

# MR10

MONTHLY REPORT • ECONOMIC AND FINANCIAL MARKET OUTLOOK

NUMBER 383 | OCTOBER 2014



## ECONOMIC & FINANCIAL ENVIRONMENT

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### FINANCIAL MARKETS

*The euro area's interbank markets: searching for normality via unusual channels*

### INTERNATIONAL ECONOMY

*Brazil: a rough patch in the short term, significant challenges in the long*

### EUROPEAN UNION

*The impact of the Russian crisis on Germany and Central Europe*

### SPANISH ECONOMY

*Changes in Spain's real estate sector*

## DOSSIER: THE KEYS TO THE RECOVERY IN CREDIT

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*The credit of credit*

*The ECB: another step forward in consolidating the euro area's recovery*

*The cost of bank debt: a thing of the past*

*A lower cost of equity for banks*

## MONTHLY REPORT - ECONOMIC AND FINANCIAL MARKET OUTLOOK

October 2014

"la Caixa"

RESEARCH DEPARTMENT

Av. Diagonal, 629, torre I, planta 6

08028 BARCELONA

Tel. 34 93 404 76 82

Telefax 34 93 404 68 92

[www.lacaixaresearch.com](http://www.lacaixaresearch.com)

For general information and inquiries:

[estudis@lacaixa.es](mailto:estudis@lacaixa.es)

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 "la Caixa" Research

- Jordi Gual  
Chief Economist
- Oriol Aspachs  
Director, European Unit
- Enric Fernández  
Director, Economic Research
- Avelino Hernández  
Director, Financial Markets Unit  
and International Unit

## INDEX

### 1 EDITORIAL

### 3 EXECUTIVE SUMMARY

### 4 FORECASTS

### 6 FINANCIAL MARKETS

- 9 *The euro area's interbank markets: searching for normality via unusual channels*
- 10 *Household finances after the crisis: the temptation of risk*

### 12 INTERNATIONAL ECONOMY

- 15 *Brazil: a rough patch in the short term, significant challenges in the long*
- 16 *International trade: what lies behind the figure*

### 18 EUROPEAN UNION

- 21 *The relationship between the value of the euro and inflation*
- 22 *The impact of the Russian crisis on Germany and Central Europe*

### 24 SPANISH ECONOMY

- 27 *On the upswing in household consumption in Spain*
- 28 *Changes in Spain's real estate sector*
- 29 *The deterioration in the income balance: reasons and trends*

### 32 DOSSIER: THE KEYS TO THE RECOVERY IN CREDIT

- 32 *The credit of credit*  
Oriol Aspachs
- 34 *The ECB: another step forward in consolidating the euro area's recovery*  
Ariadna Vidal Martínez
- 36 *The cost of bank debt: a thing of the past*  
Sandra Jódar-Rosell
- 38 *A lower cost of equity for banks*  
Pau Labró Vila

## Melancholy in the euro area

Autumn is a season prone to a certain melancholy. The days are rapidly getting shorter, the trees are losing their leaves and, after a summer break, many people are overwhelmed by their return to the daily grind. It is always tempting, and often a risk, to take refuge in a melancholy outlook at this time of year.

After suffering two recessions in just four years, the summertime was not good for the euro area's economy. Now the return to work has arrived and brought with it serious threats of melancholy, originating from the larger countries: France, Italy and also, albeit to a lesser extent, Germany.

Europe's political leaders are responsible for ensuring we do not succumb to such a gloomy temptation. On the one hand, the deterioration in the euro area's situation is closely related to geopolitical factors, particularly to tensions with Russia, but these factors should hopefully be temporary in nature. On the other hand the results of the European Parliament elections last May, together with the rise of extremist parties in many Member states, should sound the alarm for the European Union and most particularly the euro area. A jaded attitude, or merely «more of the same», will not counteract the increasing discontent among the population. Together with the new EU authorities, European leaders must ensure a true change in direction for economic policy in order to respond to today's formidable challenges. So what should form the basis of this new approach?

Regarding budget policy, the austerity debate must be suitably qualified, adjusting the reduction of public deficits to the different starting points and levels of debt. The more important countries such as Germany must especially play their part in helping to boost the aggregate demand of the euro area as a whole. It is in their own interest, given the existing degree of economic integration and Germany's great relative weight.

Regarding structural reforms, the countries now lagging most behind are France and Italy and the evident success of reforms in countries such as Ireland and Spain (and, to a lesser extent, Portugal) must spur them on to move from words to deeds.

Another area where immediate and bold action is required is the domestic market. Defeating all the protectionist resistances as necessary, Europe must integrate its service markets, especially in the area of regulated industries such as telecommunications and energy. This is a policy that would improve not only the current situation but also the long-term potential of Europe's economy.

Lastly, there is the financial area. Here the ECB has gradually worn down the resistance with an increasingly daring policy that has underpinned the integrity of the euro area and attempted to restructure the mechanism to pass on monetary stimuli and ensure liquidity reaches families and firms. This endeavour will be helped by the advances being made in Banking Union and by suitably handling the current assessment of Europe's banks. As discussed in depth in the Dossier of this *Monthly Report*, the stabilisation of regulatory policy will also help, eliminating the uncertainties that still influence the decisions taken by economic agents.

The recently deceased management guru, Warren Bennis, used to say that a good manager helps his team to reach their goal while a good leader convinces his people of what their goal should be. In the melancholy season par excellence, European citizens deserve chiefs who are not merely managers of the complex situation we have to deal with but true leaders, thereby successfully overcoming the huge challenges facing Europe's economy.

**Jordi Gual**  
Chief Economist  
30 September 2014

## CHRONOLOGY

### SEPTEMBER 2014

- 4 The ECB reduces the **Refi rate to 0.05%** and the **deposit facility rate to –0.20%**. It also announces a programme to **buy up asset-backed securities (ABS) and covered bonds**.

### 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).

## AGENDA

### 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).  
21 GDP flash estimate for China (third quarter).  
23 Labour Force Survey (third quarter).  
24 European Council.  
28 Actual expenditure of the central government (September).  
29 Fed Open Market Committee.  
30 Economic sentiment index of the euro area (October).  
GDP flash estimate for Spain (third quarter).  
Flash CPI (October).  
GDP flash estimate for the United States (third quarter).  
31 Balance of payments (August).

### NOVEMBER 2014

- 4 Registration with Social Security and registered unemployment (October).  
6 Governing Council of the European Central Bank.  
7 Industrial production index (September).  
17 Foreign trade (October).  
GDP flash estimate for Japan (third quarter).  
18 Loans, deposits and NPL ratio (September).  
25 Actual expenditure of the central government (October).  
27 Economic sentiment index of the euro area (November).  
Flash CPI (November).  
Quarterly national accounts (third quarter).

## An uneven recovery

**World growth continues but unevenly and with downside risks.** Although several institutions have lowered their global growth forecasts for this year, growth is still at a satisfactory level in line with its historical average (3.4%). The contribution to be made by two big engines will be crucial in order to achieve this figure: the US, which is showing signs of speeding up in the second half of the year, and China, which is managing to maintain acceptable activity rates while readjusting its machinery. The performance of the rest of the emerging countries is highly disparate but positive in general. In Japan, the VAT hike has not halted the country's modest economic expansion and the ultra-expansionary policies of the Bank of Japan (BOJ) have already started to bear fruit. Q3 indicators for the euro area also suggest that its decline will not go any further than the nasty shock experienced in Q2. With the help of the new ECB stimuli, the region should embark on a path of moderate growth, although this expansion is highly uneven between countries and there are downside risks to growth.

**The US economy's recovery is consolidating.** The strong upswing in GDP in Q2 (1.1% quarter-on-quarter) and the good tone of most activity indicators for Q3 confirm that US expansion is occurring on a solid base. For the moment this growth is not leading to inflationary pressures, allowing the Fed to continue its plan of very gradually withdrawing stimuli. At its September meeting, it repeated its commitment to keep interest rates very low for a «considerable time» after tapering ends, planned for the end of October. For the time being, the US government bond markets reflect this stability and this situation will continue provided inflation remains low and the pressure is contained resulting from the low interest rates on the price of some assets.

**The VAT hike has not halted the modest expansion in Japan's economy.** Japan's GDP shrank by 1.8% quarter-on-quarter in Q2, affected by the drop in private consumption and investment. However, after this temporary bad patch, leading indicators for Q3 point to the recovery starting up again. Moreover, the BOJ is prepared to prolong its expansionary monetary policy so that deflationary risks are increasingly unlikely. The increase in nominal wages is also a reason for optimism as this should boost domestic demand.

**The emerging countries continue to perform reasonably well.** In general, their trend is positive although two large groups can be distinguished. Some are still reporting satisfactory activity rates, such as China, whose modest slowdown in Q3 will be cut short by expansionary policies that are already being implemented and India, which is capable of growing and containing inflation at the same time. Others are immersed in healthy adjustment processes which are temporarily affecting their growth but form the basis of a subsequent sustainable expansion (as in the case of Turkey and Brazil). The alarm due to geopolitical risks has diminished but fronts in the Middle East, Russia-Ukraine, the Brazilian elections and disturbances in Hong Kong are still a source of concern.

**There are still signs of weakness in the euro area.** After a disappointing Q2, business and confidence indicators for Q3 suggest that the recovery will be very gradual and uneven. Although the prevailing tone is lethargic, some improvement can be seen in the foreign sector, supported by the euro's depreciation, and in the labour market which is gradually getting back to normal. Given this situation, inflation has remained constant although it looks likely to embark on a slight upward trend. Certainly the start-up of the ECB's programme of corporate bond purchases is more than welcome although, as Mario Draghi has pointed out, in order for the recovery to be solid and balanced, those countries with the greatest signs of weakness, such as France and Italy, must carry out far-reaching structural reforms to reduce the risk of relapse.

**Spain's recovery is withstanding Europe's slowdown.** After the strong initial push seen in Q2, the Spanish economy is still growing but at a slightly slower rate. Private consumption, which increased visibly in Q2, has slowed down slightly but its contribution to GDP growth will still be considerable thanks, in part, to improved employment expectations. The foreign sector, which did not contribute to growth in Q2, should become important once again as the gradual recovery in the euro area and the euro's depreciation help to boost exports. According to the macroeconomic table presented by the government as part of its 2015 budget, GDP will grow by 1.3% in 2014 and by 2.0% in 2015, a scenario that will make the fiscal adjustment required in 2015 much easier. For the time being, achieving the fiscal deficit target for 2014 (5.5% of GDP) seems feasible.

# 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
<b>GDP GROWTH</b>										
<b>Global<sup>1</sup></b>	3.2	3.0	3.4	3.8	3.4	3.3	3.3	3.4	3.8	3.9
<b>Developed countries</b>										
United States	2.3	2.2	2.2	3.1	1.9	2.6	2.3	2.2	3.5	3.0
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	-0.1	0.8	-0.4	-0.2	0.0	0.1	0.4	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	1.3	2.7	0.0	0.6	1.1	0.0	2.2
United Kingdom	0.3	1.7	2.9	2.1	3.0	3.2	2.8	2.6	2.3	2.0
<b>Emerging countries</b>										
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 <sup>2</sup>	4.5	4.7	5.9	6.2	4.6	5.7	5.8	5.9	6.0	6.2
Brazil	1.0	2.5	0.5	1.4	1.9	-0.9	0.2	0.6	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	3.2	3.3	3.5	3.3	2.9	2.9	2.9	3.2
Turkey	2.1	4.1	2.7	3.5	4.7	2.1	2.1	2.1	2.6	3.2
<b>INFLATION</b>										
<b>Global<sup>1</sup></b>	4.0	3.3	3.4	3.3	3.3	3.5	3.4	3.5	3.4	3.3
<b>Developed countries</b>										
United States	2.1	1.5	1.8	1.7	1.4	2.1	1.8	1.7	1.7	1.4
Euro area	2.5	1.4	0.6	1.2	0.7	0.6	0.4	0.7	0.9	1.1
Germany	2.1	1.6	0.9	1.5	1.0	0.9	0.8	1.0	1.2	1.4
France	2.2	1.0	0.7	1.2	0.9	0.8	0.5	0.7	0.9	1.1
Italy	3.3	1.7	0.2	0.8	0.5	0.4	-0.1	0.2	0.5	0.7
Spain	2.4	1.4	0.1	1.0	0.0	0.2	-0.4	0.3	0.6	0.9
Japan	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	1.7	2.1	1.7	1.7	1.6	1.8	2.0	2.0
<b>Emerging countries</b>										
Russia	5.0	6.8	7.3	7.0	6.4	7.6	7.5	7.6	7.6	7.2
China	2.7	2.6	2.2	2.6	2.3	2.2	2.1	2.4	2.8	3.2
India <sup>3</sup>	7.5	6.3	5.0	5.8	5.4	5.7	3.4	5.7	6.7	6.6
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	0.4	1.5	0.9	0.5	-0.1	0.4	0.8	1.5
Turkey	8.9	7.5	8.8	6.9	8.0	9.4	9.1	8.8	7.3	6.9

