying the vigorous start to Q3 is industrial production which, after growing by 4.1% year-on-year in Q2 has speeded up to 5.0% in July.

The real estate market eases off. After a relatively positive May in terms of the real estate market, June and July posted somewhat weaker figures. After falling by 7% in June, new house sales were down again in July (-2.4%). The figures for second-hand home sales were slightly better, seeing moderate but positive growth in June and July (2.4%). Neither is the trend in property prices helping to completely resolve the doubts surrounding the sector. In June, the Case-Shiller 20-City Composite Home Price Index increased by 8.1% year-on-year, a slowdown of 1.2 percentage points compared with May. As there currently seems to be something of a slowdown in the market, should we conclude that the recovery in real

USA: GDP growth

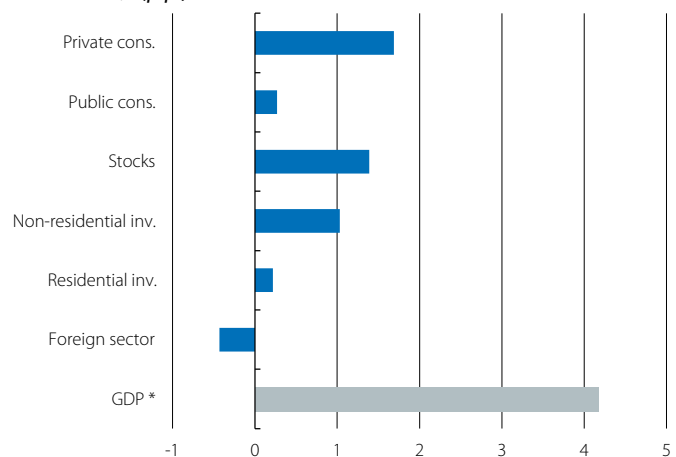
Annualised year-on-year and quarter-on-quarter change (%)



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

USA: GDP by demand component

Contribution to annualised quarter-on-quarter growth of GDP in Q2 (p.p.)

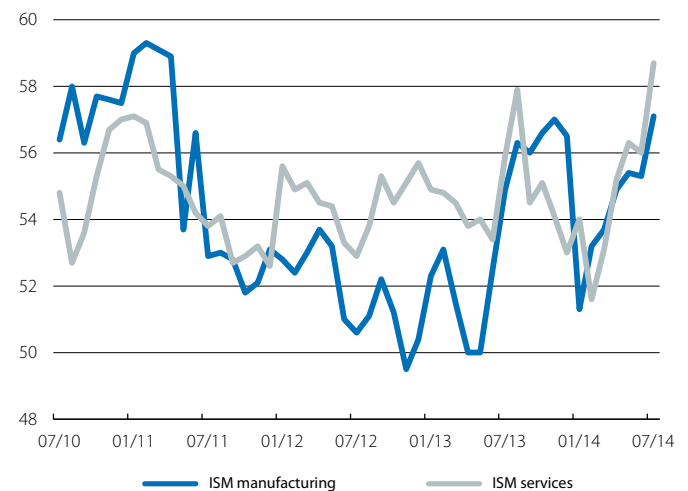


Note: * Annualised quarter-on-quarter change.

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

USA: business sentiment indicators

(Index)



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

estate has come to a halt? An overall diagnosis based on the above data is that the market is still recovering but at a slower rate than expected. Nonetheless, and as suggested by the strong upswing in housing starts recorded in Q2 and in July, the underlying trend is still expansionary.

Stable inflation. One favourable element within the current economic situation is the trend in prices, these remaining contained considering the strength of the recovery. After the upswing in the CPI in Q1, since April inflation has been growing year-on-year by around 2%, both its general index and also after discounting the more volatile components of energy and foods. Specifically, in July the CPI stood at 2.0% in year-on-year terms and the core CPI (without energy or foods) at 1.9%. Given this situation, the growth in prices remains within the range set by the Federal Reserve. Specifically, July's deflator for personal consumption expenditure (PCE) stood at 1.6% year-on-year, below the Fed's 2.0% limit. Our forecasts predict this 2% growth rate for prices will not speed up significantly over the coming quarters.

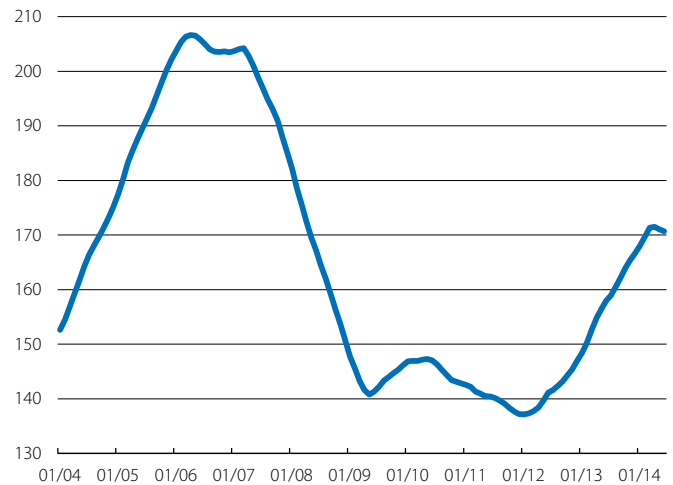
The labour market looks quite healthy. Employment figures continue to confirm the labour market is still on the road to recovery. 209,000 jobs were created in July, exceeding the level of 200,000 for the sixth month in a row, indicating a strong labour market. Although the unemployment rate rose slightly to 6.2%, the participation rate improved to 62.9%. In spite of stronger employment, the growth in wages is still moderate. Taken as a whole, the labour figures point to two equally true situations: the recent trend is one of evident expansion in employment but the recovery is far from complete (as shown by the still low participation rate). Given that labour's performance is a fundamental indicator for establishing the future path of monetary normalisation, how the Fed interprets these somewhat conflicting developments will be crucial over the coming months.

JAPAN

VAT hinders growth in Q2. April's VAT hike, which raised the tax to 8% from its previous rate of 5%, led to the biggest drop in GDP since the earthquake in 2011. Specifically, Japan's GDP fell by 1.7% quarter-on-quarter in Q2 (a year-on-year change of 0%). Although this tax hike was expected to cause an economic setback, its negative impact on private consumption and investment was greater than predicted. If we look at the trend in activity for the first six months as a whole, we can see that GDP fell slightly during this period (note that, in Q1, there was a sharp upswing in GDP due to economic agents bringing expenditure forward to avoid the proposed tax hike). We will have to wait until Q3 to properly evaluate the outcome of this negative impact on the Japanese economy's underlying trend. This analysis will also be important because it will affect the decision of whether to carry out a further VAT hike in October 2015, a measure that has already been announced but not officially adopted.

USA: real estate prices

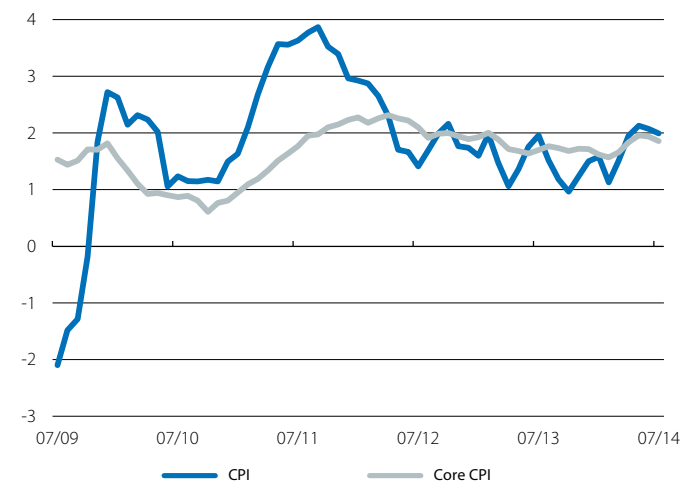
Case-Shiller 20-City Composite Home Price Index



Source: "la Caixa" Research, based on data from S&P/Case-Shiller.

USA: CPI

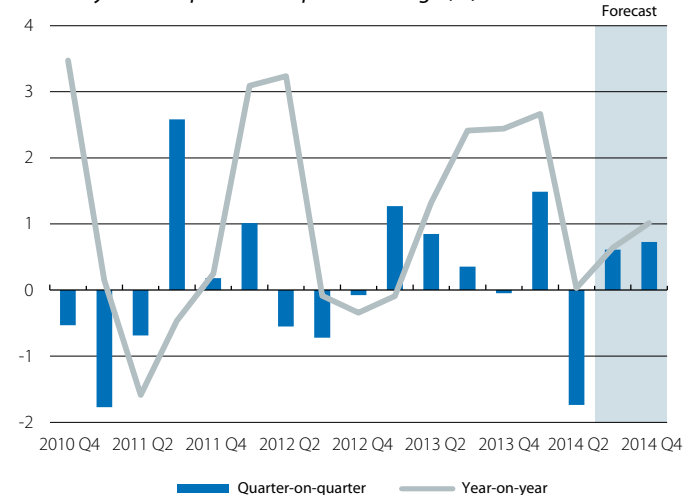
Year-on-year change (%)



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

Japan: GDP

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



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

Inflation starts to digest the effect of VAT. In July the CPI rose by 3.4% year-on-year, less than the figure of 3.6% in June, while the core CPI (not including food or energy) remained the same at 2.3%. Given how important it is for Japan to consolidate its gradual exit from deflation, it is important to determine the price trend without the distorting effect of the VAT hike. According to some estimates, July's CPI would have grown by around 1.4% year-on-year, similar to the rates before April. This indicates that the exit from deflation beginning in mid-2013 is still on track. This is an important support for the recovery, in addition to other factors such as the increase in corporate earnings and positive export figures in the summer (although this last factor may be rather more circumstantial, considering their poor performance in previous months).

EMERGING ECONOMIES

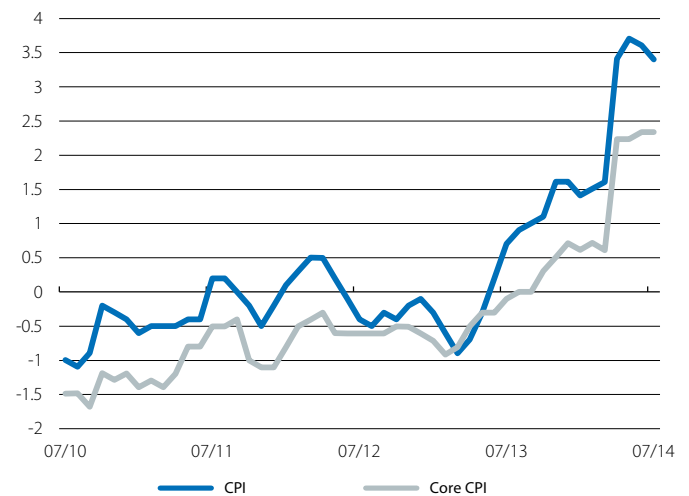
China speeds up in Q2 and then slows down a little. When a slowdown was feared in Q2, the Chinese economy surprised by growing 7.5%, more than the 7.4% achieved in Q1 and consensus forecasts. This good performance has depended basically on investment, the main beneficiary of the government's expansionary policy, as well as the foreign sector. On the other hand, the contribution made by private consumption has been less than in Q1, a reminder that the rebalancing towards greater household spending will be slow. In slight contrast, early indicators for Q3 tend to be more contained, with the important exception of exports which picked up again in July.

Disparate growth in the rest of the emerging economies. Q2 growth figures confirm that activity is performing differently depending on the country in question. The situations of India and Brazil contrast particularly among the main emerging economies. In Q2, while the Asian giant surprised with year-on-year growth of 5.7% (4.6% in Q1), Brazil slumped to 0.6% quarter-on-quarter (-0.9% year-on-year) and has slid into its first technical recession (a decline in GDP for two consecutive quarters) since the Great Recession of 2008-2009.

Attention is still focused on correcting imbalances. Brazil exemplifies the difficulties faced by some emerging countries to both sustain activity and correct macroeconomic imbalances at the same time (inflation or current deficit, principally). This is also Turkey's situation, whose activity is slowing down (albeit not to the extent of Brazil's) at the same time as inflation rose to 9.3% year-on-year in July and with a 7.5% current deficit in Q1. Another country with similar problems is Russia, suffering from rising prices (7.4% inflation in July) and a deteriorating outlook for activity (aggravated by the Ukrainian conflict). The other side of the coin is provided by the emerging Asian countries that are successfully combating inflation, as shown by the slowdown in July's CPI in both India and Indonesia.

Japan: CPI

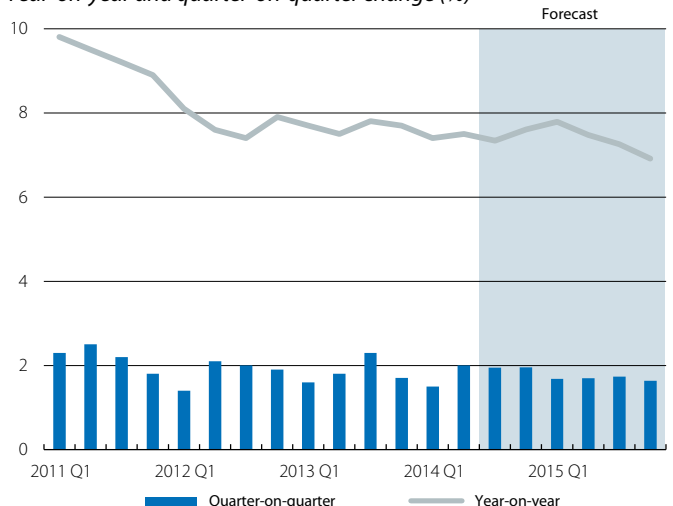
Year-on-year change (%)



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

China: GDP growth

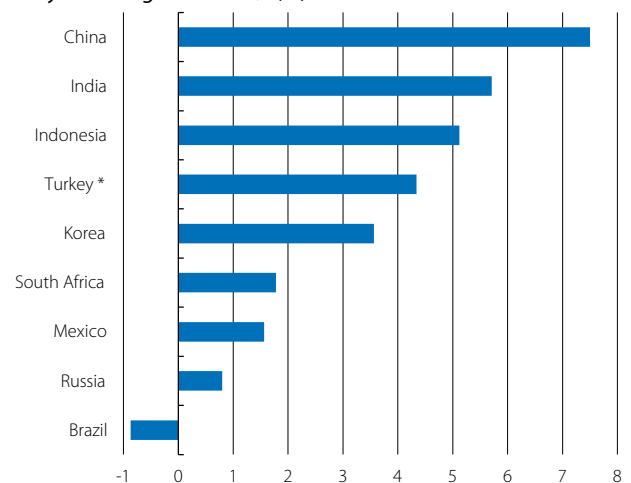
Year-on-year and quarter-on-quarter change (%)



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

Emerging countries: GDP

Year-on-year change in 2014 Q2 (%)



Note: * 2014 Q1.

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

FOCUS · Should we be concerned about China's property market?

The real estate sector undeniably plays an extremely important role in the Chinese economy: with a 15% share of GDP it also has extensive and far-reaching connections with a large number of other industries such as steel and cement. It is therefore logical that this sector's loss of steam over the last few months should be monitored so closely, in terms of its causes and consequences. But it is not reasonable to set the alarm bells ringing because an alleged property bubble is inevitably going to burst in the near future.