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

Forecasts

## Spanish economy

	2012	2013	2014	2015	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1	2015 Q2
<b>Macroeconomic aggregates</b>										
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
<b>Gross domestic product</b>	<b>-1.6</b>	<b>-1.2</b>	<b>1.2</b>	<b>1.7</b>	<b>0.5</b>	<b>1.2</b>	<b>1.5</b>	<b>1.8</b>	<b>1.9</b>	<b>1.7</b>
<b>Other variables</b>										
Employment	-4.8	-3.4	1.0	1.4	-0.4	0.8	1.5	2.0	2.0	1.6
Unemployment rate (% labour force)	24.8	26.1	24.6	23.3	25.9	24.5	23.9	24.2	24.3	23.0
Consumer price index	2.4	1.4	0.1	1.0	0.0	0.2	-0.4	0.3	0.6	0.9
Unit labour costs	-3.0	-1.5	-0.3	0.4	-0.9	0.0	-0.1	-0.2	0.8	0.0
Current account balance (cum., % GDP) <sup>1</sup>	-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) <sup>1</sup>	-0.6	1.5	0.9	1.4	1.0	0.5	0.7	0.9	1.0	1.2
Fiscal balance (cum., % GDP) <sup>1</sup>	-10.6	-7.1	-5.6	-4.2						

## Financial markets

<b>INTEREST RATES</b>										
<b>Dollar</b>										
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	0.74	0.24	0.23	0.23	0.29	0.36	0.58
12-month Libor	1.01	0.68	0.59	1.23	0.56	0.54	0.56	0.67	0.79	1.04
2-year government bonds	0.27	0.30	0.48	1.30	0.36	0.40	0.50	0.65	0.82	1.09
10-year government bonds	1.78	2.33	2.66	3.23	2.75	2.61	2.49	2.77	2.95	3.13
<b>Euro</b>										
ECB Refi	0.88	0.54	0.16	0.05	0.25	0.22	0.12	0.05	0.05	0.05
3-month Euribor	0.57	0.22	0.21	0.05	0.30	0.30	0.17	0.07	0.05	0.05
12-month Euribor	1.11	0.54	0.48	0.33	0.56	0.57	0.44	0.34	0.32	0.32
2-year government bonds (Germany)	0.08	0.13	0.05	0.09	0.14	0.10	-0.01	-0.05	-0.01	0.05
10-year government bonds (Germany)	1.55	1.62	1.33	1.34	1.68	1.43	1.06	1.15	1.24	1.30
<b>EXCHANGE RATES</b>										
\$/euro	1.29	1.33	1.34	1.25	1.37	1.37	1.33	1.28	1.26	1.25
¥/euro	102.71	129.65	137.44	134.44	140.98	140.11	135.89	132.78	133.28	134.11
£/euro	0.81	0.85	0.81	0.85	0.83	0.82	0.80	0.80	0.80	0.80
<b>OIL</b>										
Brent (\$/barrel)	111.38	108.47	105.20	103.26	107.74	109.65	103.38	100.02	101.56	102.63
Brent (euros/barrel)	86.61	81.67	78.74	82.72	78.61	79.96	78.02	78.34	80.39	81.89

Note: 1. Four quarter cumulative.

Forecasts



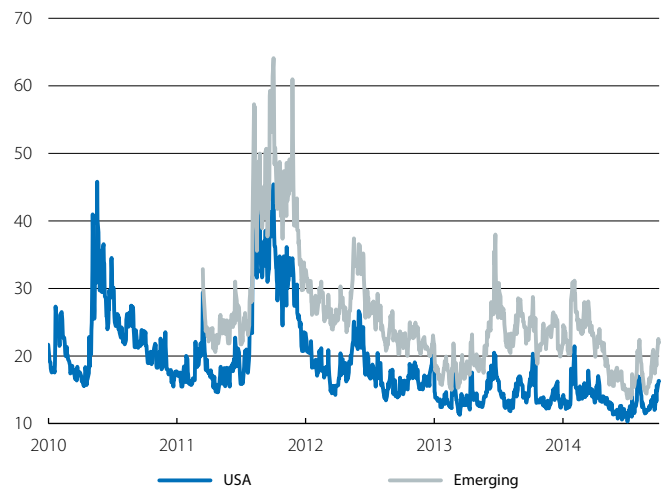
## CURRENT SITUATION · Diverging paths for the US and euro area

**Central banks to the rescue once again.** The episodes of instability dotting the global economic-financial scenario between July and August (geopolitical conflicts in Russia and the Middle East, slumps in activity in the euro area and China) were easily extinguished by the appearance of the central banks on the scene. On this occasion the key player was the European Central Bank (ECB), although the central banks of Japan and China also helped out. By announcing various monetary measures and using rhetoric, they managed to placate the outbreaks of volatility in the different financial asset markets while the Federal Reserve (Fed) has remained firmly in the background. However, the disparate tone of cyclical indicators over the last few weeks between countries augurs an autumn full of news in the monetary area. In the US, investors expect the Fed to follow its roadmap, completing its tapering in October and planning the first interest rate hike for mid-2015. In the short and medium term, the market trend is characterised by greater level of volatility, largely due to this growing divergence in the orientation of monetary policy between the US and the euro area.

**On the verge of ending tapering, the Fed ratifies its dovish tone.** At the first meeting of the FOMC (the committee in charge of monetary policy decisions) after the summer break, two familiar basic messages were repeated outlining its strategy. Firstly the plan is for interest rates to remain at a low level for «considerable time» after tapering ends in October and, secondly, the reason is that resources in the labour market are still considerably underused. However, the FOMC members suggested a slightly faster rise in the official interest rate than in previous meetings. Monetary conditions being tightened up sooner than expected would be the result, primarily, of a scenario in which the reduction in idle labour resources was faster than expected, but also of greater risks jeopardising controlled inflation or financial stability (the formation of bubbles). In this respect, the institution is likely to clarify its strategy regarding developments in the official interest rate at its next meeting on 29 October.

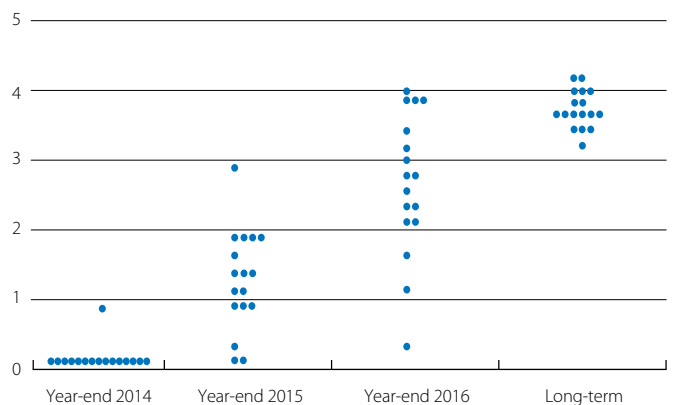
**The ECB adds more fuel to the fire.** In an unexpected move, the Governing Council of the ECB decided to cut the official interest rate to 0.05%, as well as the marginal lending facility and deposit rate to 0.30% and -0.20% respectively. Moreover, Mario Draghi announced the launch of a dual private debt purchase programme which will start in October: over the next two years the institution will acquire mortgage-backed securities and asset-backed securities from companies in the euro area, as well as buying up covered bonds. Although these decisions were not unanimously supported by the members of the Governing Council, their adoption was in

### Implied volatility in financial markets (VIX for the USA and VXEEM for the emerging countries)



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

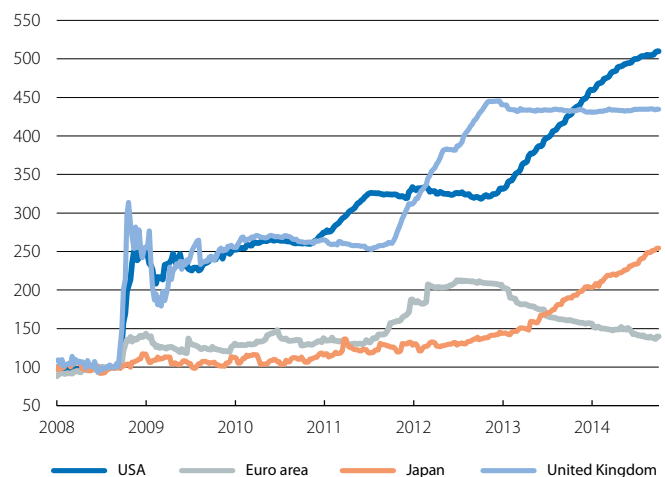
### USA: appropriate level for the official interest rate according to FOMC members on 17 September (%)



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

### Size of the balance sheet of the main central banks

(September 2008 = 100)



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



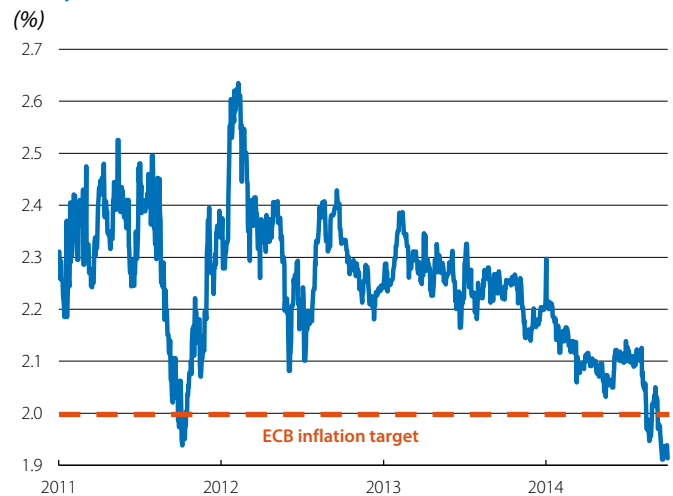
response to the deterioration in inflation expectations in the medium term and to weakening economic activity. Similarly, in September the first targeted long-term refinancing operation or TLTRO was carried out, which met with a modest demand for funds: 82.6 billion euros, clearly below the forecasts of the consensus of analysts. This circumstance has raised doubts among investors as to whether the benchmark established by the ECB itself can be reached, namely expanding its balance sheet by approximately one billion euros. The ECB has said it is prepared to take the necessary measures to achieve its ultimate objectives but it is most likely to wait a reasonable period of time before evaluating the overall effectiveness of its latest expansionary measures and proposing new areas of action.

**Investors go for long-term treasuries.** The conflicts occurring during the summer in the Middle East and Ukraine, as well as recent tensions in Hong Kong, have increased the preference of participants for safer assets, particularly US public debt and, specifically, debt with the longest maturities. The absence of any significant inflationary pressures in the US and the intensification of monetary stimuli in the EMU and in Japan have encouraged this behaviour. Paradoxically, the tranquillity now reigning in the US government bond market represents an area of vulnerability. The possibility of faster hikes in the official interest rate than currently expected, based on the apparent increase in long speculative positions in treasuries, are making the panorama more fragile.

**Minimal yield on the Bund.** The weakness of Europe's economic scenario is affecting its sovereign debt market. The economic slump suffered in Q2 by the core economies (Germany and France) is in addition to the confirmed slowdown in the euro area's inflation in September. Such figures have helped to push down the German interest rate curve even further. Specifically, one, two and three-year bonds offer a negative return while the yield on 10-year bonds is still below 1%.

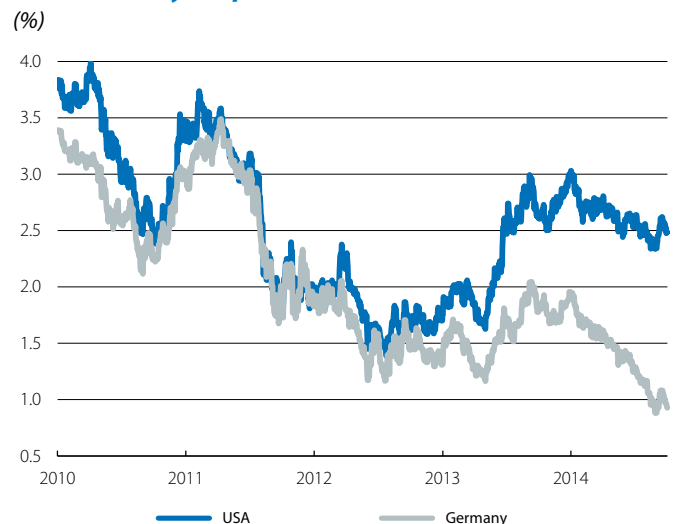
**Investors embrace sovereign debt from the periphery.** Having overcome the modest upsets of the summer (the BES crisis in Portugal and Italy's double-dip recession), yields on public debt from the periphery of Europe have once again started to fall (i.e. higher prices). The outcome of the referendum on Scottish independence has also encouraged investors to take on more risk. This trend has also been helped by the announcement of extraordinary liquidity measures by the ECB in September and could become even stronger should the central bank ultimately add to the package of measures over the coming months. Another factor to take into account is the publication of the stress test results for European banks at the end of October, which should reduce uncertainty regarding the sector without causing any upsets. Because of these tests, banks have considerably increased their issuances of contingent convertible bonds to improve their solvency ratios.

### Euro area: inflation expectations five-year rate five years ahead



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

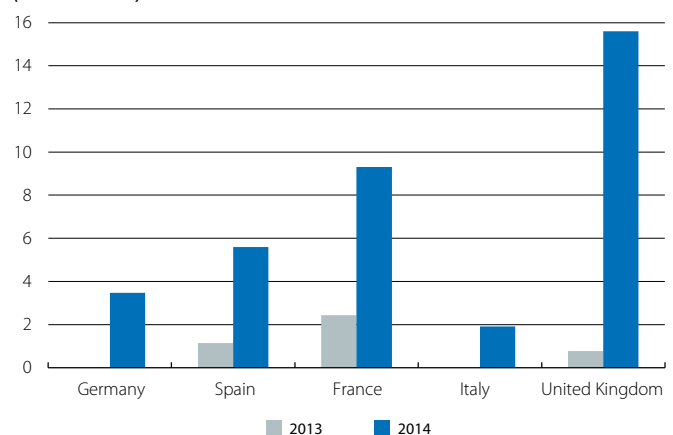
### Yields on 10-year public debt



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

### European banks: contingent convertibles (CoCos) issued

Cumulative from 1 January to 30 September every year (billion euros)



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

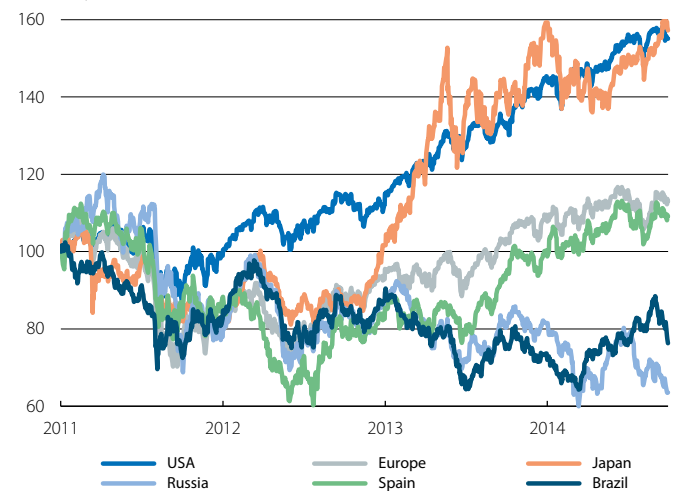
### Gains and losses in the stock markets due to doubts regarding growth in the EMU and emerging economies.

After the ups and downs seen during the summer, caution dominated the stock markets in September. The overall tone has been weak, albeit with notable differences between countries depending on their respective macroeconomic and monetary developments. Japan and the US have provided the positive note. In Japan, because investors expect another round of expansionary measures by the central bank and, in the US, thanks to the support provided by the recent good figures. Stock markets in the euro area and the emerging countries have recorded moderate corrections while, in the emerging block, doubts have been raised regarding China's economic growth although the central bank has responded quickly by injecting liquidity into the country's five largest banks. The uncertainty regarding Brazil's presidential elections, deterioration in the Russian macroeconomic scenario and altercations in Hong Kong have tipped the balance over to the side of losses. In spite of this, the medium-term outlook for the stock markets is favourable. The gradual improvement in global growth and the prolongation of accommodative monetary conditions on the whole should support this upward scenario.

**Strength of the dollar against the euro and widespread weakness in commodities.** The euro's exchange rate against the dollar has fallen to 1.26, a level not seen since 2012. The main reason for the euro's continuing depreciation is the divergence of monetary policy between the euro area and the US. In the emerging area, pressure on the Brazilian real and Russian rouble has increased. In the first case this was due to uncertainty regarding the elections that will take place in October while, in the second, it is the result of capital outflows and rumours regarding the possible establishment of exchange rate controls. Commodity prices in general, and oil in particular, are continuing their downward trend. The strength of the dollar, oversupply and an expected drop in demand for crude have pushed the price of a barrel to clearly below 100 dollars.

### Trends in the main international stock markets

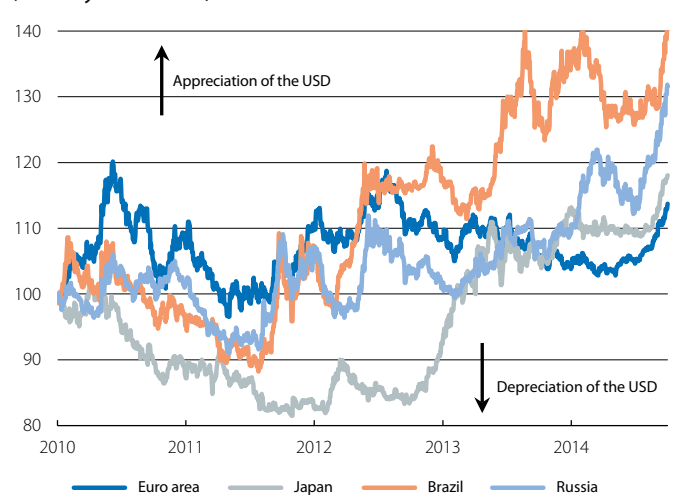
(January 2011 = 100)



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

### Value of the USD against different currencies

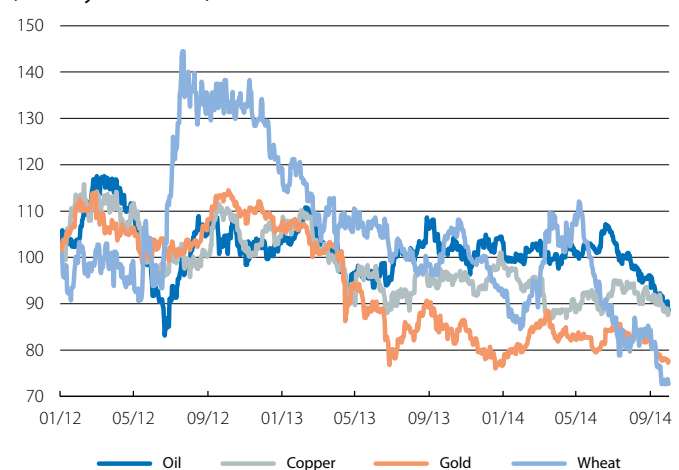
(January 2010 = 100)



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

### Trend in commodity prices

(January 2012 = 100)



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

## FOCUS · The euro area's interbank markets: searching for normality via unusual channels

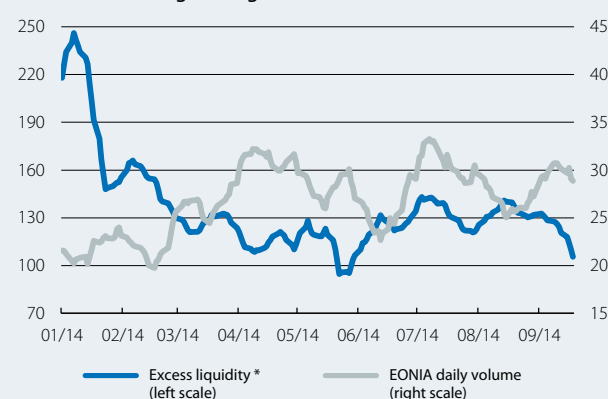
The interbank market plays a fundamental role in a country or region's economy as a whole, particularly if its banking system is highly developed, as in the case of the euro area. First of all, it is the first step in the mechanism for monetary policy transmission so the conditions under which it operates (for example, its prevailing interest rates) largely determine the financing conditions for households and companies, with direct implications for the real economy. It is therefore a huge problem if the interbank market does not work properly, as happened repeatedly between 2007 and 2011. The emergency actions taken by the central banks of almost all developed countries were decisive in cutting short those liquidity crises. Fortunately, the workings of the wholesale bank funding markets have gradually improved since then but there still seems to be too much geographical fragmentation in the euro area's interbank market, both in the secured segment (namely repo operations where the borrower provides assets as a guarantee) and unsecured (where there are no such guarantees). One of the remedies being tried by the ECB, namely establishing a negative «return» for its deposit facility (hereafter DF), has been widely questioned regarding its efficacy and possible side effects.

For several months now banks have had to pay for the amounts they deposit with the ECB's DF (and, logically, for any current account that exceeds the minimum requirement established by the reserve coefficient). In June the penalty was set at 0.10%, increasing to 0.20% as from September. It is obvious that, with this unusual decision, the monetary authority has reinforced the downward trend in Euribor rates, undoubtedly one of its intentions. However, a complete assessment of this measure's repercussions must take other aspects into account, aspects which are being extensively discussed. The relevant question is whether, as argued by those defending the measure, it will make interbank market operations more fluid, boost credit and ease financial conditions for households and companies, particularly those in the peripheral countries. Those against this measure, however, warn that the effects could be the opposite. Firstly because negative interest rates might encourage those banks with surplus liquidity to reduce this, instead of offering it on the interbank market. Such possible reticence in supply could lead to those banks that normally request funds to look for ways to reduce their dependence on the interbank market, such as decreasing their asset operations. In other words, it is argued that this decision might ultimately be detrimental to boosting credit in the real economy.

Although it is still too early to draw any definitive conclusions, the initial evidence seems to give the benefit of the doubt to the ECB. Volumes in the EONIA market (overnight interbank rates) have remained notably stable over the last few months and have even posted slight increases. Banks' excess liquidity has not changed substantially in this period either. With a view to the coming quarters, the EONIA rate is more than likely to stabilise at negative levels, very close to the deposit facility rate. In fact, the probable increase in excess liquidity in the euro area, resulting from the start-up of the TLTROs and private bond purchases by the ECB, should bolster this situation. However, such encouraging signs must not make us forget the significant degree of fragmentation that still remains, a phenomenon that bond and money market operators from financial institutions in the periphery of Europe are still concerned about. The ECB's measures are clearly a help but not a cure-all. The stress and solvency tests on European banks, as part of the future banking union, and the reforms being carried out by governments constitute the basic pillars for the complete restoration of normal operations to interbank markets. This last point is crucial to reduce the perception of counterparty risk that still prevails in the financial institutions of those countries carrying out adjustments and, in turn, such a reduction is essential for easier monetary conditions to be passed on, finally and completely, to companies and individuals.

### Euro area's interbank market

Two-week moving average (billion euros)



**Note:** \* Defined as the sum of the deposit facility (not including use of the marginal lending facility) and excess reserves above the level required by the ECB.

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

## FOCUS · Household finances after the crisis: the temptation of risk

Over the last few years Spanish households have had to handle their financial planning under abnormal conditions. Between 2003 and 2007, the formation of a bubble: strong economic expansion, easy access to credit and rocketing asset prices, especially property. Between 2008 and 2013 an unprecedented crisis after the bubble had burst: massive job losses, a credit crunch and plummeting asset prices. This year a new phase seems to be starting: economic recovery, the gradual revival in credit and, the big difference with other cycles, rock bottom interest rates, almost zero, in the traditional products for household savings. Given this complex and changing situation, households have gradually been taking decisions concerning fundamental financial issues such as how to distribute their income between consumption and savings, how much debt they should have and the composition of their asset portfolios. This new phase will also see changes in some patterns of behaviour.

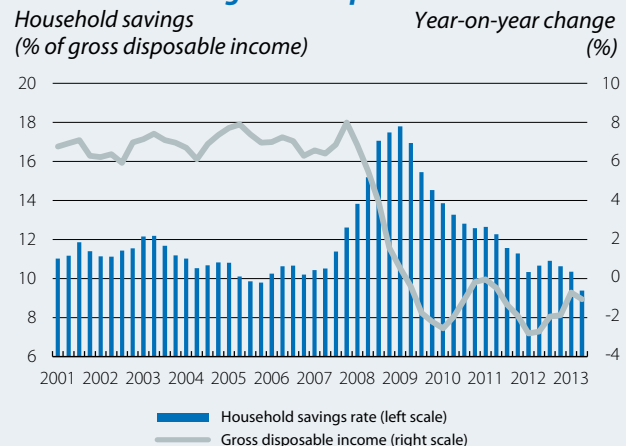
In 2014 Q1, the household savings rate fell to 9.4% of disposable income, an all-time low which is largely due to the drop in disposable income given the situation of high unemployment. In spite of the incipient recovery, no big changes are expected in the savings rate for the next year or two and the increase in disposable income will have to consolidate before any rise is seen in the savings rate towards levels close to those of the pre-crisis period. While this remains the case, other factors with currently uncertain effects will come into play, such as fiscal reform and expectations regarding state pensions.