After a period of energetic growth in 2013, both prices and the volumes of house purchases started to slow down their progress early in 2014, even recording slight decreases in recent months (see the graph). While 65 of the 70 cities studied by China's official statistics office stated that prices were still rising at the end of the last year, by March this number had fallen to 56 and in July there were only two. According to the property website Soufun, the national price for new housing began falling in May 2014. It is easy to spot the reason for this behaviour: the restrictive measures applied in the second half of 2013 by the economic authorities in the areas of credit (which have ended up affecting the mortgages being granted) and administration (licences, etc.). Two considerations justified this policy. Firstly, the realisation that some counterproductive imbalances were building up, in particular the oversupply of homes in some cities. Secondly, the strategic aim of a slow but inexorable shift towards a new economic model with less emphasis on investment (including residential).

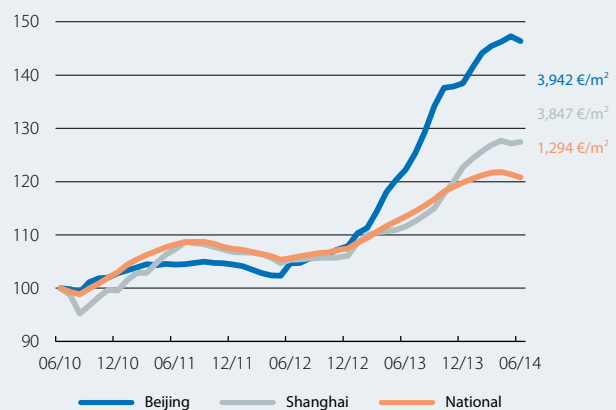
The Chinese authorities are hoping to balance the property sector's development and they have a wide range of tools, some of them very powerful, at their disposal; certainly more tools than those normally available to market economies. The long-term efficiency of such actions has yet to be seen but, in the short term, it seems clear that they can help to prevent any sharp readjustment. In fact, there are already signs of this: the government recently decided to discretionally relax purchase conditions in some cities. These are fine-tuning policies, so called because they discriminate between cities or regions depending on their different characteristics and requirements. It is also notable that China's central bank has made 48 billion dollars available to refinance real estate projects through the China Development Bank. Such kinds of measures should help to contain the sector's slowdown. We also believe that the systemic risks resulting from the housing market can be handled. One element supporting this opinion is the fact that exposure to real estate credit is relatively low, both for households (according to the most recent data,

mortgages account for 18% of GDP compared with 59% in Spain) and for banks (23% of all bank loans are related to the property sector compared with 54% in Spain). However, it is true that, in this current phase of a slowdown in growth, any sharp correction in the sector would increase doubts regarding the country's ability to avoid a hard landing.¹ And that might jeopardise the renewed reforming drive demonstrated by the new government's most recent actions (in the financial sphere, in particular).

In the long run, there are three factors that foreshadow a healthy future for the real estate sector. Firstly, the fact that urbanisation is continuing. In order to transform its economic model, the country needs more people to move from rural areas (where 45% of its population still lives) to its urban areas. Specifically, in the next 20 years 300 million people are expected to move into Chinese towns and cities; i.e. 15 million every year, the same as building a city the size of New York every six months. Secondly, the rise in the per capita income of citizens, which should improve access to higher quality housing and added value. And lastly, state support for the sector by building homes for low-income families.

China: price of new housing

(Index June 2010 = 100)



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

1. According to recent studies, a sharp correction in the real estate sector might reduce China's growth by between 0.96 and 1.92 p. p., (see «China's property sector overinvestment», Nomura, 5 May 2014), in line with our estimate of 1.75 p. p. (stated in «Is There a Property Bubble in China?», "la Caixa" Research, Working Paper Series 04/12, July 2012).

FOCUS · Abenomics: the Bank of Japan is doing its job

At the beginning of 2013, Prime Minister Shinzo Abe launched an ambitious programme of expansionary policies (popularly known as Abenomics) to reactivate Japan's sluggish economy. The strategy designed granted the Bank of Japan (BOJ) a leading role and gave it a twofold task: to combat the country's entrenched deflation and provide easy financial conditions for households, companies and government. Japan's monetary authority has implemented a wide range of measures to achieve these ends, two of which particularly stand out. On the one hand, the establishment of an explicit inflation target of 2% and, on the other, large-scale purchases of financial assets, mainly Japanese government bonds (JGB) but also securities issued by firms. Although it is still too soon to claim victory for the ultimate goal in growth terms, it can be said that the BOJ is making good headway with its intermediate goals, as shown by the bond market.

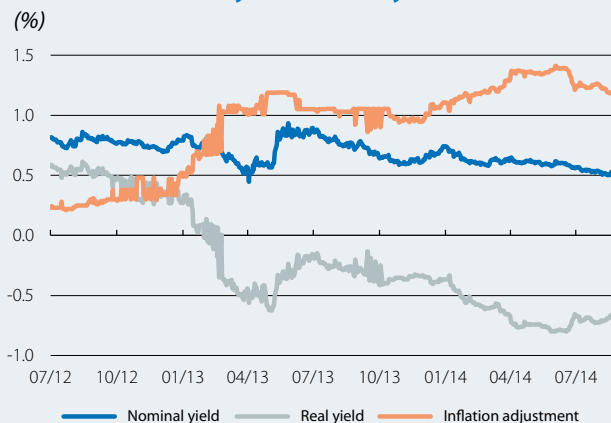
As expected, the dynamics of the JGB market have altered dramatically. In theory, the new inflation target, as it becomes accepted by private agents, should raise the nominal yield demanded while the direct bond purchases by the BOJ should push down real yields and therefore also nominal yields. The existence in Japan of both regular (nominal) JGBs and inflation-linked (real) JGBs helps to gauge the extent of both these effects as the gap between the nominal and real yield, which is usually called «inflation adjustment», is a reliable estimate of expectations regarding this variable among bond market operators (a more precise measurement would require adjustments due to the presence of various risk premia and other technical issues; inflation swaps also help to resolve certain gaps in information for JGBs).

Two broad features can be seen in the trend observed since the end of 2012 (when Abenomics was already expected) up to mid-2014. Firstly, «inflation adjustment» has increased appreciably. This reveals a change in agents long-term expectations who have effectively taken on board, at least partly, the goal of achieving and sustaining higher inflation. Secondly, the real yield has fallen dramatically and is now clearly in negative terrain, providing favourable financial conditions for economic agents (which can also be seen in the gains made by the Nikkei, 80% during this period, and in the yen's depreciation). Several studies have shown that the huge bond purchases made by the BOJ (the cumulative figure since April 2013 totals 20% of GDP and is proportionally greater than the Federal Reserve's own quantitative easing) are a key factor in this drop in the real yield (as well as other global factors, examined in the article «Real interest rates and growth prospects» in this

Report). For example, Goldman Sachs economists put the impact of these bond purchases at around 60 basis points for the yield on ten-year bonds.

The downward pressure on yields will remain as long as the BOJ continues or increases its quantitative easing but, at some point, the BOJ will have to prepare and implement an appropriate exit strategy. Everything depends on the overall economic and financial situation which, in turn, depends critically on the other two branches of Abenomics: fiscal policy and structural reforms. If everything goes according to plan, yields are bound to rise, more or less rapidly, to levels in line with the economy's fundamentals.

Nominal and real yields on 10-year JGBs *



Note: * Partially composite series based on 10-year inflation swaps.

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

JGB yields

In basis points (100 basis points = 1%)



Note: * Goldman Sachs JGB yield model that includes the yield for 10-year US Treasury bonds and inflation expectations in Japan.

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

KEY INDICATORS

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

UNITED STATES

	2012	2013	2013 Q3	2013 Q4	2014 Q1	2014 Q2	07/14	08/14
Activity								
Real GDP	2.3	2.2	2.3	3.1	1.9	2.5	–	...
Retail sales (excluding cars and petrol)	4.2	3.6	3.7	3.6	2.3	4.0	3.8	...
Consumer confidence (value)	67.1	73.2	81.0	74.0	80.5	83.4	90.3	92.4
Industrial production	3.8	2.9	2.7	3.3	3.3	4.1	5.0	...
Manufacturing activity index (ISM) (value)	51.8	53.9	55.7	56.7	52.7	55.2	57.1	...
Housing starts (thousands)	783.8	929.7	882	1,025	925	997	1,093	...
Case-Shiller home price index (value)	141.3	158.2	161	165	170	171	...	...
Unemployment rate (% lab. force)	8.1	7.4	7.2	7.0	6.7	6.2	6.2	...
Employment-population ratio (% pop. > 16 years)	58.6	58.6	58.6	58.5	58.8	58.9	59.0	...
Trade balance ¹ (% GDP)	–3.3	–2.8	–3.0	–2.8	–2.9	–2.9	...	...
Prices								
Consumer prices	2.1	1.5	1.6	1.2	1.4	2.1	2.0	...
Core consumer prices	2.1	1.8	1.7	1.7	1.6	1.9	1.9	...

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 Q3	2013 Q4	2014 Q1	2014 Q2	07/14
Activity							
Real GDP	1.5	1.5	2.4	2.4	2.7	0.0	–
Consumer confidence (value)	40.0	43.6	44.0	41.7	38.8	39.1	41.5
Industrial production	0.2	–0.6	2.0	5.8	8.3	2.6	–0.8
Business activity index (Tankan) (value)	–5.0	6.0	12.0	16.0	17.0	12.0	–
Unemployment rate (% lab. force)	4.3	4.0	4.0	3.9	3.6	3.6	3.8
Trade balance ¹ (% GDP)	–1.4	–2.4	–2.1	–2.4	–2.8	–2.9	–2.9
Prices							
Consumer prices	0.0	0.4	0.9	1.4	1.5	3.6	3.4
Core consumer prices	–0.6	–0.2	0.0	0.5	0.6	2.3	2.3

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 Q3	2013 Q4	2014 Q1	2014 Q2	07/14
Activity							
Real GDP	7.7	7.7	7.8	7.7	7.4	7.5	–
Retail sales	14.3	13.1	13.3	13.5	11.9	12.3	12.2
Industrial production	10.0	9.9	10.1	10.0	8.7	8.9	9.0
PMI manufacturing (value)	50.8	50.8	50.8	51.3	50.3	50.7	51.7
Foreign sector							
Trade balance ¹ (value)	230	259	252	259	234	254	284
Exports	8.0	7.9	3.9	7.4	–3.4	5.0	14.5
Imports	4.3	7.3	8.4	7.1	1.7	1.4	–1.6
Prices							
Consumer prices	2.7	2.6	2.8	2.9	2.3	2.2	2.3
Official interest rate ² (value)	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Renminbi per dollar (value)	6.3	6.1	6.1	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.

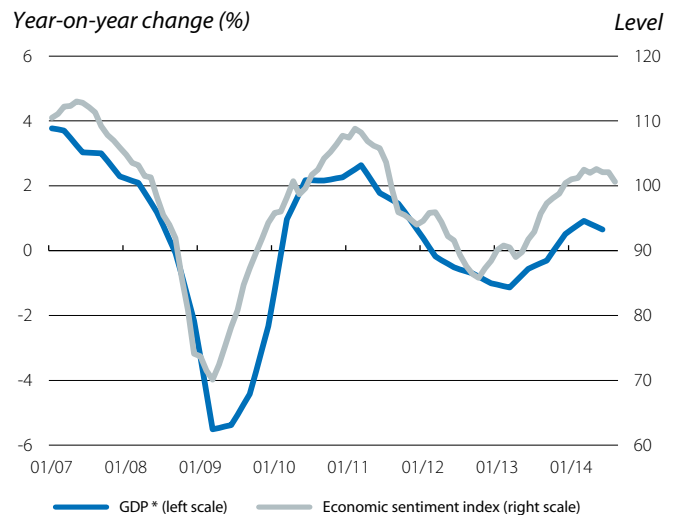
CURRENT SITUATION · Euro area: a middling recovery

The euro area's recovery is running out of steam. The weakening signs suggested by activity indicators in the last quarter have materialised with the euro area's economy standing still in Q2, putting an end to four quarters of growth at an average rate of 0.2% quarter-on-quarter. Although the breakdown in GDP by component has yet to be published, a drop in industrial confidence points to a decline in investment, halting the gradually improving trend in domestic demand. Exports have also been hindered by weak world trade at the start of the year and the escalation of geopolitical tensions, particularly in the Ukraine, is not helping either. To date, the figures available for Q3 show no clear signs of improvement: in August the economic sentiment index and PMI were below the Q2 average and consumer confidence has lost some of the ground gained in previous months. The scenario for the second half of the year is therefore not very encouraging. Although we expect the German economy to pick up slightly, growth in Europe's activity will be affected by the French and Italian economies as the most pessimistic predictions appear to be on target.

Progress is uneven. The trends in the four main economies of the euro area are highly disparate. Spain's GDP growth accelerated in Q2, increasing by 0.6% quarter-on-quarter (0.4% in Q1). This contrasts with the stagnation of the French economy for the second consecutive quarter and with the declines in GDP recorded in both Italy and Germany (0.2% quarter-on-quarter). In the German case, although its high GDP growth in Q1 (0.8% quarter-on-quarter) already suggested the economy would slow down slightly in Q2, such a slump in activity has come as an unpleasant surprise. Part of this greater deterioration is due to rising tension in the Ukrainian conflict. In this respect, although the country's relative weight of exports towards Russia is moderate (accounting for 3% of all sales abroad), uncertainty regarding the conflict's resolution and the effect this might have on the economies of Eastern Europe continues to damage German investor sentiment.

Growth in France and Italy is still unable to consolidate. The picture painted by the trends in Europe's other two large economies is not very favourable either. The main indicators available for Q3 confirm the weakness of the recovery. One symptom is the reduction in industrial confidence in July and August, now significantly below the average for Q2. This context does not suggest there will be any upswing in investment which, in Q2, fell by 1.1% and 0.9% quarter-on-quarter in France and Italy, respectively. Given this situation, the implementation of reforms to improve the poor competitiveness of both economies is still necessary to boost exports at times of need. Real French and Italian exports remained almost at a standstill in Q2 (with quarter-on-quarter variations of just 0.0% and 0.1%, respectively).

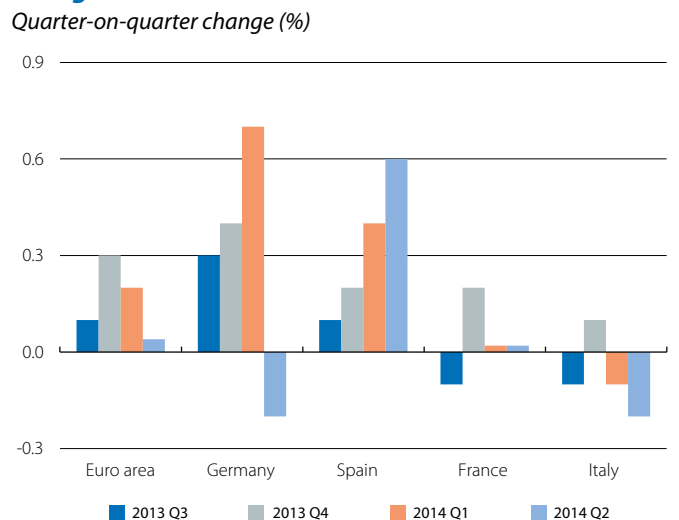
Euro area: GDP and the economic sentiment index



Note: * Quarter-on-quarter data.