The level of debt and the composition of total household assets have a basic and common determining factor: decisions regarding the purchase of housing. The last few years have been characterised by a notable drop in income allocated to acquiring a home and associated mortgage debt. This deleveraging has made a lot of progress but has yet to be completed. Today the overriding forces seem to suggest this situation will continue. First, numerous households still have a high debt burden and will tend to reduce this. Second, few new households are being formed. Third, property prices have almost bottomed out but any future rises are likely to be very modest. Some factors are emerging, however, that could counteract this situation in the medium term. One is the easing of conditions to access credit after bank balance sheets have been cleaned up. Another are the low interest rates, which could encourage demand for housing as an investment by individuals disappointed with the almost zero returns from the traditional fixed income products. This effect, which some call the search for yield, can already be seen in the restructuring of the sub-portfolio of financial assets.

According to the Financial Accounts produced by the Bank of Spain, in 2014 Q1 the positions liquidised by households totalled almost 8 billion euros in the most liquid assets: cash and deposits. The reasons for this divestment can be found in the little yield currently offered by deposits, around 1%. Households also sold off their fixed income assets, albeit to a lesser extent, while mutual funds and shares received positive flows, totalling 9.4 billion euros.

Ultimately, the extent of this search for yield and assumption of risk will be crucial in determining whether the current phase of recovery and almost zero interest rates will give way, at last, to a period of relatively normalised conditions or whether the opposite will occur and we will see a repeat of the fluctuations of the last ten years.

### Household savings and disposable income \*

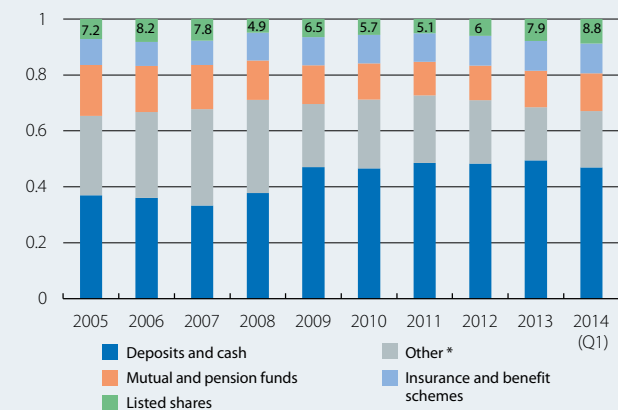


Note: \* Up to 2014 Q1.

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

### Financial assets of Spanish households

(% of total financial assets of households)



Note: \* Includes mainly investments in bonds and unlisted shares.

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

## KEY INDICATORS

*Interest rates (%)*

	30-Sep	29-Aug	Monthly change (b.p.)	Year-to-date (b.p.)	Year-on-year change (b.p.)
<b>Euro</b>					
ECB Refi	0.05	0.15	-10	-20.0	-45.0
3-month Euribor	0.08	0.16	-8	-20.4	-14.2
1-year Euribor	0.34	0.43	-9	-21.6	-19.9
1-year government bonds (Germany)	-0.06	-0.02	-4	-24.3	-16.0
2-year government bonds (Germany)	-0.08	-0.03	-5	-29.3	-24.7
10-year government bonds (Germany)	0.95	0.89	6	-97.9	-82.9
10-year government bonds (Spain)	2.14	2.23	-9	-201.1	-215.8
10-year spread (b.p.)	119	134	-15	-102.9	-132.6
<b>Dollar</b>					
Fed funds	0.25	0.25	0	0.0	0.0
3-month Libor	0.24	0.23	1	-0.6	-0.9
12-month Libor	0.58	0.57	1	-0.3	-4.9
1-year government bonds	0.10	0.08	2	-1.2	1.4
2-year government bonds	0.57	0.49	8	19.0	25.3
10-year government bonds	2.49	2.34	15	-53.8	-12.0

*Spreads corporate bonds (p.b.)*

	30-Sep	29-Aug	Monthly change (b.p.)	Year-to-date (b.p.)	Year-on-year change (b.p.)
Itraxx Corporate	63	60	3	-7.7	-41.3
Itraxx Financials Senior	64	61	3	-23.5	-84.1
Itraxx Subordinated Financials	92	84	8	-36.7	-124.2

*Exchange rates*

	30-Sep	29-Aug	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
\$/euro	1.263	1.313	-3.8	-8.1	-6.6
¥/euro	138.490	136.690	1.3	-4.3	4.2
£/euro	0.779	0.791	-1.5	-6.2	-6.8
¥/\$	109.650	104.090	5.3	4.1	11.6

*Commodities*

	30-Sep	29-Aug	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
CRB Index	473.4	483.8	-2.2	3.7	1.3
Brent (\$/barrel)	93.2	101.3	-8.0	-15.9	-14.7
Gold (\$/ounce)	1,208.2	1,287.8	-6.2	0.2	-9.1

*Equity*

	30-Sep	29-Aug	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
S&P 500	1,972.3	2,003.4	-1.6	6.7	17.3
Eurostoxx 50	3,225.9	3,172.6	1.7	3.8	11.5
Ibex 35	10,825.5	10,728.8	0.9	9.2	17.8
Nikkei 225	16,173.5	15,424.6	4.9	-0.7	11.9
MSCI Emerging	1,005.3	1,087.9	-7.6	0.3	1.8
Nasdaq	4,493.4	4,580.3	-1.9	7.6	19.1



## CURRENT SITUATION · Not as weak as it seems

### World growth is in line with the historical average.

According to our main scenario, the world economy will post growth of 3.4% in 2014, a satisfactory figure insofar as it coincides with the average achieved over the last three decades from 1980 to 2013. However, the overriding perception is one of weak performance. Given this situation, the OECD has lowered its growth forecasts for most of the world's large economies and has stated that the global economy is expanding «unevenly and at only a moderate rate». Various circumstances may be contributing to this opinion. Firstly, the great diversity seen between countries and regions, highlighting some striking black sheep (currently the euro area). Secondly, the shift occurring in relative weights: the emerging countries now exceed 50% of world GDP and are decisive in raising the average figure but they are still perceived as far from drivers of growth. And thirdly, the exceptional figures posted in the period 2000-2007, the boom before the last great crisis, still seem to linger in the memory as a benchmark. Although such speeds will not be reached, the current situation has led us to predict around 4% growth in 2015 which should serve to improve sentiment regarding the global economy. The contribution made by two big engines will be crucial: the US, which is already speeding up in the second half of this year, and China, which is maintaining acceptable rates of activity while readjusting the machinery.

### UNITED STATES

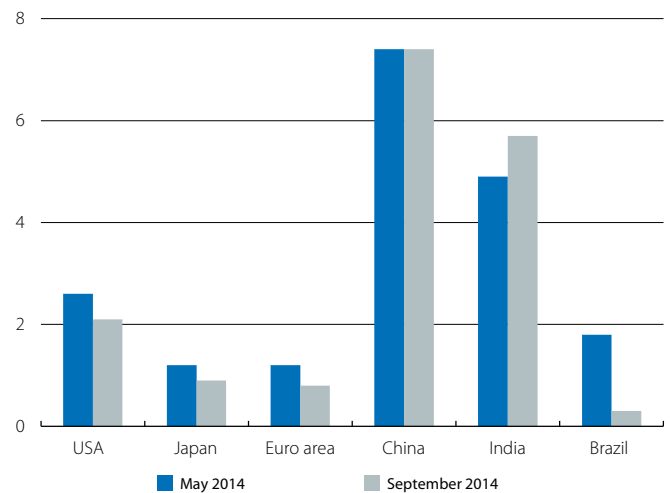
#### The US economy confirms its expansion during the summer.

First of all, GDP growth was once again revised upwards for 2014 Q2, from 2.5% year-on-year to 2.6% (from 4.2% annualised quarter-on-quarter to 4.6%), largely attributable to the components of non-residential investment and exports. This push in Q2 offsets the sharp drop suffered by GDP in Q1 as a consequence of the winter storms. Together with the good performance by most activity indicators in Q3, this confirms our forecast of 2.2% for the year as a whole. The business sentiment indices performed particularly well. In August, the ISM for manufacturing rose to 59.0 points, coming close to its post-recession peak of February 2011 (59.3 points), while its peer in the services sector rose to 59.6 points from 58.7 points in July. Retail sales also gained a healthy 5.0% year-on-year in August, indicating the dynamism in consumption. On the other hand the industrial production figures for the same month came as a disappointment, slowing down from 4.9% year-on-year in July to 4.1%. Nonetheless, a large part of this drop can be attributed vehicle production getting back to normal after a particularly sharp rise in July.

**Inflation is under control.** Prices are remaining stable within this environment of solid growth. In August inflation stood at

### OECD: growth forecasts for 2014

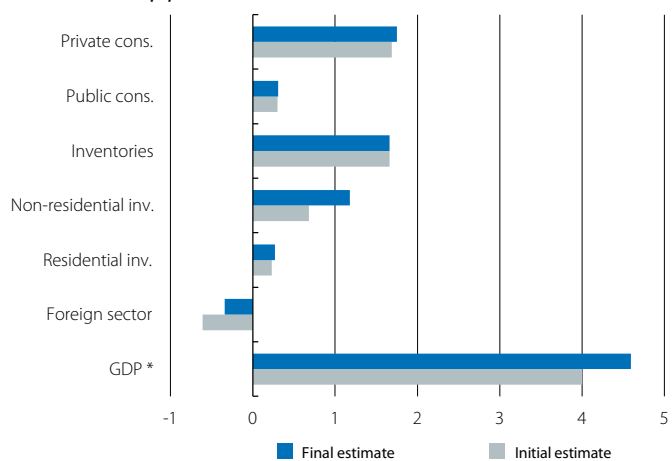
Annual change (%)



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

### USA: GDP by demand component

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

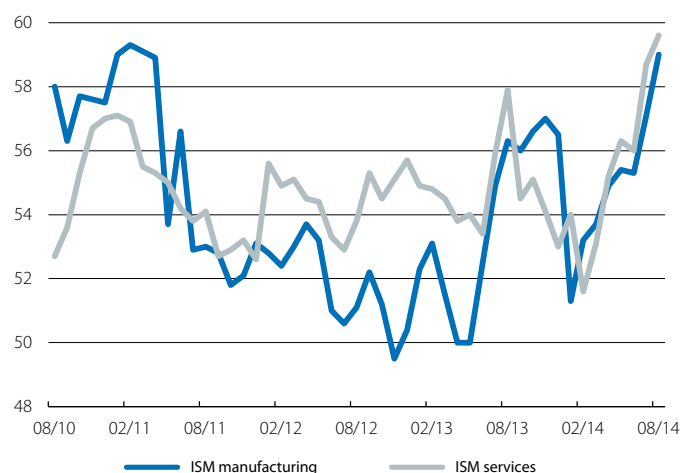


Note: \* Annualised quarter-on-quarter change.

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.

1.7% year-on-year, 0.3 percentage points lower than July's figure due to the drop in petrol prices. For its part, the core CPI (without energy or foods) also advanced by 1.7% year-on-year (1.9% in July). This stable pattern in prices, which we expect to continue for the rest of the year, supports the very gradual monetary normalisation defended by the Federal Reserve's Chairman, Janet Yellen. In particular, the September meeting of the Federal Open Market Committee or FOMC repeated its commitment to keep interest rates very low for a «considerable time» after tapering ends (planned for the end of October).

**The labour market continues to improve** in spite of August's slightly disappointing job creation figures. Specifically, 142,000 net jobs were created, the first time in six months that this figure has failed to exceed the 200,000 threshold. Nonetheless, since the end of the recession the US economy has generated more than nine million jobs, meaning that the jobs lost during the crisis have now been recovered. The unemployment rate has fallen from 10% at the end of 2009 to 6.1% in August whereas wage rises are still meagre (0.2% month-on-month and 2.1% year-on-year in August), helping the price containment in our main scenario.

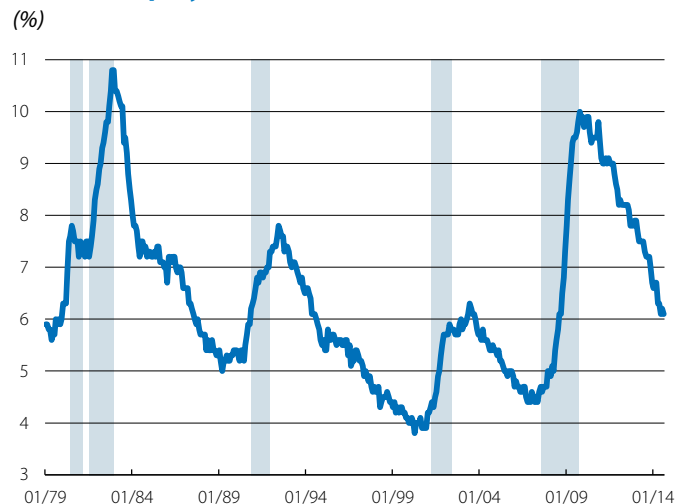
**In this improving situation, the housing market is still failing to show the expected signs of strength.** Although the real estate sector continues to recover in general terms, the prediction that it would become one of the pillars for economic growth in 2014 is far from coming true. This can be seen in the somewhat weak figures provided by several indicators over the last two months. Specifically, the Case-Shiller price index for 20 metropolitan areas increased by 6.7% in July, a further slowdown compared with June's growth (of 1.3 p.p.). Similarly, sales of second-hand homes fell for the first time since March (-1.8% month-on-month). However, there is no reason to expect a widespread slump in the sector. New house sales posted a surprising increase, up by 18% between July and August, the largest month-on-month rise since the early 1990s (accumulating 2.4% year-on-year from January to August).

## JAPAN

**The contraction in Japan's economy in Q2 was greater than first suggested by the GDP flash estimate.** After Q1's upswing in GDP due to purchases being brought forward to avoid April's VAT hike, the sharp fall in Q2 (1.8% quarter-on-quarter, previously 1.7%) has led us to lower our growth forecast for 2014 as a whole (1.1%). This revision is due to the reduction in private consumption and investment. Early indicators for activity in Q3, such as the lethargy of imports, point to domestic demand remaining weak. Exports, traditionally one of Japan's driving forces for growth, have yet to pick up, still 17% below their level in 2007.

**Within this situation, prices are still rising in Japan although less than expected.** August's CPI rose by 3.3% year-on-year,

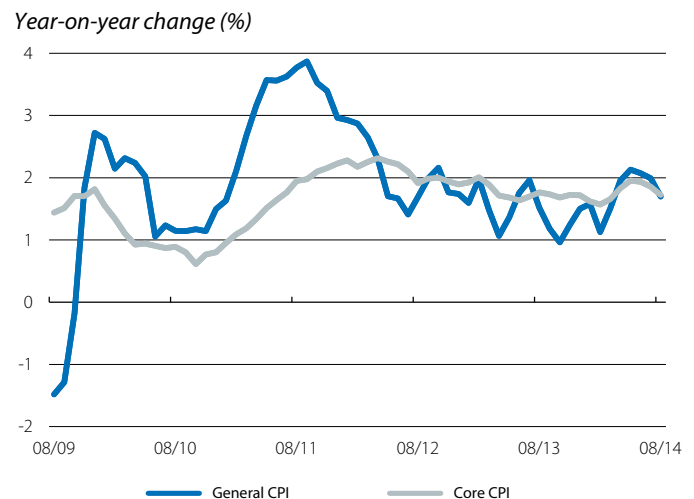
### USA: unemployment rate



Note: The shaded zones correspond to recessions.

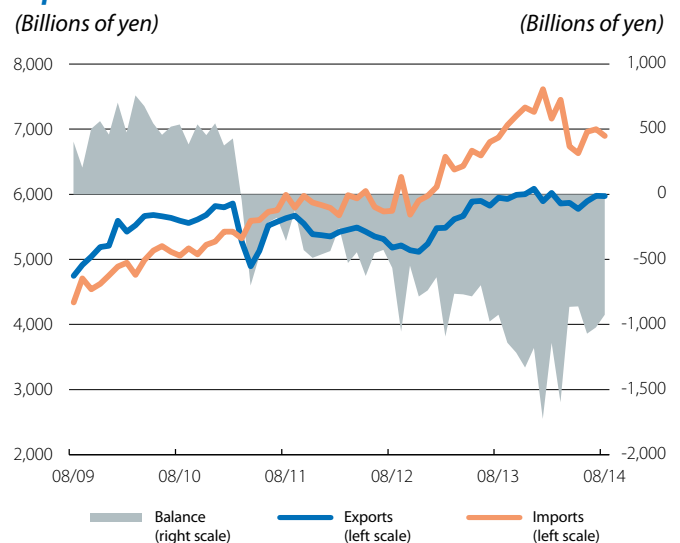
Source: "la Caixa" Research, based on data from the Bureau of Labor Statistics.

### USA: CPI



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

### Japan: trade balance



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



slightly below July's figure (3.4%) while the core CPI (without foods or energy) once again remained flat at 2.3%. Without the distorting effect of the VAT hike, the CPI would have reached 1.3%, still far from the Bank of Japan's target of 2% but without any sign of relapse into deflation. We can therefore finally talk of a significant rise in nominal wages (0.9% year-on-year in the base salary in July compared with -0.5% year-on-year in December 2013), which will be key to boosting domestic demand.

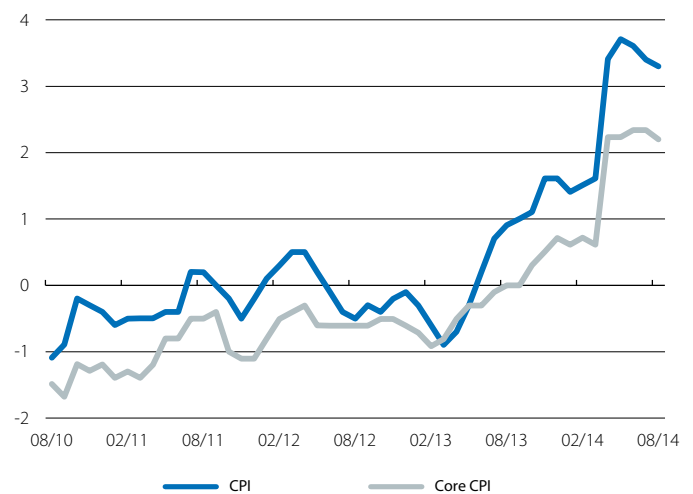
## EMERGING ECONOMIES

**China's growth prospects remain anchored around 7.5%** in spite of the loss of steam in some of August's activity indicators. Of note is industrial production, up by 6.9% year-on-year and therefore decelerating significantly since July's figure of 9.0%. Retail sales and investment also grew by a slightly slower rate than the previous month (11.9% and 16.5% year-on-year, respectively) while September's PMI business sentiment index for manufacturing (produced by Markit) remained flat at 50.2 points. On the positive side the country's external surplus reached a new monthly record in August, coming close to 50 billion dollars thanks both to strong exports, up by 9.4% year-on-year, and also falling imports (-2.4%). This contraction in imports has actually taken the shine off the good balance of trade figure as it reflects a certain weakness in domestic consumption and therefore makes it more difficult for the Asian country to shift towards a model in which household spending plays a more significant role.

**Great disparity between the rest of the emerging economies.** The cases of India, Turkey and Brazil illustrate the contrasting situations. While India continues to correct some of its more important imbalances (inflation and current account), Brazil seems unable to control its prices, in addition to the electoral uncertainty hovering over the Latin American country. For its part, GDP fell by 0.5% quarter-on-quarter in Turkey (bringing the year-on-year rate to 2.1%). In spite of this decline, it should be noted that not only did we expect a worse figure but, moreover, the GDP's composition is moving along the right lines, combining the obligatory adjustment in domestic demand with a greater contribution from external demand (helping to reduce its excessive current account imbalance). Indicators for Q3 also point to activity improving, albeit slightly. We have therefore slightly revised our growth prospects for the Turkish economy for 2014 as a whole, up to 2.8%.

### Japan: CPI

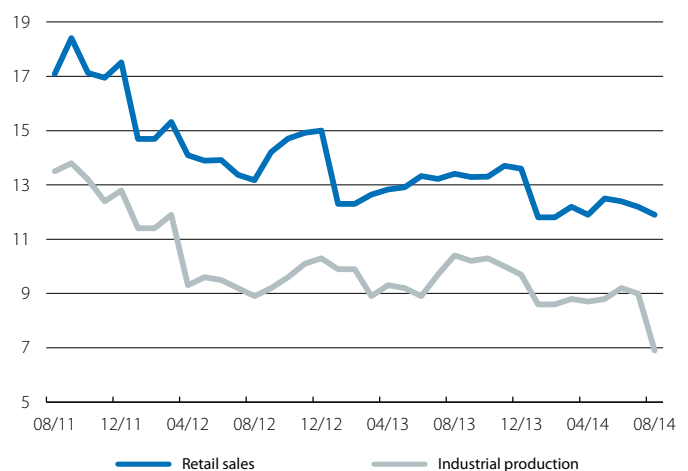
Year-on-year change (%)



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

### China: retail sales and industrial production

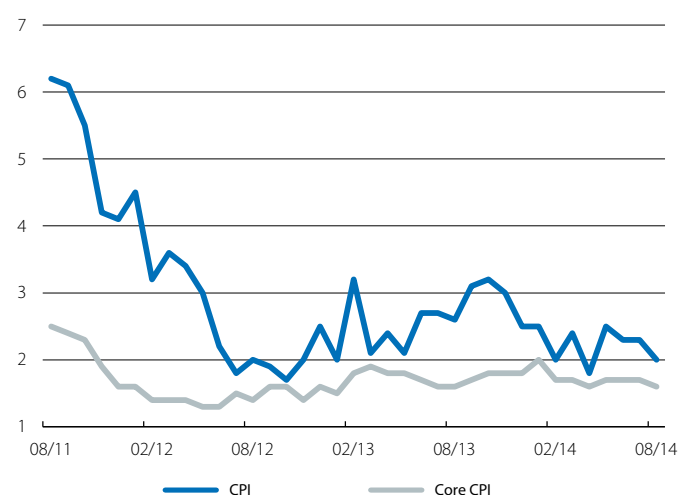
Year-on-year change (%)



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

### China: CPI

Year-on-year change (%)



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

## FOCUS · Brazil: a rough patch in the short term, significant challenges in the long

The Q2 GDP figure came as a disappointment to even the most pessimistic of forecasts: down by 0.6% quarter-on-quarter. This means that Brazil is technically in recession (conventionally defined as when GDP falls for at least two consecutive quarters) and has also pushed the year-on-year rate into negative terrain (specifically  $-0.9\%$ ). It is true that the smaller number of days worked (due to the holidays given to follow the World Cup) is a temporary factor that has affected this figure but even after adjusting for this effect it is estimated that the economy will have shrunk by around 0.4% quarter-on-quarter. The breakdown by demand component did not allay concerns either: both consumption and investment fell, leaving exports as the only source of dynamism.

The situation is complicated due to two crucial issues. On the one hand, the persistence of inflationary tensions: in July inflation stood at 6.5% year-on-year and will probably soon exceed the upper limit of the target set by the Central Bank of Brazil, limiting its capacity to lower the reference interest rate or apply other expansionary monetary measures. On the other hand, political uncertainty is high. At the time of writing, the presidential and legislative elections of the 5 October have yet to be held. These are fiercely contested and although the incumbent president, Dilma Rousseff, seems to have a slight advantage, she will probably have to go to a second round and suffer changes in her parliamentary majority.

Given this situation, the question is whether such complex political and economic developments are going to affect growth expectations in the short and long term. Available data point to a weak Q3 but the likelihood of positive quarter-on-quarter growth. This slow exit will probably continue throughout the last part of 2014 and early part of 2015. Should this scenario come about, growth in 2014 would reach 0.5%, certainly a sharp slowdown compared with 2013 when the economy grew by 2.5%. In 2015 growth could reach around 1.4%, although this forecast is quite uncertain and will depend on the economic policy applied by the new government.

In fact, as 2015 progresses, the key factor will not be the current lethargy so much as the start-up of the new government and the expectations generated by its economic policy. The previous legislature was not overly ambitious in reform terms so it is now vital to speed up policies to improve the environment in which companies operate. The list of chores is well-known: reduce the cost of regulatory compliance, simplify administrative procedures, rationalise public sector activity, improve

the tax system and strengthen social cohesion. Other structural changes, such as continuing to invest in infrastructures, should also intensify over the coming years in order to reduce the production bottlenecks the country is bound to encounter as soon as it gets back to rates of growth enjoyed in previous years. If these reforms are implemented and economic policy become more business-oriented, Brazil will be more than able to regain the confidence of international investors and local business in the country's potential. And its potential is great.