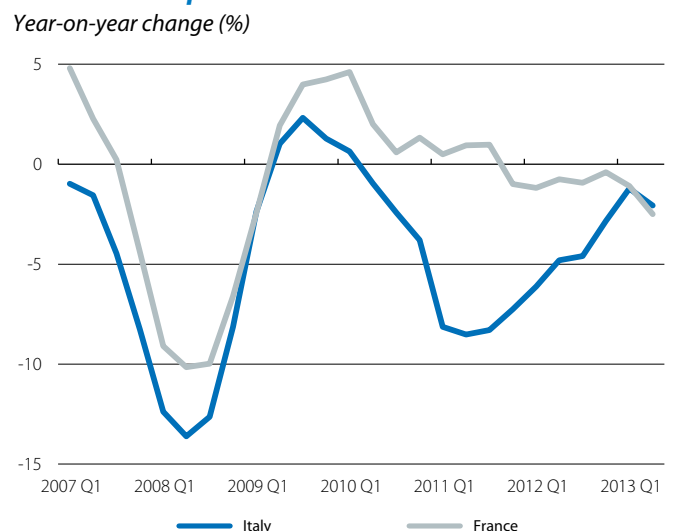
Source: "la Caixa" Research, based on data from the European Commission and Eurostat.

GDP growth



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

Gross fixed capital formation



Source: "la Caixa" Research, based on data from Istat and INSEE.

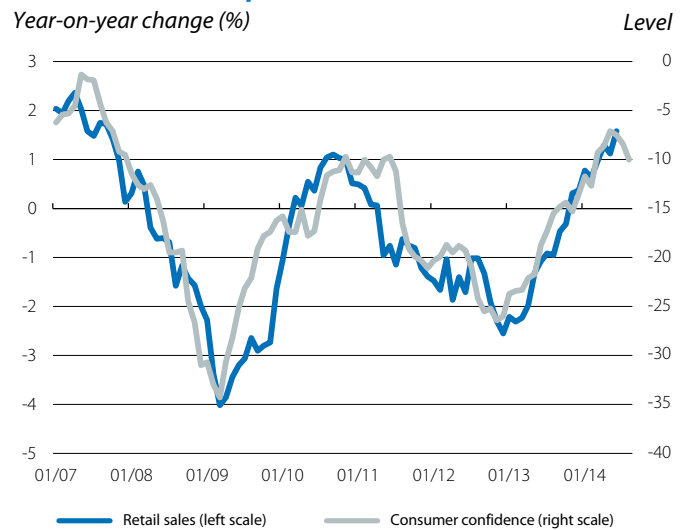
Private consumption loses steam in Q3. During the last few quarters, the recovery in household consumption has become an important support for growth in the euro area (accounting for almost one third of the GDP growth recorded between 2013 Q1 and 2014 Q1), a contribution that was still significant in Q2 judging by the good rate of growth enjoyed by retail sales (1.3% year-on-year in Q2 compared with 0.8% in Q1). However, the decline in consumer confidence in July and August suggests Q3 might see a slowdown.

The revival in activity is helping the labour market to recover, albeit very gradually. In July, the euro area's unemployment rate stood at 11.5%, 0.4 percentage points below the level recorded a year ago although there are notable differences between countries. Over the last few months the unemployment rate has particularly fallen in the periphery countries (down by 2.3, 1.7 and 1.6 p.p. in Portugal, Spain and Ireland, respectively). This improvement contrasts with the less dynamic labour market both in France and especially Italy, countries where unemployment has increased by 0.5 percentage points in the last year. The slight improvement in employment expectations of industrial and service companies in the first few months of Q3 point to this gradual recovery in Europe's labour market continuing. However, should the symptoms of economic weakness continue or get any worse employment expectations will also end up being affected.

Low inflation is putting pressure on the ECB. This context of weakness is reflected in the trend in prices, still at unacceptably low levels. In August inflation stood at 0.3%, 0.1 percentage points below its July figure although it should be noted that, in the last few months, the downward pressure has come mostly from the most volatile components while core CPI has remained stable at around 1%. In any case, this trend has significantly undermined inflation expectations over the last month, something that has not gone unnoticed by the ECB President. In his speech made at the annual symposium in Jackson Hole, Mario Draghi was categorical in stating that this reduction in inflation expectations poses an evident risk to price stability and the European authority appears to be more than ready to implement additional expansionary measures to ensure the institution's mandate is met. Rather surprisingly, Draghi also argued in favour of reconsidering the role of fiscal policy in the euro area's economic recovery. The ECB's actions over the coming months will once again be crucial. It must continue to insist that additional measures will be taken in case the weak climate get worse and should therefore offer more details regarding the work being carried out to reactivate the ABS market. The institution's communication policies (emphasising a commitment to price stability and the availability of tools that will be used if necessary) will be key to keeping inflation expectations anchored.

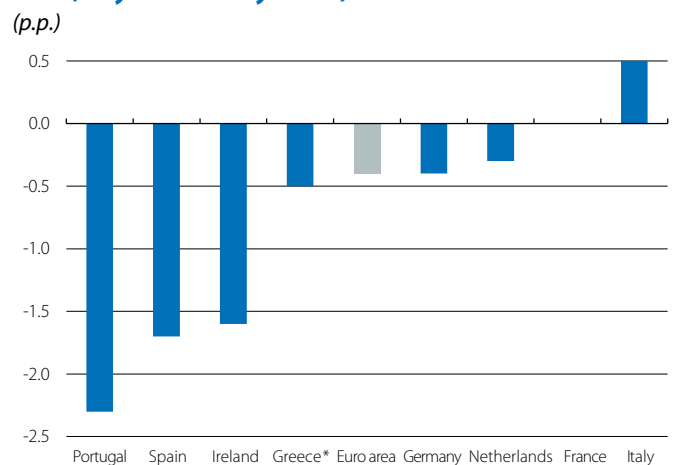
The foreign sector is finding it difficult to recover, both due to the slowdown in emerging countries and the upswing in

Euro area: consumption indicators



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

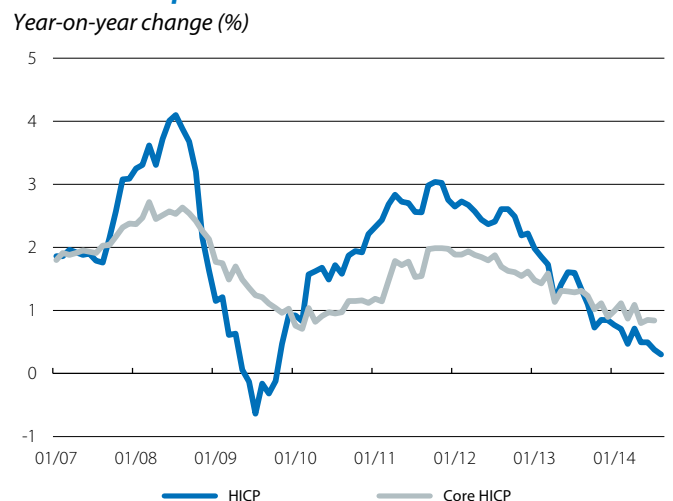
Change in the unemployment rate (July 2014 - July 2013)



Note: * Latest figure, May 2014.

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

Euro area: harmonised index of consumer prices



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

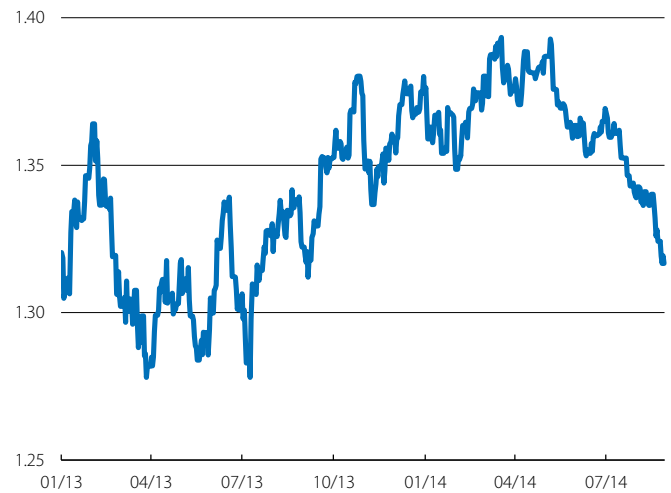
sources of geopolitical tension. Given this situation, it comes as no surprise that, in the first half of the year, growth in European exports was modest (0.9% year-on-year). Although the outlook is more encouraging for the second half of the year, assisted by the revival in the main emerging economies and the euro's depreciation, the increase in downside risks, particularly related to geopolitical tensions, has reduced confidence in exports as a mainstay for the recovery.

The slowdown in activity shifts attention back to fiscal policy. This downward revision of growth prospects poses an additional challenge for the fiscal consolidation policies that European countries need to implement. For the moment, the message repeated by Mario Draghi, underlining the fact that the ECB still has room to manoeuvre, has once again acted as a cushion. Yields on sovereign debt have fallen considerably in the last few months, in many cases now at an all-time low. By way of example, the yield on German 10-year bonds stood at 0.9%, 103 BPS below the yield demanded at the end of 2013. Bonds from Spain, Ireland and Italy also saw significant reductions.

Progress is being made towards banking union and is on schedule. Q4 of this year will be important due to the publication of the stress tests carried out on Europe's main banks. The start, in November, of the ECB's role as the sole supervisor for a large part of the financial system will also mark a new phase for European banking and should help to reduce financial fragmentation. In fact, the latest data on corporate financing costs show some reduction in Europe's periphery countries, such as Spain and Italy. In addition to this normalisation in the banking sector, the ECB's liquidity measures, conditioned on banks granting loans to SMEs, should substantially support the sector's recovery.

Euro-dollar exchange rate

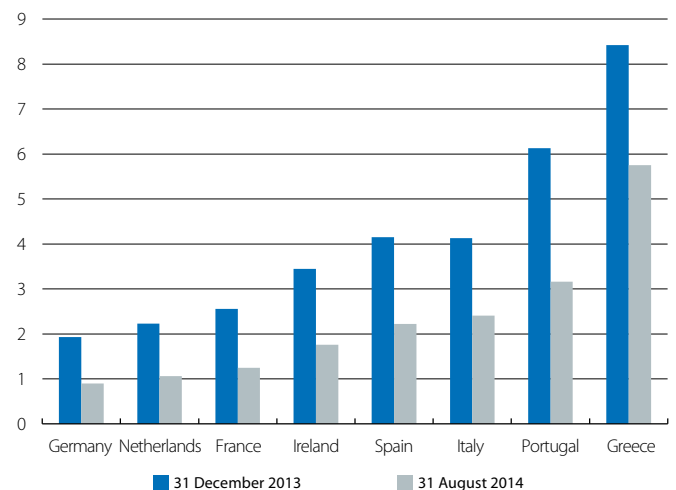
(Dollars per euro)



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

Yield on 10-year public debt

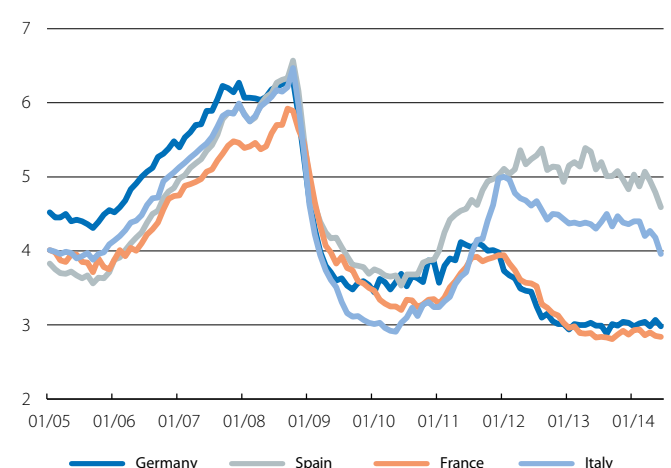
(%)



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

Financing costs for non-financial firms

Interest rate (%)



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

FOCUS · The structural deficit: a benchmark variable

The last quarter of the year is approaching and European governments are starting to draw up their budgets for 2015. In the last few years, their design has been conditioned by the European Commission's new governance policies with more emphasis on correcting the structural component of the public deficit.

Using the structural deficit to design a country's fiscal policy has clear advantages: it helps to assess the long-term fiscal position of public administrations irrespective of the point in the economic cycle. In a recession, an analysis of the structural balance shows whether measures are being taken to improve the long-term fiscal position, independently of the effects the economic situation may have in the short term. Portugal is a case in point. Between 2010 and 2013, its public deficit fell by just 0.6% of GDP, which might lead us to believe that not enough measures were being taken. However, the adjustment in the structural balance over the same period was 5.8 p.p., one of the largest among European countries. An analysis of the structural balance is just as useful within today's context. Given that the public deficit is benefitted from an economy's improved cycle, the trend in structural balance helps us to see whether measures are still being taken to improve the long-term fiscal position and, if so, whether such measures are enough.

It therefore seems vital to monitor the structural balance but there are limitations, the greatest being the problem of measuring this factor. The structural fiscal balance is the one an economy would have if it used all its production, capital and labour factors without any tension occurring in prices; in other words, if its actual GDP were the same as its potential GDP. Consequently, to measure the structural fiscal balance of an economy, first we must estimate its production capacity, a variable that has actually been revised on several occasions over the last few years. The financial crisis has highlighted the fact that the technical statistics used overestimate the proportion of observed GDP that was classified as potential GDP. During the boom years, the part of growth driven by factors unsustainable in the long term was not distinguished while, during the crisis, the downward revision of the economy's growth potential was, in many cases, exaggerated.

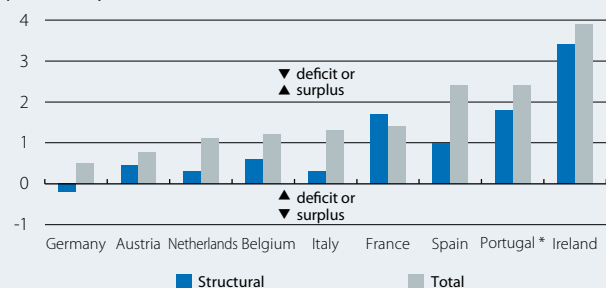
For the trend in the structural fiscal balance to be used as a benchmark variable in the design of fiscal policy, the European Commission has been forced to revise the methodology used to estimate both potential GDP and the structural balance. The aim has been, precisely, to achieve estimates that are less susceptible to the ups and downs of the economy and therefore more robust

and long-term. The impact of this new methodology on the estimates of potential GDP and the structural fiscal balance varies from country to country; while the changes have been barely noticeable in a large number of these, such as Germany and France, in others such revisions have been significant. This is particularly the case of Ireland, Cyprus, Portugal and especially Spain. In the specific case of Spain, this new methodology had led to a 2.5 p.p. increase in potential GDP for 2013, resulting in a 1.2 p.p. reduction in the structural deficit for the same year, down to 2.8% of GDP. In fact, this new calculation reveals that the adjustment achieved in the structural deficit between 2010 and 2013 was 4.3 p.p., considerably more than the previous estimate (3.3 p.p.).

In short, the efforts being made to improve methods to estimate potential GDP are undoubtedly good news, particularly if we take into account the growing importance of the structural balance in the design of European fiscal policy. However, we must be aware of the uncertainty surrounding this variable and not forget that, ultimately, our priority must still be to reduce the high level of public debt.

Change in the target budget balance in Stability Programmes (2013-2015)

(% of GDP)

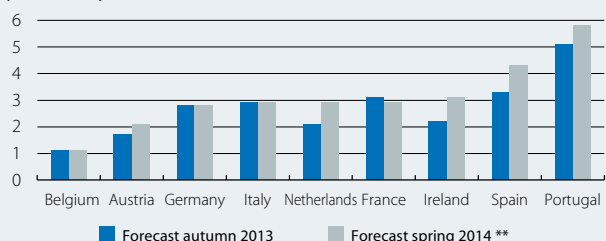


Note: * Data obtained from European Commission forecasts.

Source: "la Caixa" Research, based on data from the different national Stability Programmes and the European Commission.

Estimated change in the structural budget balance between 2010 and 2013 *

(% of GDP)



Notes: * Estimate made using the new method to calculate structural deficit.

** Positive values mean an increase in structural surplus or a decrease in the structural deficit.

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

FOCUS · Securitisation: a key role in stimulating credit?

Given the importance of SMEs to the euro area's economy, it is crucial to help them access credit to consolidate the region's recovery. A first step has been taken by the ECB, encouraging private sector loans via TLTROs and announcing technical preparations to start an asset-backed security purchase programme. A more developed and better functioning securitisation market would be a source of additional financing and will also help to pass on monetary policy by repairing the credit channel.¹ We shall therefore go over the main obstacles to this market's growth and the solutions proposed by several organisations.²

The hurdles faced by the securitisation market can be classified into two groups. The first is made up of endogenous barriers, inherent in the market's structure per se, such as the high cost of structuring these products and other operational restrictions. The second group, with a greater impact on the market's development, is made up of regulatory obstacles. The capital requirements demanded to hold ABS (Basel III for banks and Solvency II for insurance companies) are too strict compared with other assets with a similar risk profile. The short-term liquidity ratio required by Basel also harms SME loan securitisation as these are excluded from the definition of liquid assets (more benevolent for the senior tranches of mortgage-backed securities).

Taking into account the obstacles that make it difficult for this market to develop, several organisations have decided to differentiate high quality assets (simpler, more transparent and with less risk) so that these can be treated more favourably in regulatory terms. Fewer capital requirements and their inclusion as liquid assets would make this distinction even more beneficial, encouraging the supply of such products and widening the investor base. This would also help to erase the stigma still attached to such assets after the key role they played in creating the financial crisis, especially in the US.

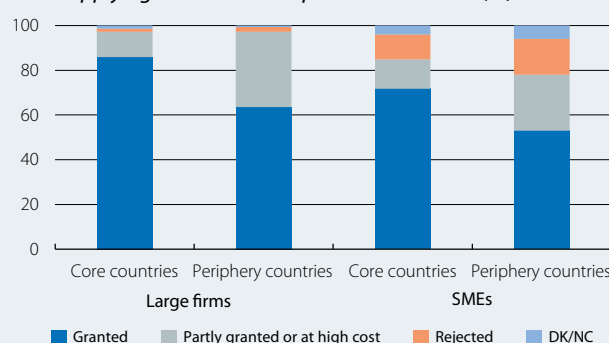
Given just how important this market could be to reactivate the flow of credit to the private sector, it is important for the measures taken to be aimed at creating a more efficient market that aligns the incentives of the different agents in order to improve transparency and standardisation, ensuring that fair rather than special regulatory treatment is provided in accordance with the risk associated with each asset.

1. See the Focus «The securitisation market: from hero to villain, and vice versa» from MR06 for more information on what they are and how they operate.

2. See «The case for a better functioning securitisation market in the European Union», by the BCE and BoE and «Capital market development: SME financing in the Euro Area» from the July report by the IMF.

Firm access to bank loans

Firms applying for loans in the previous 6 months (%)

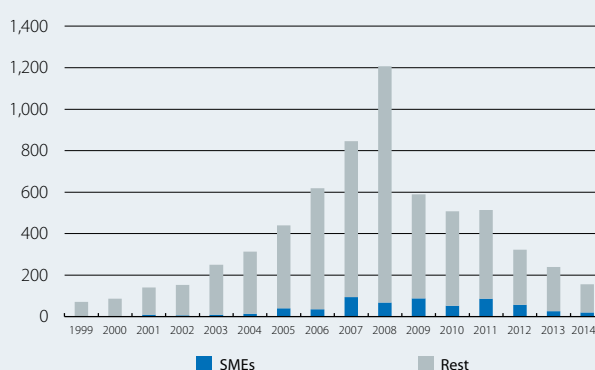


Note: Core includes Belgium, Germany, France, Netherlands, Austria and Finland. Periphery includes Ireland, Greece, Spain, Portugal and Italy.

Source: "la Caixa" Research, based on data from the SAFE survey (2S 2013) of the ECB.

ABS issuances in Europe **

(Billion dollars)



Notes: * Only includes issuances from the first six months.

** Includes Belgium, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, Russia, Spain, United Kingdom and multinational securitisation.

Source: "la Caixa" Research, a partir de datos de SIFMA.

Securitisation risk weighting by rating*

(%)

	BIS proposal		Current regulation
	1-year maturity	5-year maturity	All maturities
AAA	15	25	7
AA	25	50	8
A	50	75	12
BBB	90	130	60
BB	160	230	425
B	310	420	1,250
CCC	460	530	1,250
Less than CCC-	1,250	1,250	1,250

Note: * The minimum capital requirements (as a % of exposure) equal 8% multiplied by the corresponding weighting. For example, if the weighting is 75, the capital requirement is $8\% \times 0.75 = 6\%$.

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

KEY INDICATORS

Activity and employment indicators

Values, unless otherwise specified

	2012	2013	2013 Q3	2013 Q4	2014 Q1	2014 Q2	07/14	08/14
Retail sales (year-on-year change)	-1.7	-0.8	-0.5	0.4	1.0	1.6	...	...
Industrial production (year-on-year change)	-2.5	-0.7	-1.1	1.6	1.3	0.8	...	...
Consumer confidence	-22.1	-18.6	-15.9	-14.4	-11.2	-7.7	-8.4	-10.0
Economic sentiment	90.8	93.8	95.3	99.1	101.6	102.2	102.1	100.6
Manufacturing PMI	46.2	49.6	50.9	51.9	53.4	52.5	51.8	50.8
Services PMI	47.6	49.3	50.9	51.3	52.1	53.0	54.2	53.4
Labour market								
Employment (people) (year-on-year change)	-0.6	-0.8	-0.8	-0.4	0.1	...	-	...
Unemployment rate: euro area (% labour force)	11.3	11.9	12.0	11.9	11.7	11.6	11.5	...
Germany (% labour force)	5.5	5.3	5.3	5.2	5.2	5.0	4.9	...
France (% labour force)	9.8	10.3	10.3	10.2	10.2	10.2	10.3	...
Italy (% labour force)	10.7	12.2	12.3	12.5	12.5	12.5	12.6	...
Spain (% labour force)	24.8	26.1	26.1	25.8	25.3	24.7	24.5	...

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 Q3	2013 Q4	2014 Q1	04/14	05/14	06/14	07/14
Current balance: euro area	1.6	2.7	2.4	2.7	2.7	2.7	2.7	2.6	...
Germany	7.1	6.8	6.7	6.8	6.9	6.9	6.9	6.7	...
France					-0.6	-0.8	-1.3	-1.3	...
Italy	-0.3	1.0	0.7	1.0	1.3	1.4	1.5	1.5	...
Spain	-1.2	0.8	0.8	0.8	0.4	0.3	0.1	-0.1	...
Nominal effective exchange rate¹ (value)	97.8	101.6	101.9	103.1	103.8	104.5	103.8	103	102.6

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 Q3	2013 Q4	2014 Q1	04/14	05/14	06/14	07/14
Private sector financing									
Credit to non-financial firms ¹	-0.3	-2.3	-2.8	-2.9	-3.1	-2.8	-2.6	-2.2	-2.2
Credit to households ^{1,2}	1.2	0.3	0.3	0.3	0.3	0.4	0.4	0.5	0.5
Interest rate on loans to non-financial firms ³ (%)	2.4	2.2	2.2	2.3	2.2	2.3	2.1	2.1	...
Interest rate on loans to households for house purchases ⁴ (%)	3.1	2.8	2.8	2.8	2.8	2.7	2.7	2.6	...
Deposits									
On demand deposits	4.1	7.9	7.6	6.6	5.9	5.2	4.9	5.3	5.6
Other short-term deposits	2.0	0.0	0.3	-1.5	-2.5	-2.4	-1.9	-1.8	-1.8
Marketable instruments	0.5	-14.8	-17.2	-16.8	-12.6	-14.2	-12.1	-8.8	-6.8
Interest rate on deposits up to 1 year from households (%)	2.8	2.0	1.8	1.6	1.6	1.6	1.4	1.4	...

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 · Growing through domestic demand: a double-edged sword

The summer has helped to strengthen the Spanish economy. Although the main European economies have posted worse figures than expected, and in some cases even worrying figures, the Spanish recovery seems to be gaining traction little by little, something that is finally being noticed in the labour market. There are therefore reasons to be optimistic. We must be as cautious as possible, however, due to at least three reasons. Firstly, part of this upswing in activity is being supported by temporary factors such as decisions to consume or invest being taken that had been proposed during the years of crisis. Secondly, the recovery depends almost entirely on domestic demand, undoing the external rebalancing achieved over the last few years. Thirdly, although the Spanish economy has managed to remain relatively insulated from Europe's weak performance so far, its resilience is limited. We will now analyse these issues in more detail.

Domestic demand has taken over from the foreign sector as the driver of GDP growth in 2014 Q2. As expected, both household consumption and investment have posted considerable growth rates. Specifically, household consumption advanced by 0.7% quarter-on-quarter and has grown by an average of 0.6% for the last four quarters. This has pushed the year-on-year rate of change above 2%, at 2.4% specifically. Investment is also recovering strongly, in this case thanks particularly to investment in capital goods (+2.1% quarter-on-quarter) which, given its good performance, is likely to end the year with an almost double digit growth rate. Investment in construction also made notable progress in 2014 Q2 (+0.9% quarter-on-quarter). On the other hand, public expenditure remained the same after a surprising increase in Q1 and is likely to post negative figures for the next few quarters to ensure the government meets the deficit reduction targets agreed with Brussels.

The other side of the coin for Spain's economic growth: a deteriorating external balance. Both exports of goods and services picked up again in Q2 with quarterly growth of 1.4% and 1.2% respectively but this was not enough to offset the sharp rise in imports. These rose by 1.9%, a figure that may not seem much higher than exports but, given that this gap has occurred over the last few quarters, in year-on-year terms the difference is greater: 3.9% for imports compared with 1.7% for exports. This key support for the Spanish economy during the years of recession has disappeared quickly once domestic demand started to recover. For the moment, the result is that, in June, the current account balance once again fell into negative figures. Specifically, in cumulative terms over the last 12 months, the current account balance decreased by just

Change in the IMF forecasts

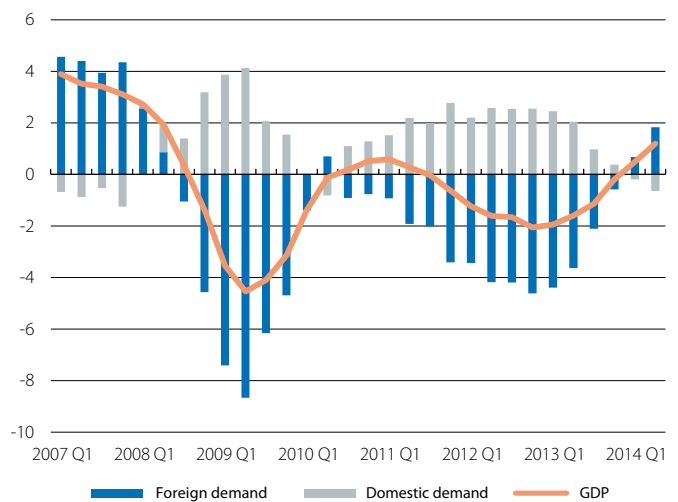
Year-on-year change, unless otherwise specified (%)

	June 2014		April 2014	
	2014	2015	2014	2015
GDP growth	1.2	1.6	0.9	1.0
Unemployment rate (% labour force)	24.9	23.8	25.5	24.9
Employment	0.2	0.8	0.3	0.4
CPI	0.1	0.8	0.3	0.8
Current account balance (% GDP)	0.6	0.7	0.8	1.4
Fiscal balance (% GDP)	-5.7	-4.7	-5.9	-4.9
Public debt (% GDP)	99.0	101.0	99.0	103.0

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

Contribution to year-on-year growth in GDP

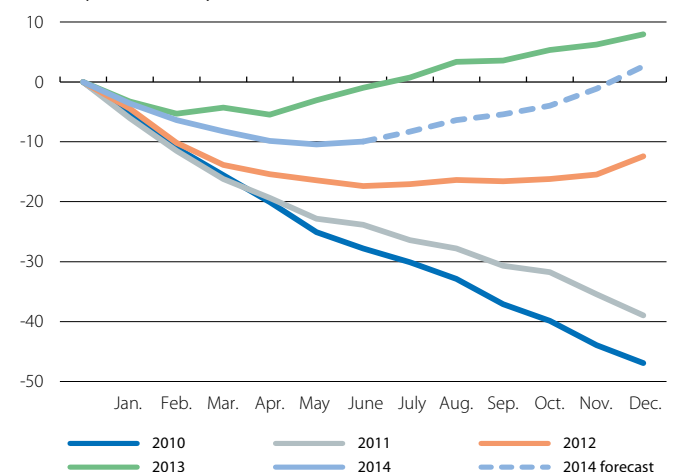
(p.p.)



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

Current account balance

Cumulative figures for the year to date (billion euros)



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

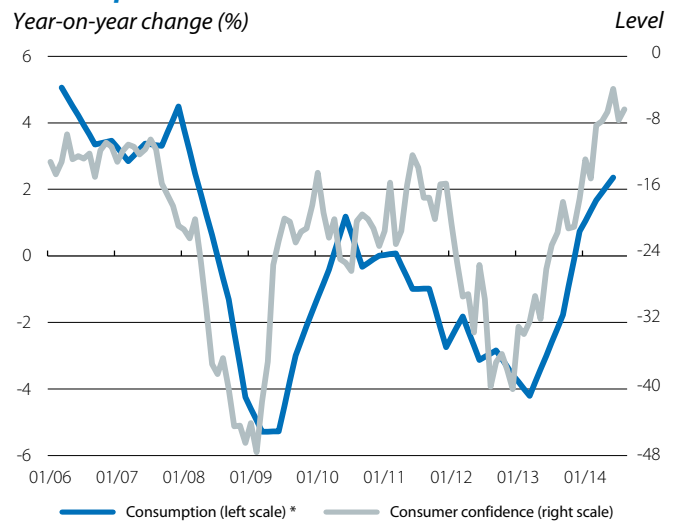
over 1 billion euros (compared with a rise of almost 8 billion euros in December 2013).

The recovery in domestic demand looks like continuing, as suggested by the main leading indicators. Consumer confidence, for example, is still following an upward trend in spite of the ups and downs of the last few months and is consolidating at levels that have not been seen for several years. Other good indicators for demand, such as the sales of large companies or automobile sales, with 2.0% and 17.2% growth year-on-year respectively, point in the same direction. However, it is important to note that the household savings rate is at an all-time low; this fell to 9.4% of the gross disposable income of households in 2014 Q1, a figure that, according to all indications, will continue to fall in the short term until the recovery in the labour market builds up steam.