### Brazil: GDP growth

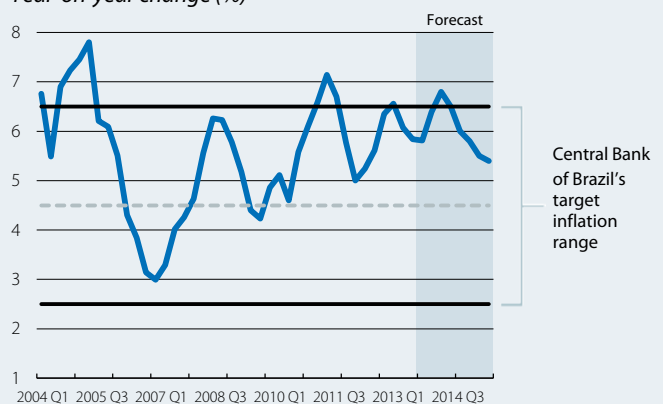
Year-on-year change (%)



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

### Brazil: inflation and the Central Bank of Brazil's target

Year-on-year change (%)



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

## FOCUS · International trade: what lies behind the figure

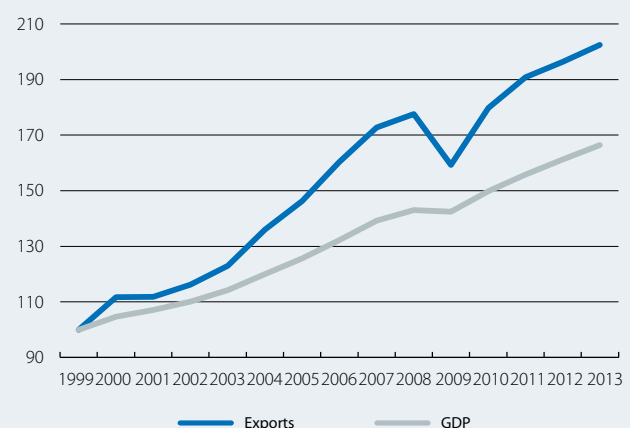
In the last few decades, the geographical fragmentation of production processes has spread beyond countries' borders, giving rise to «global value chains» (GVCs). There are few cases of goods (or services) produced entirely in a single country. According to the United Nations' figures, intermediate goods and services account for around 60% of international trade, moving from one country to another to become successively integrated within the production processes of other goods or services until reaching the end of the chain (resulting in complex products). The proliferation of GVCs raises doubts as to both the usefulness of classic theoretical models of international trade based on simple goods (produced in a single country and generally with a limited level of fragmentation) as well as the use of «gross» measurements of trade in analysing the situation. One good example is a country's total exports, a widely used indicator of economic activity, which does not, however, identify where the value added of these exports has been created. Neither does the immediate geographical destination of exports of goods in the initial or intermediate stage identify the final geographical destination when these goods reach the end of the chain. This kind of issue is particularly relevant in the euro area at present, where it is vital to apply macro and microeconomic policies that take into account the local creation of value and employment. Unfortunately, the information available is not as complete as we would wish.

The reality is that the world is made up of both simple and complex goods. And it is precisely the increase in the latter that explains some of the patterns observed in trade. In particular, the mere transition towards a world with GVCs led to a sharp rise in flows of exports and imports, higher than the rise in real production. The reason is that goods crossed borders several times within the same production process, each of these times being counted. It therefore comes as no surprise that, over the last few decades, total exports have grown 1.5 to 2 times faster than global GDP. However, trade recently seems to have suffered from a change in trend: after a slump in 2009 and their rapid recovery subsequently, world exports have started to slow up. Some economists put this down to a structural factor: the process of creating new GVCs is coming to an end. However, the fact that this has coincided with a hangover from a widespread economic and financial crisis in a highly connected world (more than ever before) makes it difficult to discern whether this slowdown in trade is a cyclical phenomenon resulting from the crisis or is actually structural. Because, in a world with so many GVCs, economic slowdown can lead to greater problems in trade flows than in a world without GVCs. This is the case when the slowdown is more pronounced in the demand for complex goods than in the

demand for simple goods, as the former affect a larger number of trade flows. Moreover, the uneven implementation of GVCs between countries lies behind the notable differences seen in trade flows at a regional level. In general, those countries more connected to global chains will be impacted more by shocks in world demand. Similarly, those countries whose production is more closely related to the initial or intermediate stages of GVCs will tend to experience greater trade fluctuations than those whose production is in the final stages. The reason is the upstream magnification (or bullwhip effect) seen in all supply chains, be they global or otherwise.

In short, the growing complexity of production processes makes it difficult to interpret gross figures on international trade. A combined conceptual and empirical effort is vital to refine economic policies and avoid counterproductive effects when attempting to influence trade flows which are already complicated per se. From a theoretical point of view, the influential work of Grossman and Rossi-Hansberg, which divides the production of a good or service into different tasks, some of which can be offshored, has laid the foundations for new models of trade.<sup>1</sup> From a statistical perspective, several initiatives are now underway to take GVCs into account and thereby avoid counting the same trade flow more than once, identifying where value is really created and the final destination of flows and more accurately estimating exports of services.<sup>2</sup>

### Exports and world GDP (Index)



**Note:** 1999 = 100; volume of exports of goods and services; GDP in constant terms.  
**Source:** "la Caixa" Research, based on IMF (WEO) data.

1. See Gene M. Grossman and Esteban Rossi-Hansberg (2006), «The Rise of Offshoring: It's Not Wine for Cloth Anymore», The New Economic Geography: Effects and Policy Implications, Jackson Hole Conference Volume, Federal Reserve Bank of Kansas City.

2. Of note among recent initiatives are the databases UNCTAD-Eora GVA and OECD-WTO TiVA.

## 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	09/14
<b>Activity</b>									
Real GDP	2.3	2.2	2.3	3.1	1.9	2.6	–	...	–
Retail sales (excluding cars and petrol)	4.2	3.6	3.6	3.6	2.3	4.1	4.1	4.8	...
Consumer confidence (value)	67.1	73.2	81.0	74.0	80.5	83.4	90.3	93.4	86.0
Industrial production	3.8	2.9	2.7	3.3	3.3	4.2	4.8	4.1	...
Manufacturing activity index (ISM) (value)	51.8	53.9	55.7	56.7	52.7	55.2	57.1	59.0	...
Housing starts (thousands)	784	930	882	1,025	925	985	1,117	956	...
Case-Shiller home price index (value)	141	158	161	165	170	171	170	...	...
Unemployment rate (% lab. force)	8.1	7.4	7.2	7.0	6.7	6.2	6.2	6.1	...
Employment-population ratio (% pop. > 16 years)	58.6	58.6	58.6	58.5	58.8	58.9	59.0	59.0	...
Trade balance <sup>1</sup> (% GDP)	–3.3	–2.8	–3.0	–2.8	–2.8	–2.9	–3.8	...	...
<b>Prices</b>									
Consumer prices	2.1	1.5	1.6	1.2	1.4	2.1	2.0	1.7	...
Core consumer prices	2.1	1.8	1.7	1.7	1.6	1.9	1.9	1.7	...

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 &amp; Poor's, ISM and Thomson Reuters Datastream.

## JAPAN

	2012	2013	2013 Q3	2013 Q4	2014 Q1	2014 Q2	07/14	08/14
<b>Activity</b>								
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	41.2
Industrial production	0.2	–0.6	2.0	5.8	8.3	2.6	–0.8	–1.6
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	3.5
Trade balance <sup>1</sup> (% GDP)	–1.4	–2.4	–2.1	–2.4	–2.8	–2.9	–2.9	–2.9
<b>Prices</b>								
Consumer prices	0.0	0.4	0.9	1.4	1.5	3.6	3.4	3.3
Core consumer prices	–0.6	–0.2	0.0	0.5	0.6	2.3	2.3	2.2

Note: 1. Cumulative figure over last 12 months.

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

## CHINA

	2012	2013	2013 Q3	2013 Q4	2014 Q1	2014 Q2	07/14	08/14
<b>Activity</b>								
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	11.9
Industrial production	10.0	9.9	10.1	10.0	8.7	8.9	9.0	6.9
PMI manufacturing (value)	50.8	50.8	50.8	51.3	50.3	50.7	51.7	51.1
<b>Foreign sector</b>								
Trade balance <sup>1</sup> (value)	230	259	251	259	234	254	284	305
Exports	8.0	7.9	3.9	7.4	–3.4	5.0	14.5	9.4
Imports	4.3	7.3	8.5	7.1	1.7	1.4	–1.6	–2.4
<b>Prices</b>								
Consumer prices	2.7	2.6	2.8	2.9	2.3	2.2	2.3	2.0
Official interest rate <sup>2</sup> (value)	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Renminbi per dollar (value)	6.3	6.1	6.1	6.1	6.1	6.2	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 · Lethargy dominates the euro area

### The euro area's recovery is still showing signs of weakness.

This can be seen both in GDP being at a standstill in Q2 and also in the continued downward revision of growth prospects by leading international bodies. The revision carried out by the OECD in September was particularly significant, both in size and scope, affecting Germany, France and especially Italy. The activity and confidence data published over the last month have merely confirmed this scenario of a slow, fragile recovery. However, it is important to note that, although it is slower than expected, the scenario is still one of recovery. In this respect the foreign sector appears to be gaining the importance lost over the last few quarters. Fast action by the European Central Bank has also helped to curb the deterioration in growth prospects although, as Mario Draghi noted, those countries showing the greatest signs of weakness, such as France and Italy, need to carry out far-reaching structural reforms to ensure the recovery is solid and balanced in the long term.

### GDP stalled in Q2 with some sombre underlying trends.

The breakdown of GDP by component shows that this deterioration was concentrated in stocks (−0.2% quarter-on-quarter) and gross fixed capital formation (−0.3% quarter-on-quarter), this last component halting the gradual improvement that had been seen in domestic demand. Although the investment component is normally highly erratic, neither the tone of Q3 indicators nor the confidence index for industry has provided any grounds for great optimism. The rest of the GDP components looked healthier for Q2, particularly the 0.3% rise in household consumption and the 0.5% rise in exports in quarter-on-quarter terms.

**Demand indicators are losing steam.** The deterioration in investment indicators has spread to those for consumption. For example, the consumer confidence indicator has fallen for the last four months and stood at −11.4 in September. This loss in confidence can also be seen in the slowdown in July's retail sales, which grew by 0.8% year-on-year, far from their 1.4% average growth rate in Q2.

**The PMIs for the euro area confirm this weak scenario,** falling in Q3 compared with the previous quarter. The composite PMI has gone from 53.4 points in Q2 to 52.9 in Q3. Both the PMI for services and for manufacturing have slowed down over the last two months although they are still in expansionary terrain; specifically, in September they stood at 52.8 points and 50.5 points, respectively. By country, of note is the French relapse, whose PMI is still contracting (49.1 points in September), making it even more vital for the country to carry out far-reaching structural reforms. The trend in industrial production also suggests that Europe's economy is continuing to grow but only moderately. In this case, growth

### GDP forecasts by the OECD

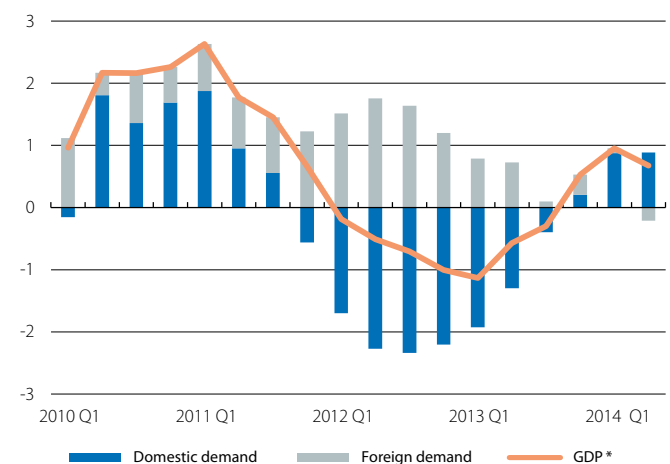
Year-on-year change (%)

	GDP 2014		GDP 2015	
	May 2014	September 2014	May 2015	September 2015
France	0.9	0.4	1.5	1.0
Italy	0.5	−0.4	1.1	0.1
Germany	1.9	1.5	2.1	1.5
Spain	1.0	1.2	1.5	1.6
Euro area	1.2	0.8	1.7	1.1

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

### Euro area: GDP

Contribution to growth (p.p.)



Note: \* Year-on-year change, %.

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

### Euro area: consumption indicators

Year-on-year change (%)



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



in July stood at 1.7% year-on-year, 1 p.p. higher than the average figure for Q2 but, given the series' volatility, we cannot conclude that this is the start of an upward trend.