The improvement in the labour market is becoming stronger and broader. The LFS for Q2 suggests that the labour market has finally started to reflect the recovery in economic activity. The number of employed increased by 402,400 people, its largest rise since the start of the crisis. Discounting seasonal effects, employment grew by 1.0% quarter-on-quarter compared with 0.1% in 2014 Q1. It is significant that this revival has not appeared exclusively in the services industry: industry has also reported positive growth. It also seems as if this progress by employment has started to alleviate the discouraging effect as the labour force, which had been shrinking for several quarters, increased by 92,000 people and the unemployment rate therefore fell by 1.45 p.p. down to 24.5%. The data for workers affiliated to Social Security in July continue to point to a recovery in the labour market although the rate of growth slowed down slightly compared with previous months. Although these figures are good in general, a significant proportion of this recovery is being supported by tourism, which continues to break records in 2014. The figures for the coming months will therefore be crucial to determine just how solid this recovery in employment may be.

Business indicators are withstanding Europe's increased weakness, for the moment. Unlike the data coming from the main countries on the Old Continent, the different leading indicators for activity in the Spanish economy are still enjoying an upward trend. The PMI for manufacturing, for example, continued to rise in July. Although this might be interpreted as a sign of a strong economic recovery in Spain, it is important to remain cautious. Part of this upswing in activity is a result of improved confidence in the Spanish economy's growth capacity, leading to decisions to consume or invest being taken that had been postponed during the years of recession. The underlying trend, therefore, is lower than the observed trend. Moreover, although the Spanish economy may have diversified its exports over the last few years, its relative weight of trade with the rest of the European countries is still substantial, so if the European situation becomes entrenched, sooner or later Spain will notice its effects.

Consumption and consumer confidence

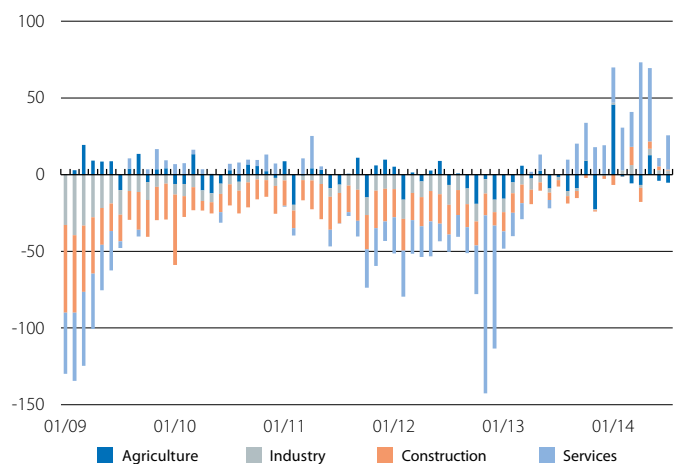


Note: * Quarter-on-quarter data.

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

Employment trend

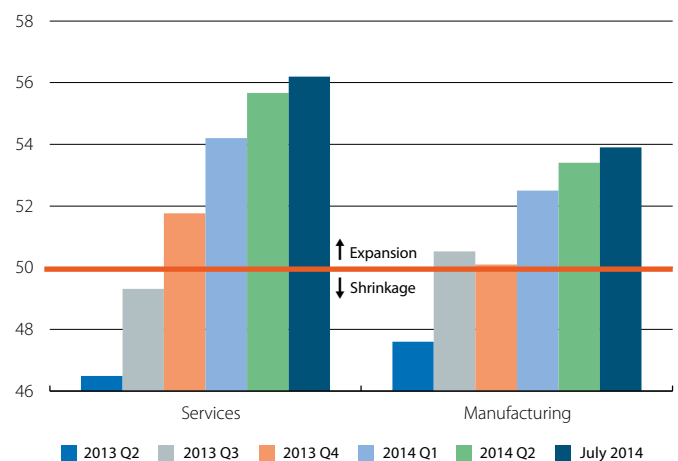
Month-on-month change, seasonally adjusted (thousands)



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

Activity indicators

Purchasing Managers' Index (value)



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

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

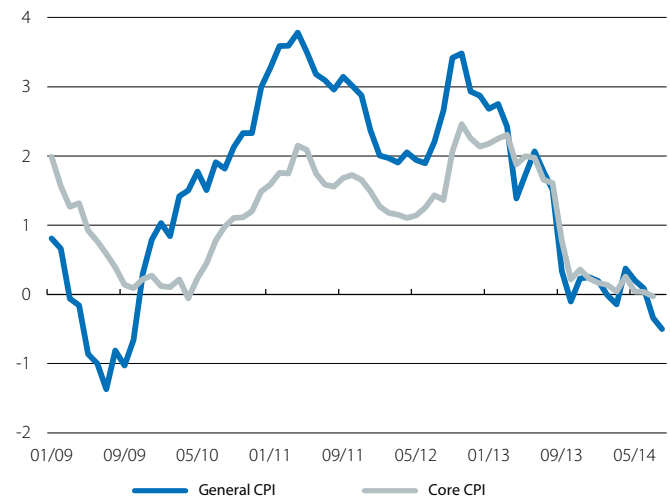
Inflation is not responding to the higher growth rates and falls to negative figures. In August it stood at -0.5% (-0.3% in July), driven by the fall in lubricant and fuel prices compared with the rise seen in 2013. Part of the answer to why, within a context of economic recovery, the inflation rate has a downward trend can be found in the fact that it is the most volatile components, such as those previously mentioned and also food prices, that have been pushing down inflation over the last few months. Core inflation has remained stable for several months at around 0.0% and is not expected to start any downward slide in the near future. However, we must remember that, although activity has enjoyed positive growth rates for the last four quarters, industrial capacity utilisation is still relatively low and wages contained, helping the economy to continue gaining in competitiveness. This explains why inflation is taking longer than usual to recover.

The adjustment of the general government deficit is progressing at a good pace thanks to higher revenue and improved financing terms. In July, the government deficit stood at 3.1% of GDP, 0.5 p.p. less than the balance for 2013. To a large extent, this improvement is thanks to the economy's greater growth, which has helped to increase tax revenue and a decrease in transfers to other public administrations is also playing an important role. Public expenditure has been contained, essentially due to improved financial conditions. For example, the bills issued in August closed with a yield close to 0% and the spread between the yield on ten-year Spanish bonds and their German equivalent was just 130 b.p. in August. However, although the government looks like meeting its deficit target, it must not let its guard down.

Further signs of improving bank activity. In June the decline in the credit balance eased (from -6.9% to -6.3% year-on-year) and the drop in the NPL ratio speeded up (13.06% compared with 13.62% in December 2013). One particularly positive note was the revival in new loans, especially for household consumption and SMEs. Specifically, in July 12.44% more new loans were granted to SMEs than in the same month in 2013 (and 4.72% more than in July 2012). We expect the results of the stress tests on banks, to be announced in October, to help stabilise the banking sector and consolidate this revival in loans.

CPI

Year-on-year change (%)



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

Central government balance

Cumulative figures for the year to date (billion euros)

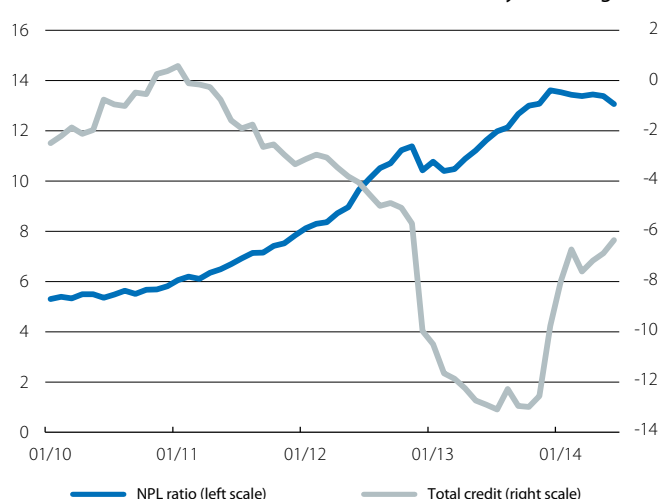


Source: "la Caixa" Research, based on data from the Bank of Spain.

NPL ratio and bank credit

Doubtful loans out of total credit (%)

Year-on-year change (%)



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

FOCUS · The improvement in the current account balance comes to a halt

Although the growth and the labour market figures have come as a pleasant surprise over the last few months, we cannot become complacent. The adjustment of the external imbalance, which has served to convince those both within and outside Spain of the economy's medium-term growth capacity, is showing clear signs of losing steam.

The current account balance went from a deficit of 114.3 billion euros in June 2008 to a surplus of almost 8 billion euros in December 2013, boosted by gains in competitiveness that have helped exports to grow substantially while a weak domestic demand has kept imports at a standstill. However, over the last few months the improvement in the current account balance has come to a halt, a worrying sign given the country's high gross external debt (163% of GDP in 2014 Q1). The latest figures published for June were particularly negative: over the last 12 months the cumulative current account balance has returned to negative terrain, reaching just over 1 billion euros.

One of the main reasons for this change in trend is the development in the income balance: its deficit has increased by almost 5 billion euros over the last six months. However, to a large extent this is due to the recovery in foreign investor appetite for Spanish assets, which is gradually getting back to normal. It is therefore unlikely to increase much further.

Attention is now focused on the balance of goods, whose deficit has risen by nearly 5.6 billion euros this year so far, up to 15.8 billion euros. Of particular note is the upswing in imports (5.3% year-on-year in the first half of the year compared with -1.3% for 2013 as a whole), especially automobiles, consumer durables and capital goods. Exports of goods have suffered from the slowdown experienced by important emerging economies (Brazil, South Africa and Russia) and the weakness of France and Italy. This means they only grew by 0.5% year-on-year in the first half of 2014, a much lower figure than the 5.2% of 2013.

Part of this upswing in imports is likely to be temporary. Greater confidence in the ability of Spain's economy has boosted consumption and investment decisions that had been postponed during the crisis years and which, given their nature, are highly import-intensive. We also expect imports to be boosted by the recovery in world demand over the coming months.

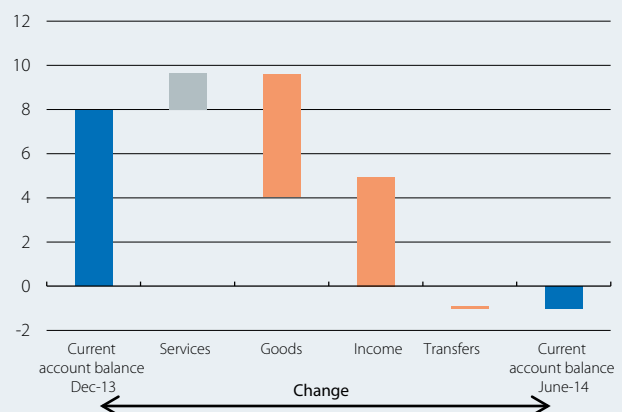
In any case, the Spanish economy is unlikely to end the year with a current account balance larger than the one

in 2013 (0.8% of GDP). By way of example, should the trade in goods perform the same in the second half of this year as it did in the second half of 2013, which would constitute a more than remarkable change in trend, the current account balance would reach around +0.5% of GDP. If such a change in trend does not occur and the dynamic of the first six months continues, 2014 could end with a current account balance of around -0.5% of GDP.

This reminds us of how important it is for the Spanish economy to continue making gains in competitiveness. For several months now the consensus of analysts has been lowering its current account balance forecasts. This is a trend that will very probably continue over the coming months and that, if not corrected, could erode the highly prized confidence of the international community in the Spanish economy.

Change in the current account balance *

Cumulative figures over twelve months (billion euros)

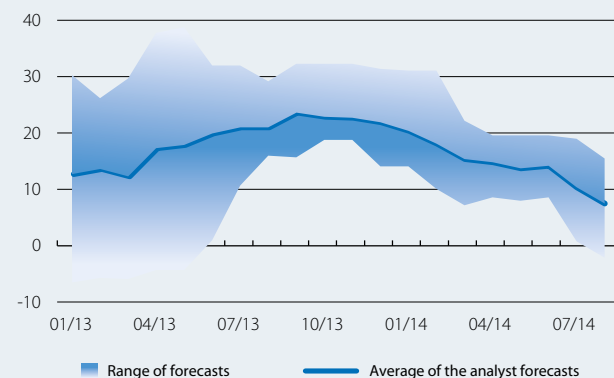


Note: * December 2013-June 2014.

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

Trend in the 2014 current account balance forecast by the consensus of analysts

(Billion euros)



Source: "la Caixa" Research, based on data of the Consensus Forecast.

FOCUS · The automobile industry is revving up in Spain

There is no doubt that one of the key sectors for the Spanish economy is the automobile industry. According to figures from the Spanish car and truck manufacturer association (ANFAC), it contributed 6.7% of GDP in 2013 (10% once all activities related to automobiles are included, such as insurance and distribution). It also added 16% to the total for exports and employed, directly and indirectly, 8.1% of the country's labour force.

The motor vehicle industry was one of the first to revive after the crisis, with the annual rate of change in vehicle manufacturing workers affiliated to Social Security already achieving positive figures by September 2013, five months sooner than the economy as a whole. Other indicators also confirm the sector's good performance and point to a healthy future. Growth in turnover has been consolidating for several months, first in motor vehicle manufacture and then in the number of sale and repair operations, reaching high year-on-year growth rates in June of 10.5% and 12.0%, respectively.

In 2013, vehicle production increased by 9.3%, coming close to 2.2 million units. Spain therefore led the growth in manufacturing in Europe: Germany and the United Kingdom grew by 1% while France and Italy suffered big setbacks, 11.6% and 2%, respectively. Should this rate continue, 2.4 million vehicles will have been made in Spain in 2014, a higher figure than the one recorded in 2011 and close to the average for the period between 2004 and 2007, namely 2.6 million.

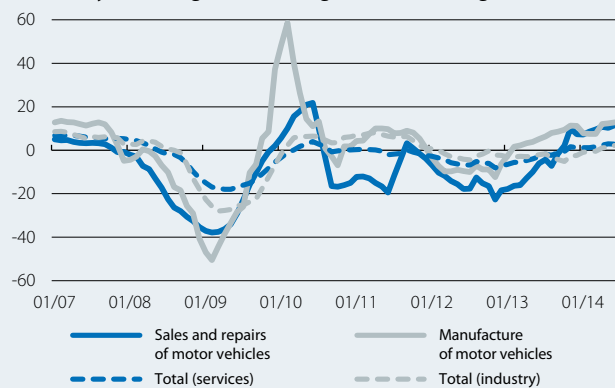
The motor vehicle industry has also helped to boost exports and thereby stimulate Spain's economic recovery. For one year now automobile exports have far outperformed activities as a whole, helped by a considerably wide range of destinations. In 2013 a total of 1.9 million vehicles were exported, 8.7% more than the previous year and with increasing numbers towards new countries such as Algeria, the US and Turkey. Although this growth in exports halted during the first few months of 2014 due to changes in the assembly lines to launch new models, exports should continue to increase once this adjustment phase is over.

The automobile industry is also reflecting the improved household confidence in the economic recovery, as well as the support of plans to stimulate vehicle purchases (such as the PIVE plan), implemented over the last few years. In 2013, 0.8 million vehicles were sold in Spain, 4% more than the previous year, and this trend is expected to continue due to the relatively old age of Spain's existing cars (the average age of vehicles in Spain was 11.3 years in 2013, much higher than the 8.5 years in 2007 and 8.3 for the EU in 2010).

Another determining factor in the progress of the motor vehicle industry is the increase in the national share of the market: i.e. the percentage of vehicles registered in Spain that have been produced in the country. Since 2012, incentives to buy efficient vehicles (the PIVE plan) have boosted the national share in the market (going from 22.3% in 2011 to 24.3% in 2013) since a large part of the aid was aimed at segments of cars made in Spain. In the future, it is vital to strengthen the competitiveness of nationally produced vehicles to ensure this improvement in the share does not depend entirely on the design of programmes to boost vehicle sales.

Trend in turnover

Year-on-year change (%), moving 3-month average

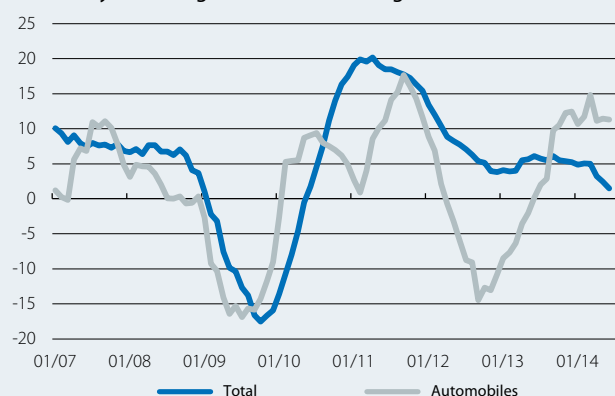


Note: Data adjusted for seasonal and calendar effects.

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

Exports

Year-on-year change (%), cumulative figures over 12 months



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

FOCUS · Employment quality: higher in industries with more exports and larger firms

During the recession, those sectors¹ exporting the most² and with a larger concentration of large firms³ performed better in terms of employment. In 2013, in the sectors analysed with more than 50% of their sales abroad, the average annual rate of change in employment was positive (6.1%) while, in those industries with a lower share of foreign sales, jobs were still being lost on average (-5.7%). This gap has narrowed in 2014 as the recovery in domestic demand has helped to increase new jobs in sectors that are more dependent on domestic consumption. Nonetheless, there can be no doubt that internationalisation and larger firms help to create jobs. But what kind of jobs do such sectors generate? The number is important but so is quality.

In 2013, those sectors selling more than 50% abroad had a markedly higher ratio of employees with permanent contracts than the rest (7.9 p.p.). This ratio was also higher in sectors with at least 50% of all turnover produced in firms employing more than 250 workers (7.0 p.p.).

Regarding wages, the situation is once again more favourable for those industries with more exports and larger companies, judging by the data from the Annual Labour Cost Survey for 2013. For example, on average workers in export-intensive industries received a salary of 36,690 euros while the annual wage for the least export-intensive group was 24,260 euros.

Given the higher wages in the sectors in question, it comes as no surprise that they also tend to have more workers with a higher education. According to data from the labour force survey for 2013, 51.3% of workers in highly export-intensive industries had completed higher education (13.3 p.p. higher than the rate for the rest). This advantage, albeit smaller (4.4 p.p.), can also be seen when sectors are compared in terms of company size.

In short, the relatively better progress made by the labour market in more export-intensive sectors and larger firms is not limited to the quantity of employment but also relates to its quality. Any economic policies aimed at boosting internationalisation and encouraging firms to grow will therefore be very welcome.

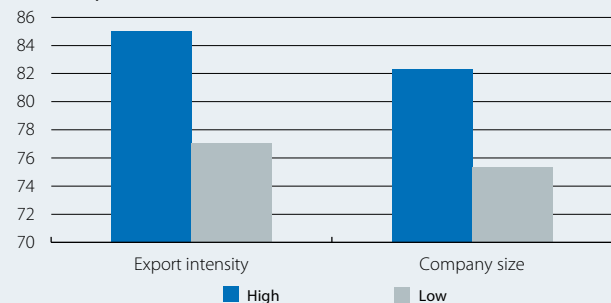
1. It should be noted that only some industrial and service sectors are analysed, namely those where enough data are available to classify them in terms of their export intensity and company size. These employed 44% of all workers in 2013.

2. See the Focus «Internationalisation: an opportunity for employment» in MR12 (2013).

3. See the Focus «Spanish firms are getting bigger» in MR06 (2014).

Type of employee contract by export intensity and company size *

Share of permanent contracts out of total (%)

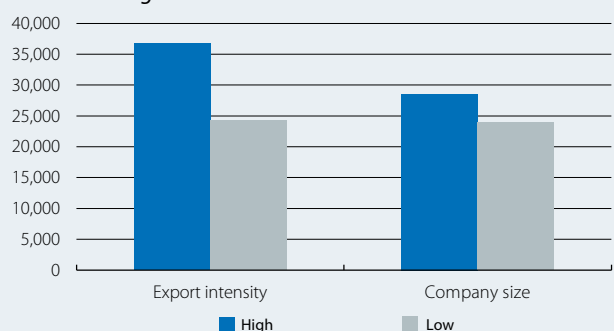


Note: * «High» export-intensive sectors are those whose sales abroad exceed 50% of the total. «High» sized companies are those in which more than 50% of their total turnover comes from companies employing 250 workers or more.

Source: «la Caixa» Research, based on data from the Industrial Survey of Companies (2012), Annual Survey of Services (2012) and Labour Force Survey (2013).

Wage costs by export intensity and company size *

Annual average in 2013

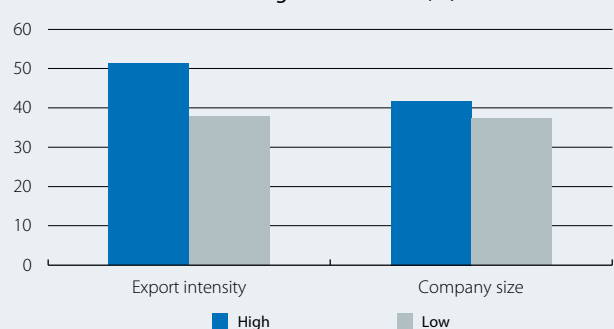


Note: * See the note for the first graph.

Source: «la Caixa» Research, based on data from the Industrial Survey of Companies (2012), Annual Survey of Services (2012) and Annual Labour Cost Survey (2013).

Education of the workers by export intensity and company size *

Share of the workers with higher education (%)



Note: * See the note for the first graph.

«High» education corresponds to having completed higher professional or university studies (codes 50-56, 59, 61 in CNED-2000).

Source: «la Caixa» Research, based on data from the Industrial Survey of Companies (2012), Annual Survey of Services (2012) and Labour Force Survey (2013).

KEY INDICATORS

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

Activity indicators

	2012	2013	2013 Q3	2013 Q4	2014 Q1	2014 Q2	06/14	07/14	08/14
Industry									
Electricity consumption	-2.2	-2.1	-2.4	0.1	-0.4	0.8	0.1	0.1	...
Industrial production index	-6.6	-1.5	-0.7	1.1	1.5	2.7	0.6	...	...
Indicator of confidence in industry (value)	-17.5	-13.9	-12.8	-11.6	-9.1	-8.2	-7.4	-5.7	-5.7
Manufacturing PMI (value)	43.8	48.5	50.5	50.1	52.5	53.4	54.6	53.9	...
Construction									
Building permits	-42.7	-21.4	-24.0	-6.5	-8.9	...	...	...	...
House sales	-8.7	-2.4	-9.3	-9.8	-9.3	6.5	8.8	...	...
Services									
Foreign tourists	2.0	5.6	4.8	10.8	8.1	7.8	4.5	5.9	...
Services PMI (value)	43.1	48.3	49.3	51.8	54.2	55.7	54.8	56.2	...
Consumption									
Retail sales	-7.1	-3.7	-1.8	0.4	-0.1	0.7	0.3	-0.4	...
Car registrations	-13.5	5.6	8.4	22.6	11.8	23.2	23.9	10.9	...
Consumer confidence index	-31.7	-25.3	-20.5	-19.4	-11.8	-6.1	-3.9	-7.7	-6.4

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 Q3	2013 Q4	2014 Q1	04/14	05/14	06/14	07/14
Registered as employed with Social Security¹									
Employment by industry sector									
Manufacturing	-5.3	-4.3	-3.9	-2.5	-1.3	-0.3	0.1	0.3	0.6
Construction	-17.0	-12.1	-10.8	-7.9	-5.3	-3.0	-2.3	-1.6	-1.1
Services	-1.7	-2.0	-2.1	-0.4	1.1	2.0	2.3	2.4	2.6
Employment by professional status									
Employees	-3.8	-3.8	-3.9	-1.8	0.1	1.0	1.4	1.6	1.9
Self-employed and others	-1.4	-0.6	-0.5	0.4	1.4	2.1	2.3	2.4	2.4
TOTAL	-3.4	-3.2	-3.3	-1.4	0.4	1.2	1.6	1.8	2.0
Employment²	-4.3	-2.8	-2.5	-1.2	-0.5	-	1.1	-	-
Hiring contracts registered³									
Permanent	29.7	-14.2	-27.8	-2.1	6.8	24.7	20.9	26.2	18.4
Temporary	-4.0	6.4	7.1	15.0	19.4	11.3	13.1	18.4	8.5
TOTAL	-1.6	4.0	2.7	13.5	18.2	12.4	13.7	18.9	9.1
Unemployment claimant count³									
Under 25	4.5	-6.2	-6.4	-8.0	-9.4	-12.4	-11.0	-9.2	-5.8
All aged 25 and over	11.7	3.7	2.3	-1.2	-3.7	-5.5	-6.1	-6.3	-6.0
TOTAL	10.9	2.7	1.5	-1.8	-4.2	-6.1	-6.5	-6.6	-5.9

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 Q3	2013 Q4	2014 Q1	2014 Q2	07/14	08/14
General	2.4	1.4	1.2	0.1	0.0	0.2	-0.3	-0.5
Core	1.6	1.5	1.3	0.3	0.1	0.1	0.0	...
Unprocessed foods	2.3	3.6	6.0	0.7	0.7	-2.3	-5.2	...
Energy products	8.8	0.1	-2.1	-1.1	-1.0	2.4	0.3	...

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	04/14	05/14	06/14
Trade of goods									
Exports (year-on-year change)	3.8	5.2	11.9	4.4	0.8	3.2	-3.7	-1.3	-1.2
Imports (year-on-year change)	-2.8	-1.3	0.6	-0.6	2.0	7.0	-1.1	7.0	5.4
Current balance	-12.4	8.0	4.0	7.7	8.0	4.0	3.5	0.6	-1.0
Goods	-27.8	-11.6	-14.5	-11.5	-11.6	-13.9	-14.3	-15.8	-17.2
Services	37.6	40.9	38.7	39.3	40.9	41.6	42.1	42.4	42.5
Income	-17.9	-15.3	-15.0	-14.6	-15.3	-17.2	-18.0	-19.9	-20.2
Transfers	-4.3	-6.0	-5.2	-5.5	-6.0	-6.4	-6.3	-6.1	-6.1
Net lending (+) / borrowing (-) capacity	-5.8	15.8	12.1	15.6	15.8	12.5	11.7	8.2	6.9

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 Q3	2013 Q4	2014 Q1	04/14	05/14	06/14	07/14
Net lending (+) / borrowing (-) capacity	-10.6	-7.1	-4.6	-7.1	-0.5	-	...	-	-
Central government ¹	-8.1	-4.9	-4.0	-4.9	-1.6	-1.4	-2.5	-2.5	-3.1
Autonomous regions	-1.9	-1.5	-1.0	-1.5	-0.3	-0.4	-0.6	...	...
Local government	0.2	0.4	0.5	0.4	0.2	-	...	-	-
Social Security	-1.0	-1.2	-0.3	-1.2	0.3	0.5	0.5	...	...
Public debt (% GDP)	86.0	93.9	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 Q3	2013 Q4	2014 Q1	04/14	05/14	06/14	Balance 06/14 ¹
Financing of non-financial sectors ²									
Private sector	-4.0	-7.8	-8.1	-7.4	-6.1	-6.0	-5.6	-5.6	1,811.7
Non-financial firms	-4.1	-9.8	-10.2	-8.7	-6.4	-6.6	-5.9	-6.0	1,038.9
Households ³	-3.8	-4.9	-5.0	-5.5	-5.6	-5.3	-5.2	-5.1	772.7
General government ⁴	14.9	17.0	17.5	13.1	8.6	7.4	6.2	6.7	1,007.3
TOTAL	0.6	-0.9	-0.9	-1.4	-1.4	-1.7	-1.7	-1.5	2,819.0
Liabilities of financial institutions due to firms and households									
Total deposits	-4.5	2.1	4.7	2.2	0.2	-1.0	-0.7	-0.6	1,184.4
On demand deposits	0.2	4.2	4.6	8.1	7.4	4.5	7.1	10.7	309.3
Savings deposits	-2.8	-0.1	-0.2	1.4	3.8	5.0	7.1	5.5	214.1
Term deposits	-6.7	1.7	5.7	0.2	-3.6	-5.0	-6.1	-7.0	640.4
Deposits in foreign currency	-4.0	16.8	24.1	-0.1	-1.1	2.2	-0.9	-0.9	20.5
Rest of liabilities ⁵	-13.2	-16.8	-15.3	-12.7	-11.1	-11.1	-8.8	-5.1	129.0
TOTAL	-5.7	-0.2	2.3	0.5	-1.1	-2.1	-1.5	-1.1	1,313.4
NPL ratio (%) ⁶	10.4	13.6	12.7	13.6	13.4	13.4	13.4	13.1	-
Coverage ratio (%) ⁶	73.8	58.0	63.8	58.0	58.6	58.6	59.2	59.5	-

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.

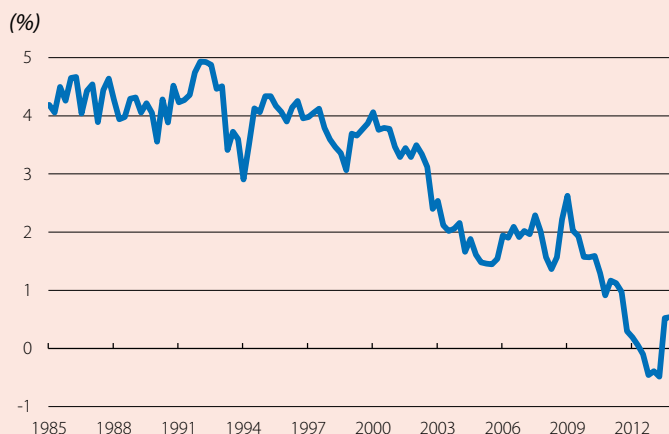
Source: "la Caixa" Research, based on data from the Bank of Spain.

LOW REAL INTEREST RATES AND ECONOMIC STABILITY

Real interest rates and growth prospects

Paul Samuelson used to say that good questions outrank easy answers.¹ His nephew, Larry Summers, seems to have come up with a very good question, at least judging by the commotion it has caused. The former US Treasury Secretary has asked why real interest rates are so low and, above all, why they are expected to remain low for such a long time. The answer is as provocative as it is worrying: it suggests we are embarking on a new era in which the growth rate is likely to be much slower than what we are used to: what economists call secular stagnation.

Real interest rate of the G7 countries *



Note: * Weighted average of the real interest rate for 10-year sovereign debt estimated for the countries of the G7 except Italy.