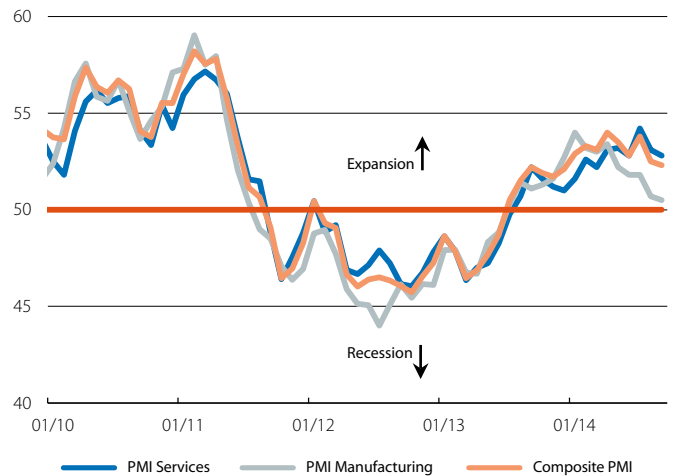
**The incipient improvement in the labour market has continued in Q2** with employment rising by 0.2% quarter-on-quarter (0.1% in Q1). The unemployment rate has also continued to improve for the euro area as a whole: in August it stood at 11.5%, 0.5 p.p. below the figure for August 2013. There are still substantial differences between countries however. In Germany unemployment is still at a minimum (4.9% in August) while the periphery countries have seen a significant drop (1.4 p.p. in Ireland, 1.7 p.p. in Spain and 2.1 p.p. in Portugal compared with August 2013). However, in France and Italy the labour market has yet to show signs of improvement. In fact, in August France's unemployment rate stood at 10.5%, 0.3 p.p. higher than the figure for August 2013.

**The trend in prices also reflects a more lethargic scenario.** Inflation in the euro area is still extremely low: in September it stood at 0.3%, 0.1 p.p. below August's figure. Core inflation also moderated, going from 0.9% in August to 0.7% in September. But the particularly worrying aspect in this trend is that it is not due to just one or two components of the HICP, such as the price of oil or fresh foods. This low rate of inflation is the result of a widespread drop in the price of all HICP components (as can be seen in the corresponding graph). These underlying trends can also be seen in general in the main countries of the euro area. Nonetheless, we expect this trend will gradually change direction over the coming months thanks to the improvement in domestic demand and especially to the euro's depreciation (see the Focus «The relationship between the value of the euro and inflation» in this Report).

**The trend in prices puts the ECB on the alert.** Although Europe's top monetary authority had already announced a package of accommodative measures in June, the deterioration in the economic outlook over the summer has forced it to take further steps. In September it announced a new asset purchase programme of corporate bonds; specifically, as from October the ECB will buy asset and mortgage-backed securities. This new package of measures, together with the targeted long-term refinancing operations (TLTRO) announced in June, is expected to help consolidate the incipient recovery in credit. However, important details of this programme have yet to be clarified, such as to what extent it will help banks transfer risk. For the moment, the first TLTRO, held in September, was less widely used than expected by the markets (only 21% of the liquidity available was borrowed). Nevertheless, we expect participation to be greater in the second tender in December, once the results of the stress tests carried out by the ECB have been published.

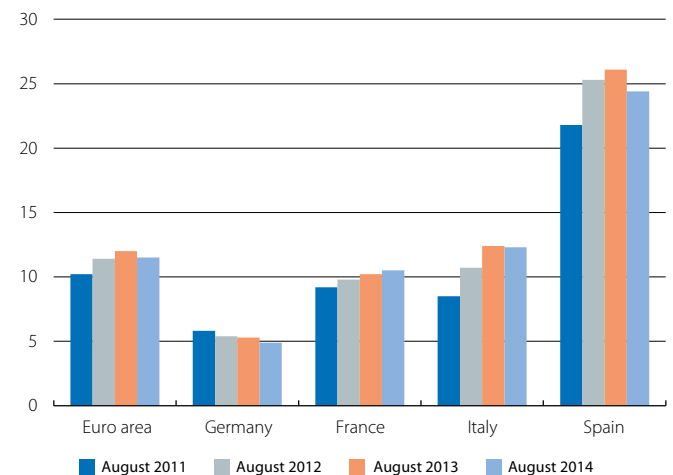
**The foreign sector is building up steam.** Within this rather gloomy scenario, exports offer a slight ray of hope. The first

### Euro area: activity indicators (Index)



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

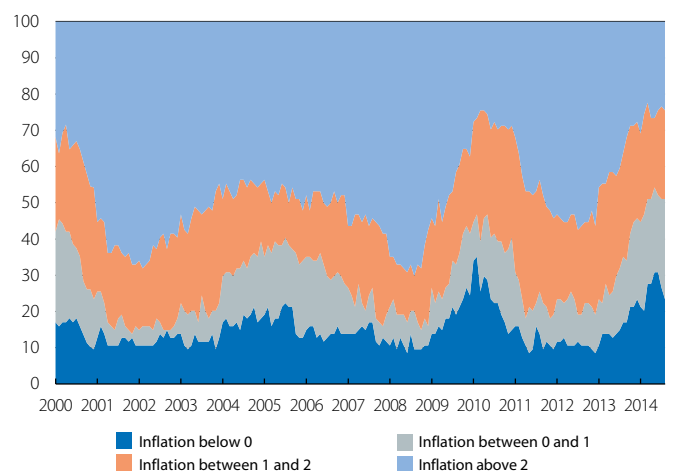
### Unemployment rate (%)



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

### Euro area: distribution of HICP goods by level of inflation

Share of each group (% total)



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

half of the year was affected by a slowdown in growth in the main emerging countries and geopolitical tensions. In the last few months, however, the bulk of the evidence suggests that this sector has started to pick up. Specifically, in July exports of goods grew by 2.7% year-on-year (compared with 1.0% in the first half of the year). Of particular note is the upswing in exports to the US and China, namely 10.1% year-on-year in both cases, helping to cushion the 12.2% drop in sales to Russia. Moreover, the overall outlook is positive: growth prospects are favourable for the main emerging economies and geopolitical tensions are not expected to get any worse, although in this case it is more difficult to guess the path they might take (see the Focus «The impact of the Russian crisis on Germany and Central Europe», also in October's *Report*). Similarly, the euro's recent depreciation should boost growth in exports over the coming months.

**Italy is one of the weak links hindering the euro area's recovery.** The Italian economy is still coming out of a long and very deep economic recession with extremely high unemployment and an inflation rate that is still very low. The government led by Matteo Renzi has announced that it intends to implement a wide range of structural reforms in order to restore the Italian economy's growth capacity. On the table are proposals to reduce the dual nature of the labour market and increase its flexibility, to make the legal system more agile and reform electoral legislation to make the country more politically stable. The last IMF report on the Italian economy stressed that these measures need to be firmly implemented to create employment and improve the country's productivity. However, in spite of the new government's good intentions, there are still strong doubts regarding its ability to carry these out and the speed at which it can do so, with the result that the region's prospects in the medium and long term are still pessimistic.

### Euro area: excess liquidity \*

(Billion euros)

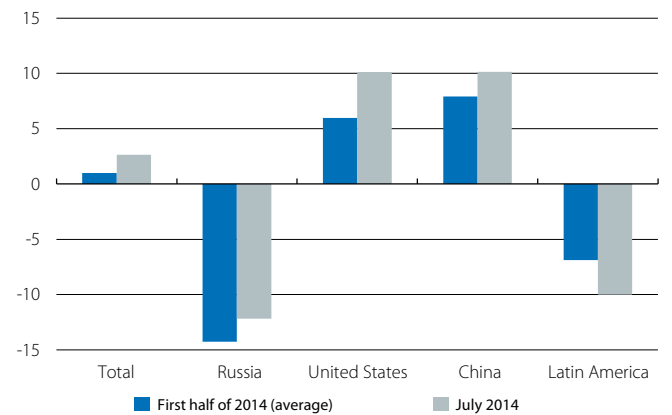


Note: \* Bank assets on demand with the ECB above the mandatory reserves.

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

### Euro area: exports of goods by destination

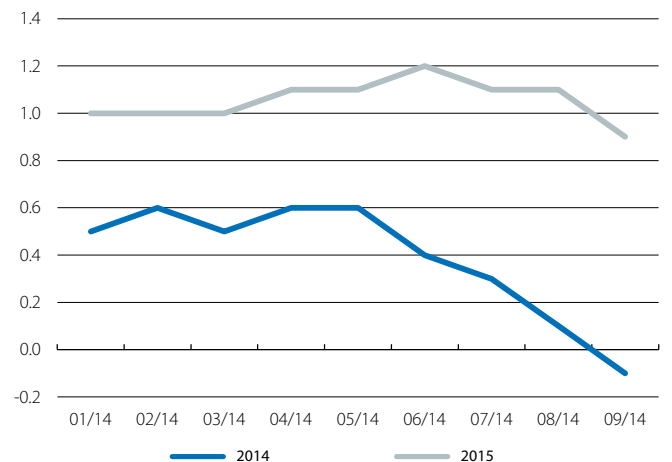
Year-on-year change (%)



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

### Italy: trend in GDP growth forecasts

Year-on-year change (%)



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



## FOCUS · The relationship between the value of the euro and inflation

The trend in prices has been the focus of attention in the euro area for the last year. The inflation rate recorded in September was one third of the figure recorded a year ago (from 1.1% in September 2013 to 0.3% in 2014). This fall of 0.8 percentage points has been blamed on the convergence of several temporary or exogenous factors to the economy such as the downward trend in oil prices and other agricultural commodities. In spite of the fact that these factors have played an important role in pushing down inflation, specifically by 0.4 p.p. since September 2013, the trend in core inflation (which excludes these components) has also fallen, decreasing by a total of 0.4 p.p. since September last year.

Although part of the weak underlying trend in core inflation is due to excess production capacity and a domestic demand that is still recovering, this weakness has been exacerbated by the euro's appreciation, starting mid-2012 and increasing its value by up to 10% against the dollar. This effect is particularly strong on two components of the harmonised index of consumer prices or HICP, the first being oil prices, whose downward trend in dollars has been amplified by the exchange rate, with the price in euros being even cheaper.

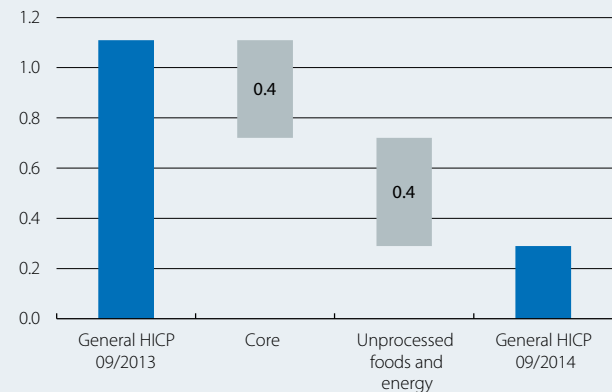
The second component particularly affected by the trend in the euro is the price of non-energy industrial goods (excluding services and foods), which has a significant weight of 27% within the total HICP. The relationship observed between the exchange rate and this component is intense and negative; i.e. when the euro appreciates the price of these goods falls.<sup>1</sup> This is due to the fact that a significant percentage of these goods are imported (so their price in euros falls) and those that are locally produced suffer from competitive pressure to adjust their margins and lower their sale price.

It is important to note that, historically, the price of industrial goods has had a somewhat delayed reaction to variations in the exchange rate. Because of this, and given that the exchange rate started to depreciate as from June when the ECB announced more accommodative measures, we should start to see a gradual reversal to these downward pressures on inflation caused by the euro. This, however, will not be enough to counteract the pressure still being exercised by the aforementioned underlying factors. Therefore, although we expect inflation to change course over the coming months, it will still remain at abnormally low levels.

1. A 10% depreciation in the nominal effective exchange rate is associated with a 0,40 p.p. rise in the CPI for industrial goods.

### Fall in inflation by component

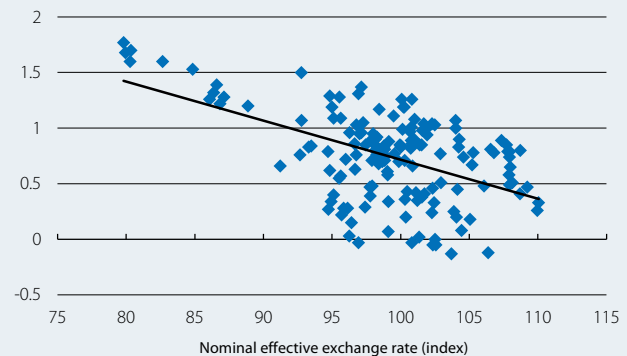
Year-on-year change in HICP (%) and contribution of components (p.p.)