Source: "la Caixa" Research, based on data from King, M. and Low, D. in «Measuring the "world" real interest rate», NBER Working Paper No. 19887.

Before analysing the dynamics of the real interest rate and the possible causes and consequences, we should take a moment to specify what is meant by the real interest rate. Whereas the nominal interest rate, the one normally given for a current account or mortgage, measures how many euros a saver will obtain in the future in exchange for one euro today, the real interest rate adjusts this figure to the expected rise of prices. It therefore measures the saver's future purchasing power in exchange for lending one euro today.

It is not easy to calculate real interest rates as inflation expectations must be deducted from the nominal interest rate and these are difficult to measure. In a recent article, M. King and D. Low estimated the trend in the real interest rate for a large number of countries with the aim of obtaining what they call the world real interest rate.² As shown by the first graph, during the 1980s and 90s this was relatively stable but, at the turn of the century, a marked downward trend

started which became even sharper with the advent of the financial crisis. This is therefore a far-reaching phenomenon, both in the number of years it has been occurring and the number of countries it affects. Debate regarding the possible causes of this trend is not new, especially concerning the years prior to the crisis, and three explanations have received the most support. Firstly, an increase in savings at a global level from the emerging and oil-producing countries. Secondly, a shift in investor preference towards assets considered to be safer, such as debt, in detriment to riskier assets. Lastly, monetary policy, which was particularly lax during the pre-crisis years, has also been put forward as one of the determining factors.

The financial crisis merely increased the downward pressure on real interest rates. Monetary authorities have used all the tools available to maintain as accommodative a monetary policy as possible. They have also influenced credit conditions which, in the advanced countries, are generally stricter. As recently pointed out by the President of the Minneapolis Federal Reserve, Narayana Kocherlakota, this last circumstance has led households and firms to increase their savings as much as possible, pushing interest rates down even further.³ He also added another factor: a change in perceived macroeconomic risk. The relative lack of economic volatility over the last few decades, particularly in the developed countries, meant that most agents let down their guard, believing that volatility had become less of a risk and one they did not need protection against. However, after the crisis households perceive the possibility of suffering a significant sustained loss of income from employment as greater, just as firms now accept that a sustained drop in demand is no longer so unlikely. The reaction to this new scenario, increasing savings as a precaution, has pushed real interest rates down even further.

Although these different reasons for falling real interest rates have not been formerly proven and we are therefore unclear as to their relative importance, they do seem to be satisfactory explanations. The debate now focuses on the outlook for the next few years. Judging by the markets, real interest rates will remain low for a very long time. In the US, for example, the implicit real

1. See Davis, G., «The implications of secular stagnation».

2. See King, M. and Low, D., «Measuring the "world" real interest rate», NBER Working Paper No. 19887.

3. See Kocherlakota, N., «Low real interest rates», Ninth Annual Finance Conference, Carroll School of Management, Boston College, June 2014.

interest rate for inflation-linked 5-year bonds stands at -0.2% , while the same bonds at 10 years are just 0.4 p.p. higher.⁴

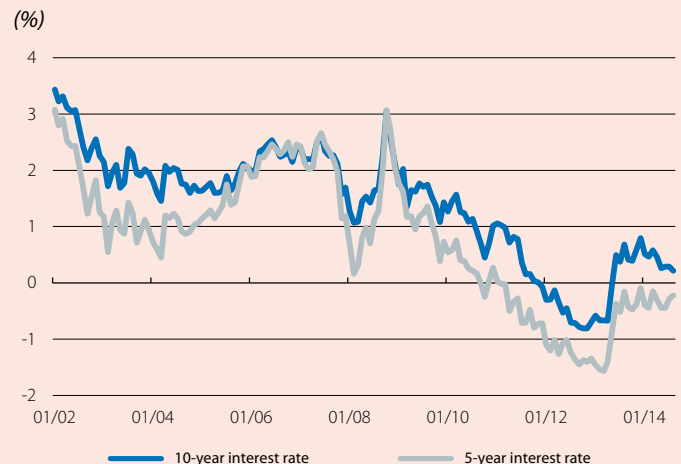
According to the IMF, real interest rates will pick up but only very slowly, taking years to return to their pre-crisis levels.⁵ The institution gives several reasons for this opinion. Although the lower growth predicted for emerging countries will reduce excess savings, it will probably not push up interest rates to any great extent. Moreover, the IMF adds that the investment factor in development countries is unlikely to exercise much upward pressure as this is expected to recover very slowly, as is typical after a financial and real estate crisis. Lastly, idle production capacity is and will continue to be very high in the developed countries for the next few years, so monetary policy needs to remain very lax.

Larry Summers' view for the US is more pessimistic.⁶ According to him, real interest rates would need to be negative for the economy to achieve full employment and inflation to reach around 2% . His estimate is essentially based on the observation of two facts. Firstly, during the years prior to the crisis, although interest rates were low there were no inflationary pressures, nor was the unemployment rate particularly low or industrial capacity utilisation particularly high. Secondly, after the recession, the recovery is taking much longer in spite of being supported by very low interest rates and, at present, there is still very little inflationary pressure. Given this situation, he notes, it is difficult to go on stimulating the economy through monetary policy. He believes the only way to boost growth significantly is via fiscal policies that stimulate private demand. Larry Summers' provocative speech has encouraged voices in favour, such as the Nobel laureate for Economics, Paul Krugman, as well as, naturally, several voices against his proposals. For Kenneth Rogoff, for example, the factor limiting growth in most developed countries is the irremediable deleveraging they have to carry out.⁷

In short, Larry Summers has certainly asked a good question but the answer is far from conclusive. However, there is some consensus in that the recovery will be slow and that real interest rates will consequently remain low for some time. If this scenario comes about, certain financial and real estate assets will probably come under pressure, as analysed by the rest of the articles in this Dossier. However, we should remember that, at the end of the 1930s, theories about economic stagnation were also popular in the US, just before its economy went through a long period of growth and prosperity.⁸ Surely, just as growth is usually accompanied by optimism, big crises can also be accompanied by an excess of pessimism.

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Implicit real interest rates of inflation-linked bonds in the US



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

4. From such a narrow spread between the ten and five-year real interest rate we can infer that the markets expect the five-year real interest rate to be only slightly positive in five years' time.

5. See «Outlook on global real interests rates», IMF World Economic Outlook, April 2014.

6. See IMF fourteenth annual research conference in honour of Stanley Fischer, November of 2013.

7. See Lo, S. and Rogoff, K., «Secular Stagnation, debt overhang and other rationales for sluggish growth, six years on», Annual BIS Conference, July 2014.

8. See Hansen, A., Full recovery or stagnation?, 1938.

The temperature is rising in international financial markets: bubble or just a hot spell?

The gains being made by the financial assets of developed economies are shifting from a reason for celebration to a source of concern, at least for some people. Specifically, the high values enjoyed by numerous sovereign debt, corporate bond and stock markets, as well as the circumstances under which such gains are being achieved, are setting off alarm bells due to the possibility of speculative bubbles appearing. Unfortunately there's no such thing as a precise, reliable «bubble meter» based on theory, so determining whether these financial markets are entering a bubble phase in the strict sense of the term (prices much higher than those justified by their underlying variables), is inexact and debatable. Fortunately, past experience can throw some light onto the situation: there are other areas where bubbles tend to leave traces in addition to asset prices, such as low volatility, high trading volumes, a bullish market, a large number of novice investors in the market in question, increased leverage, etc. An overall evaluation of indicators for the different types of assets reveals there are more reasons to be concerned about the high yield corporate bond market than stock or government bond markets. And, geographically, the US markets are more worrying than those in the euro area.

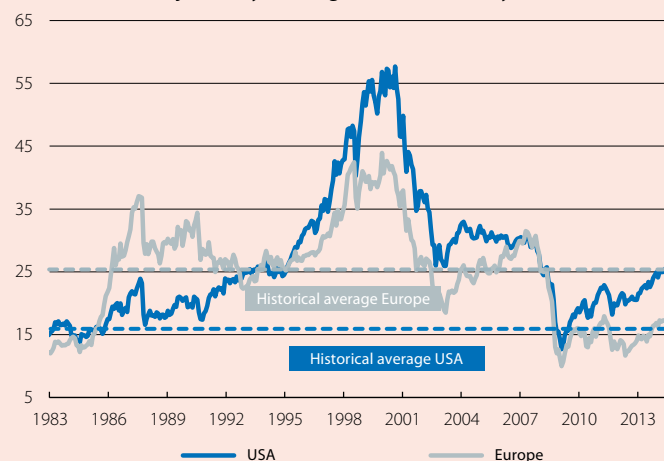
The current situation of booming financial markets is dominated by exceptionally low nominal and real interest rates. This is reflected in the high price of the most creditworthy public bonds, such as those of the US and Germany. One factor contributing to this development is the expansionary monetary policy adopted by central banks in response to the crisis of the last few years. Certainly the quantitative measures implemented (quantitative easing, in particular the Fed's bond purchases, and the full allotment of ECB loans), together with those aimed at official interest rates (forward guidance), are pushing down and reducing

volatility in the interest rate curve but their effect does not seem to be so great as to create a bubble in the Treasury and Bund markets. As explained in the article «Real interest rates and growth prospects», there are several underlying factors, some cyclical and others structural, that can explain the current low level of risk-free interest rates, which are expected to continue for some time yet (albeit with a slightly upward trend). Market climate indicators tend to suggest there is no bubble: private investors have moved away while central and commercial banks have been buying; most of them expect prices to fall and yields to rise; trading volumes are moderate.

Beyond this controversial debate regarding causes (monetary policy or otherwise), this situation of low interest rates does seem to be affecting other financial assets, essentially through the channel known as the search for yield: the readiness of investors to buy risk assets such as shares and corporate bonds, in an attempt to secure higher yields given the poor returns from monetary assets and government bonds.

Stock markets: P/E ratio adjusted to the economic cycle

CAPE: P/E ratio adjusted by earnings over the last 10 years



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

The equity of developed countries has seen substantial gains over the last few years but ostensibly more in the US than in the euro area. In 2009, the S&P 500 index began a remarkable rise that has now reached almost 200% and brought it to a level 28% above its previous all-time high in 2007. Affected by the debt and institutional crisis, the Eurostoxx 50 did not start to make any convincing gains until 2012 and, since then, it has risen by just over 50% and is still 30% below its record of 2007; in the case of the Ibex 35, this has risen by over 80% since its all-time low of 2012 but is also 30% below its record of 2007. To a large extent, this difference between the US and European stock markets is due to macroeconomic developments and trends in corporate earnings on both sides of the Atlantic, these being much more positive in the US over the last few years. But it also seems to be due to the risk premium in this country falling more quickly than in the euro area. This can be seen from the cyclically adjusted P/E ratio¹ which, for the US, is above its historical average and at a level close to the one recorded in the previous upward cycle of 2003-2007, although still very far from the levels reached in the dot.com bubble of 2000. According to this indicator, the US stock market as a whole is expensive, so we should expect poor performance in the medium term, but there does not seem to be a

1. Also called CAPE (Cyclically Adjusted Price Earnings), this measurement of value calculates the standard P/E ratio using the average earnings over the last ten years.

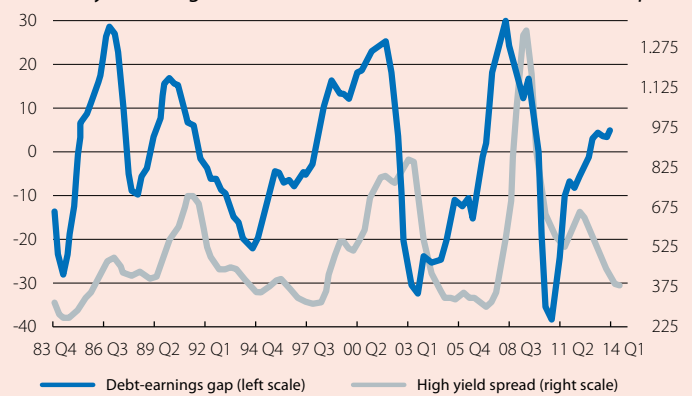
bubble of any significant size. Climate indicators also suggest that the US market is moderately overheated but not euphoric: trading (including areas as M&As, IPOs, etc.) is brisk but within the usual parameters, as is also the case for most of the investor confidence or sentiment indicators. We must, however, mention some exceptions where new conditions have been detected that could indicate bubbles, specifically sectors related to the internet and social networks, as well as biotechnology. However, in the euro area both indicators for share prices (CAPE and others) and for the climate point to a temperate to cool temperature.

An examination of the situation in the corporate bond markets provides a more worrying picture than the stock markets, both in the US and in the euro area. The renewed appetite for risk of institutional investors (insurance companies, pension funds, etc.) and individuals is creating a scenario which, if not reversed or at least reduced, could lead to a bubble. First of all, the risk premia for credit and liquidity (the difference between yields compared with top quality public debt) have once again fallen, almost reaching the minimum levels prior to the crisis in 2007. Moreover, numerous indices are pointing in a dangerous direction, especially in high yield and junk bonds. In terms of issuances, the records are relentless: according to data from Moody's, in the second quarter of the year these totalled 88 billion dollars in the US and 102 billion in Europe, record figures in both cases although the net issuances in Europe are still negative due to corporate deleveraging. But perhaps the most worrying sign is the type and use of these funds, as well as the increasing proportion of ultra-high risk assets being issued² compared with all high yield issuances. In the second quarter, the total number of bonds issued of this type increased by 78% year-on-year up to 60 billion dollars, an all-time high and accounting for 29% of all high yield assets issued in the period. A large part of this financing has been used to pay for mergers and acquisitions. Along the same lines, the last 18 months have witnessed renewed energy in the sale of products with zero or very little protection for bond holders, such as covenant-lite loans and payment-in-kind bonds,³ far above the pre-crisis levels. Another illustrative example of the current situation, characterised by investors taking on more risk in exchange for increasingly poor returns, can be found in cat (or catastrophe) bonds, instruments issued by insurance companies which specifically exempt, either totally or partially, the issuer from paying the principal or coupons in the case of losses caused by hurricanes or earthquakes). According to data from Bloomberg, the number cat bonds issued picked up in the first half of the year by 30% year-on-year and 15% in volume terms, totalling 6.5 billion dollars, within a context of a downward trend in yields and spreads for these products, very close to the historically minimum levels.

All the above suggests that corporate bond markets are currently vulnerable in several areas, with weaknesses that could be triggered and interact together. Firstly, the gap between the growth in corporate debt and earnings has started to show signs that suggest default rates may rise in the US, perhaps not in the short term but certainly in the medium term, albeit starting from a low level. Secondly, companies are facing high risks related to interest rates, credit and refinancing, especially if global interest rates eventually start rising and given the low risk premia for corporate bonds and growing leveraging in some sectors. Lastly, one aspect that has not attracted so much attention but has important implications is the fact that liquidity in the secondary corporate bond markets has decreased considerably due to regulatory reasons. Should there be a sudden rise in risk aversion, this would potentially amplify and lead to falls in bond prices.

In summary, the financial bubble that has repeatedly threatened over the last three decades is still there. Whereas it appeared in the stock markets in 2000 and in the real estate sector in 2007, the area it is most likely to threaten now is corporate bonds.

Spread of high yield bonds and debt-earnings gap * Year-on-year change (%) (p.b.)



Note: * Difference between the year-on-year growth in corporate debt and earnings of US non-financial firms.

Source: "la Caixa" Research, based on data from Moody's Capital Markets Research and the Federal Reserve.

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2. According to Moody's, assets issued with a credit rating of B3 or lower.

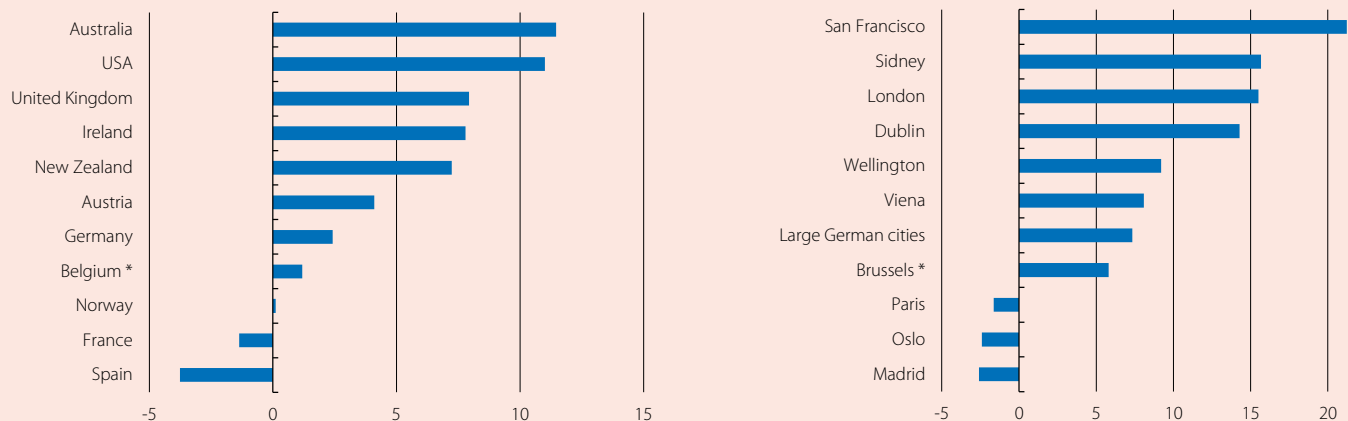
3. High risk bonds with conditions that affect the payment of the coupon and/or principal depending on the occurrence of certain events. In the case of PIKs, the issuer can choose to pay compensation in kind, generally in additional debt securities.

Are international property markets overheating?

Growth in housing prices is starting to reach high levels in some markets. Taking 2014 Q1 as our benchmark, significant increases can be seen in the nominal price of housing in the US (11.0% year-on-year), United Kingdom (7.9%), Ireland (7.8%) and New Zealand (7.2%). These rises are even more substantial if we only take into account the trend in prices in certain towns and cities. For the year to date, year-on-year growth in housing prices was well into double figures in both London and Dublin. Similarly, the value of property in Germany's large cities has grown three times faster than the rate for the country as a whole (7.3% and 2.4% year-on-year, respectively), the former seeing cumulative growth of 42% over the last five years.

Risk of overheating in some property markets

Year-on-year change in 2014 Q1 (%)



Note: * Data from 2013 Q4.

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

Given this situation, there are fears that, should the current environment of extremely lax monetary conditions go on for much longer (in other words, interest rates at an all-time low, limited volatility and ample liquidity worldwide), this might lead to property prices overheating. It should be noted that a large proportion of the imbalances created in the sector in the last decade have been attributed to the low real interest rates recorded at the beginning of the same decade. Considering the impact on the economy and financial sector of the bursting of the real estate bubble, it comes as no surprise that the rapid growth in housing prices observed recently has aroused misgivings.

To determine whether such arguments are enough to confirm the formation of imbalances in housing prices in developed countries, we will use the simile of a physics principle, according to which the position of a body at a future point in time cannot be determined solely through the speed at which it is currently moving; we also need to know its current position. Returning to real estate, if the growth in prices is equivalent to speed, we need some kind of reference to determine the current position of real estate prices in terms of their equilibrium level. An increasingly widespread indicator used for this purpose is the relation between a country's housing prices and household income. Consequently, should housing prices greatly and extensively exceed the rise in household income, this could suggest that the former are above their equilibrium level. According to OECD data, this would be the case of, among others, countries such as Belgium, New Zealand and Canada where, judging by this index, housing prices would be overvalued by more than 30%.

Using this indicator, we can classify different countries according to the degree of overheating observed in their real estate sectors. To this end, we have related the extent of imbalance in housing prices (i.e. the current position) with the change recorded in 2013 (the speed). Without doubt, the countries more likely to experience an overheated property market are those in which the overvaluation of housing prices has continued to increase in the last year (top right quadrant). This group would be made up of Canada, New Zealand, Australia and the United Kingdom, among others. Less alarming, however, is the case of countries such as France, Italy, the Netherlands or Spain where, although housing prices are somewhat overvalued, this is gradually being corrected (bottom right quadrant). The US, Germany and Ireland head the third group of countries (top left quadrant) where the rise in housing prices is bringing them close to their equilibrium level. This suggests that the growth observed recently in the US and Irish property markets is due, to a certain extent, to their recovery after an excessive price adjustment over the last few years and

is not the result of another real estate bubble forming. And, lastly, the bottom left quadrant contains those countries whose housing prices are falling even though they are already at a relatively low level.

The above diagram shows that, according to our classification, in 2013 only 6 of the 24 countries analysed showed signs of overheated housing prices. This is a very different picture from 2005, when the number of countries was much higher, namely 14. Given this situation, should measures be taken to reduce the overheating of housing prices observed in some countries? And, if so, what should these measures be?

Regarding the first question, the experience of the recent real estate crisis seems to have tilted opinion in favour of early intervention to reduce any negative effects of overheating in the property market. One initial option might be to raise interest rates since higher financing costs act as a brake both on the demand and supply of real estate and ultimately help to cool down housing prices.¹ However, given that signs of overheating are often geographically localised, this does not seem to be the ideal solution: removing any monetary stimulus would affect economic activity as a whole and would be counterproductive, particularly in those economies that are still fully immersed in their recovery.

More precise and direct alternatives should therefore be found to cool down localised booms in housing prices, such as macroprudential management tools (see the article «Macroprudential tools, the great unknown» in this Dossier). Among the range of measures available, recent studies have shown that those limiting household demand for credit, by relating the loan granted either to their income or to the value of the property (the Loan-to-Value or LTV ratio), are the most effective in controlling growth in real estate credit. This reduces any potential risks in the financial system due to the property market overheating and, in turn, cools down rising real estate prices.²

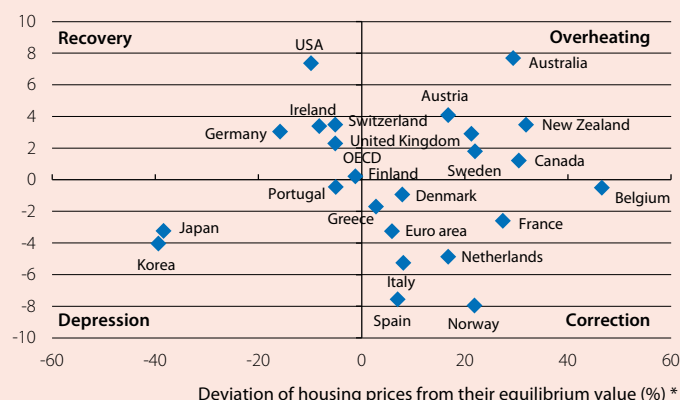
Other measures that can also have a localised effect on housing prices are of a fiscal nature. According to a recent article by the European Commission, a large number of European countries provide substantial incentives to acquire housing (such as tax deductions on mortgages).³ Over the last few years there have been notable reforms to reduce such incentives in several peripheral European countries, although the political cost of such measures generally limits their implementation.

In short, the recovery in the property market does not seem to be showing any widespread overheating of housing prices in developed countries, although some locations have been detected where the temperature is rising fast. For the moment, macroprudential and fiscal policies are enough to remedy such localised imbalances without having to resort to tightening up monetary measures which are still needed to support the incipient economic recovery.

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Situation of the property market in different developed countries

Annual change in price in 2013 (%)



Note: * Calculation based on price-to-income ratio.

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

1. Although a large amount of literature has proved this negative relation between property prices and interest rates, there are substantial differences in estimates of its extent. For more information, see Kuttner, K. «Low interest rates and Housing Bubbles: Still no Smoking Gun».

2. For more information, see Kuttner and Shim «Taming the Real Estate Beast: The Effects of Monetary and Macroprudential Policies on Housing Prices and Credit».

3. See «Quarterly Report on the Euro Area», European Commission, Vol. 13 no. 2.

Macroprudential tools, the great unknown

The vital signs of the world economy and especially the advanced economies are starting to stabilise. The serious economic and financial crisis that erupted in 2008 affected most countries, with a wide range of symptoms: unsustainable levels of debt, sharp drops in some assets and huge losses in output and employment terms. Some of the economies affected were immediately treated with large doses and got quickly back on their feet. Others, however, have needed intensive care to recover. The drip that has helped all of them to consolidate their recovery, albeit still at differing rates, is the ultra-accommodative monetary environment established by the central banks, cutting interest rates to their lowest ever levels and implementing unconventional monetary policies. This protective environment has been crucial for the administration of different treatments to remedy the imbalances of the economies affected, including restructuring the financial system, strict fiscal consolidation policies, private sector deleveraging and structural reforms to boost competitiveness.

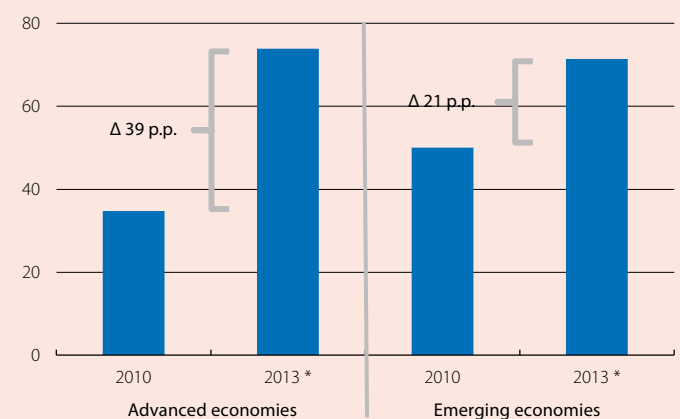
Although this environment of ultra-lax monetary policy has undoubtedly helped the economic recovery, there may be harmful side effects for some sectors should it go on for too long, such as the overheating of financial or real assets (for example, real estate). Withdrawing the monetary stimulus could help to cool down overheated markets but today's recovery still needs an accommodative monetary context to boost consumption, keep financial markets calm and consolidate the growth in economic activity. Given this dilemma, and due to the need to prevent, or at least reduce the likelihood of such bubbles forming, macroprudential tools have appeared on the scene, largely unknown but increasingly important as it becomes clear they have the potential to complement the more commonly used monetary tools.

Let us start at the beginning. Macroprudential policy is the use of supervisory and regulatory instruments with the common goal of limiting any pro-cyclical impact¹ the financial sector may have on the rest of the economy. Under certain circumstances, decisions regarding the most ideal banking strategy for each bank, if also implemented by a significant proportion of the industry, could affect the course of the economy as a whole. The current situation is a good example of this. Given that the quality of the demand for credit in several countries is still suffering from the repercussions of the recession, a lot of banks need to implement a strict credit policy. However, this could slow down the recovery which, in turn, would also ultimately delay the recovery in credit.

For the first time, the new banking regulation, also known as Basel III,² includes mechanisms that explicitly take such aspects into account. The most obvious example is the introduction of countercyclical capital buffers which increase at times of high credit growth and are relaxed during credit squeezes. In this way, during booms the banking system becomes strong enough to tackle any recessionary phases under better conditions. Moreover, this kind of policy limits how much the sector can amplify economic cycles. An increase in capital requirements may help to slow up a possible credit bubble while a relaxation in capital requirements during recessionary periods helps to cushion the drop in credit, thereby easing the crisis. Nevertheless, in the current contracting cycle the opposite happened and capital requirements were tightened up, making the slump in credit even worse. A recent study³ highlights the importance of this tool, suggesting that, if it had been put into practice before the crisis, it would have saved almost all the fiscal costs incurred by Spain for bank recapitalisation and one fourth of these costs in Ireland.

Macroprudential policy is becoming more important

Countries with a formal macroprudential mandate (%)



Note: * Countries with plans to introduce a formal, explicit mandate of macroprudential policy between 2010 and 2013.

Source: "la Caixa" Research, based on data from the IMF survey on macroprudential policy (2010).

1. See Jódar-Rosell, S. and Gual, J. (2014), «La prociclicidad del sistema financiero tras las reformas», Documents on Economics, "la Caixa" Research.

2. See Gual, J. (2011), «Capital requirements under Basel III and their impact on the banking industry», Documents on Economics, "la Caixa" Research.

3. See Annex III of the IMF staff paper «Key aspects of macroprudential policy» (2013).

There are other instruments that share the same philosophy but which, instead of acting on credit as a whole, allow action to be taken on certain assets in particular. This option can be very useful when bubbles are spotted in specific assets as direct action can be taken without affecting the rest of the sectors. For example, one option would be to modify the capital requirements for the type of credit in question. For the specific case of real estate which, as mentioned in the article «Are international property markets overheating?» in this Dossier, is once again becoming a concern in several developed countries, in addition to the aforementioned policies another option would be to limit mortgages for households throughout the cycle, either via loan-to-value restrictions, which limit the size of the mortgage compared with the value of the property, or via the debt-to-income ratio, which conditions the size of the loan on the borrower's income. These measures have already been extensively used both in emerging countries and also in advanced economies, Sweden and the United Kingdom being the most recent cases. In the Scandinavian country, banks' capital requirements in proportion to their mortgages were increased and new mortgages could not exceed 85% of the market value of the property being financed, with the aim of slowing down the rapid growth in mortgage loans and thereby making a property bubble less likely. The United Kingdom has also carried out similar measures. Specifically, the British macroprudential authority (Prudential Regulation Authority) has established that higher risk mortgages (those worth more than 4.5 times the customer's annual income) should not represent more than 15% of all new mortgages granted by British banks.

Going back to our medical analogy, an illness often needs to be tackled from different angles in order to be cured. The successful implementation of macroprudential policy depends on there being a good system of macroeconomic policies (fiscal and monetary) and a good financial regulatory and supervisory framework. It is therefore crucial to realise that such policies are complementary in order to get the maximum benefit from them.

Macroprudential policies and monetary policies are very closely related and, if not applied correctly, they could act against each other. A monetary policy that is too lax could affect financial stability and encourage participants to take greater risks (see «The temperature is rising in international financial markets: bubble or just a hot spell?» also in this Dossier). Similarly, a badly regulated macroprudential regulation might restrict the flow of credit to the economy too far. However, good coordination between both policies could be very useful. For instance, the harmful effects of a monetary policy that is too accommodative can be offset by a more restrictive macroprudential policy that cools down any sources of overheating in specific sectors. Given the important role of macroprudential policy, this requires a well-defined regulatory framework with a wide range of previously tested instruments that are ready to be implemented.

The role of macroprudential tools can therefore be vital. If regulatory institutions are capable of detecting the origin of vulnerabilities affecting financial stability and they have sufficient regulatory power to implement the tools required to smother systemic risk, the potential of combining both policies might be very great. The only drawback is the fact that these may need to be used before they have been properly designed and tested. Time is running out but we must be prudent.

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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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