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

### Relationship between the price of industrial goods and the nominal effective exchange rate

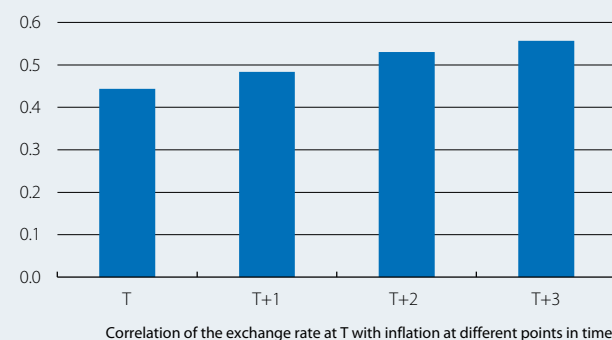
Price of industrial goods (year-on-year change, %)



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

### Relationship between the price of industrial goods and the nominal effective exchange rate over time

Correlation coefficient



Note: The correlation measures the degree of comovement between two variables. It fluctuates between 1 and -1, 1 being a perfect comovement and 0 being zero comovement.  
Source: "la Caixa" Research, based on data from the IMF and Eurostat.

## FOCUS · The impact of the Russian crisis on Germany and Central Europe

Germany's bad GDP figures in Q2 (down by 0.2% quarter-on-quarter) and the downward trend in business confidence over the last few months have been associated, at least in part, to the increased uncertainty surrounding the Russian geopolitical and economic situation. In particular the sanctions levied by the European Union and US on Russia, the response by the latter and the entrenched armed conflict in Ukraine (in spite of an ostensible ceasefire) are all factors helping to impair the confidence of German business people. Given this situation, we should ask ourselves to what extent this deterioration in sentiment is based on fact and whether it could also affect the countries of Central Europe.

First of all, the two main channels through which Russia's economic situation could impinge on Germany are finance and international trade. Generally speaking, the financial ties are not very significant. According to data from the IMF, in 2012 German bank loans to Russia were the equivalent of 0.6% of German GDP, far from the figure of the loans made to Russia by Austria (4.1%), Sweden (2.8%), France (2.0%) and Italy (1.5%). Other indicators such as foreign direct investment also reveal Germany's modest financial exposure to Russia. However, commercial ties are a good deal more relevant. The concerns of German business have grown in line with the bad performance of exports to Russia. In cumulative terms from January to April this year, exports to this country were down 9% year-on-year, precisely in a period when Germany's total exports rose by 7% year-on-year. However, in spite of this startling contrast we should remember that, overall, Russia is not a key market for Germany: it ranks only eleventh among the country's international buyers, accounting for barely 1.1% of German GDP.

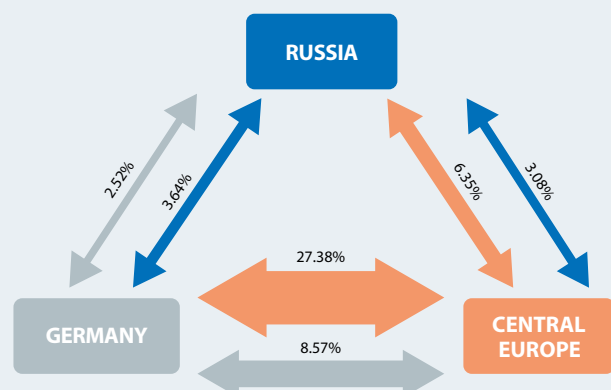
This figure does not seem to support the dramatic situation reflected by the decline in business confidence. Although it is difficult to provide quantitative evidence, there are some estimates of the impact of the mounting Russian crisis. Barclays Capital estimates that, under the (perfectly plausible) hypothesis that euro area exports to Russia will end up falling by 20% in 2014, the region's GDP growth would be 0.1 percentage points less than if such a shock had not existed. Other analysts point out that, in the case of Germany, growth would be between 0.2 and 0.3 percentage points lower given such a scenario. Most of the forecasts provided for German growth, and by extension growth of the euro area and Central Europe, are likely to have already incorporated a large part of this estimated effect. While, in July, the consensus of analysts predicted 2% growth for Germany in 2014, after a new round of sanctions in July, August and September, the forecast in September was 1.7%, a reduction in line with the aforementioned figures.

However, quantifying the impact of the Russian crisis on German growth merely in terms of a short-term shock on exports could be underestimating the importance of this episode. Russia's role in how the region made up of Germany and Central Europe is organised economically is more important than the channel of direct exports would suggest. Economic relations between Germany, Central Europe and Russia are largely based on the notable amount of trade between the first two (exports and imports between both represent 27.4% of Central Europe's GDP) and Russia's role as a fundamental supplier of Central Europe (imports from Russia account for more than 6% of the GDP in Hungary, Slovakia and Bulgaria, and between 3% and 4% in Poland and the Czech Republic). Given this situation, the work carried out by each of the parties is clear. Russia is an important supplier of commodities (in particular energy but neither should we underestimate mineral products and metals). Central Europe uses these inputs to produce what will be their exports of intermediate and end goods (in no small measure to Germany), and Germany uses goods from Central Europe as an input for its exports to the rest of the world.

Consequently, at present the biggest risk being evaluated by German business, and European business in general, is probably the disruptive effect of a conflict on an economic region that actually functions as a large, integrated transnational production chain. Such a risk would probably only materialise in extremely adverse scenarios but, in any case and given its serious consequences, the European Union and Russia should attempt to find some common ground of agreement as quickly as possible.

### Commercial relations between Germany, Russia and Central Europe \*

Total exports and imports (% GDP) \*\*



Notes: \* Central Europe: Poland, Czech Republic, Hungary, Romania, Bulgaria and Slovakia.

\*\* For example, the blue arrow between Germany and Russia shows total Russian exports and imports as a percentage of Russian GDP, and so on.

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

## KEY INDICATORS

### Activity and employment indicators

Values, unless otherwise specified

	2012	2013	2013 Q4	2014 Q1	2014 Q2	07/14	08/14	09/14
Retail sales (year-on-year change)	-1.7	-0.9	0.4	1.0	1.4	0.8	...	...
Industrial production (year-on-year change)	-2.5	-0.7	1.5	1.4	0.9	2.2	...	...
Consumer confidence	-22.1	-18.7	-14.4	-11.2	-7.7	-8.3	-10.0	-11.4
Economic sentiment	90.8	93.8	99.1	101.6	102.2	102.2	100.6	99.9
Manufacturing PMI	46.2	49.6	51.9	53.4	52.5	51.8	50.7	50.5
Services PMI	47.6	49.3	51.3	52.1	53.0	54.2	53.1	52.8
<b>Labour market</b>								
Employment (people) (year-on-year change)	-0.6	-0.8	-0.4	0.1	0.5	-	...	-
<b>Unemployment rate: euro area</b> (% labour force)	11.3	12.0	11.9	11.7	11.6	11.5	11.5	...
Germany (% labour force)	5.5	5.3	5.2	5.1	5.0	4.9	4.9	...
France (% labour force)	9.8	10.3	10.2	10.1	10.2	10.5	10.5	...
Italy (% labour force)	10.7	12.2	12.5	12.5	12.5	12.6	12.3	...
Spain (% labour force)	24.8	26.1	25.8	25.3	24.7	24.5	24.4	...

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

### Foreign sector

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

	2012	2013	2013 Q4	2014 Q1	2014 Q2	06/14	07/14	08/14
<b>Current balance: euro area</b>	1.6	2.7	2.7	2.7	2.7	2.7	2.7	...
Germany	7.1	6.8	6.8	6.9	6.8	6.8	7.1	...
France <sup>1</sup>	-2.2	-1.3	-1.3	-0.6	-1.3	-1.3	-1.3	...
Italy	-0.3	1.0	1.0	1.3	1.5	1.5	1.5	...
Spain	-1.2	0.8	0.8	0.4	-0.1	-0.1	...	...
<b>Nominal effective exchange rate<sup>2</sup> (value)</b>	97.8	101.6	103.1	103.8	103.8	103	102.6	101.9

Notes: 1. Methodology changed as from 2014. 2. 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 Q4	2014 Q1	2014 Q2	06/14	07/14	08/14
<b>Private sector financing</b>								
Credit to non-financial firms <sup>1</sup>	-0.3	-2.3	-2.9	-3.1	-2.5	-2.2	-2.2	-2.0
Credit to households <sup>1,2</sup>	1.2	0.3	0.3	0.3	0.4	0.5	0.5	0.5
Interest rate on loans to non-financial firms <sup>3</sup> (%)	2.4	2.2	2.3	2.2	2.1	2.1	2.0	...
Interest rate on loans to households for house purchases <sup>4</sup> (%)	3.1	2.8	2.8	2.8	2.7	2.7	2.6	...
<b>Deposits</b>								
On demand deposits	4.1	7.9	6.6	5.9	5.1	5.3	5.6	5.8
Other short-term deposits	2.0	0.0	-1.5	-2.5	-2.0	-1.8	-1.8	-1.7
Marketable instruments	0.5	-14.8	-16.8	-12.6	-11.7	-8.8	-6.8	-6.4
Interest rate on deposits up to 1 year from households (%)	2.8	2.0	1.6	1.6	1.4	1.4	1.3	...

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

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

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

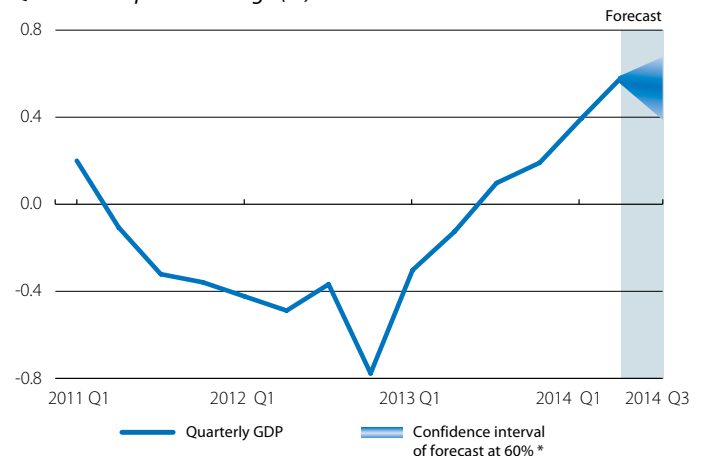
## CURRENT SITUATION · The recovery looks like continuing

The Spanish economy is still growing, albeit at a somewhat slower rate. After sharp GDP growth in Q2 of 0.6% quarter-on-quarter, the latest figures suggest a slight slowdown. The economic activity index of "la Caixa" Research points to quarter-on-quarter growth in GDP of around 0.5% in 2014 Q3. Our forecast of 0.4% is within the lower band of the acceptable probability interval and is due to two factors. Firstly, the Spanish economy may have been affected by the recent slowdown in European activity and this would be seen in the figures for Q3, which are not available at the time of writing. Secondly, part of the sharp upswing in activity in 2014 Q2 was boosted by temporary factors such as decisions being taken to consume or invest that had been postponed during the crisis. In any case, the bulk of the evidence available suggests that the growth rate will continue to be significant, given the determining factors currently affecting the Spanish economy.

Supply indicators are showing signs of stabilising at positive figures. In general, the various leading indicators for activity point to a somewhat more moderate growth scenario in 2014 Q3. One sign of this is the slight slowdown in corporate turnover while new industrial orders have also lost some steam (2.4% year-on-year in July compared with 4.2% in June). The PMIs for services and manufacturing also suggest the situation is stabilising, albeit remaining in the zone of expansion. For the time being Spain's figures are better than the data arriving from the main countries in the euro area although the Old Continent's slowdown in activity is a risk that must be borne in mind. As the euro area starts to grow at a more vigorous rate again, Spain's economic recovery will gradually consolidate.

The labour market's rate of improvement is also moderating. After a period in which the year-on-year growth in employment was rising month by month, this remained stable in August at 2.0%. We do not expect the progress seen in the labour market to stop but the rate of job creation does appear to be reaching its medium-term level. The fact that the number of workers registered with Social Security in industry and construction has stopped falling compared with the previous year and that the recovery is not focused exclusively on the services sector gives us reason to believe that it will continue. Undoubtedly the new jobs created over the last few months have played a key role in reviving consumption. Judging by the main series, consumption will continue to pick up although less energetically, in line with the indicators for activity and the labour market. Consumer confidence, for example, fell in Q3 (-7.9 points compared with -6.1 points in Q2) but is still at a historically high level. Retail sales also suggest a slowdown in consumption. While they rose by 0.6% year-on-year in Q2, in the months of August and September the average increase was just 0.1%.

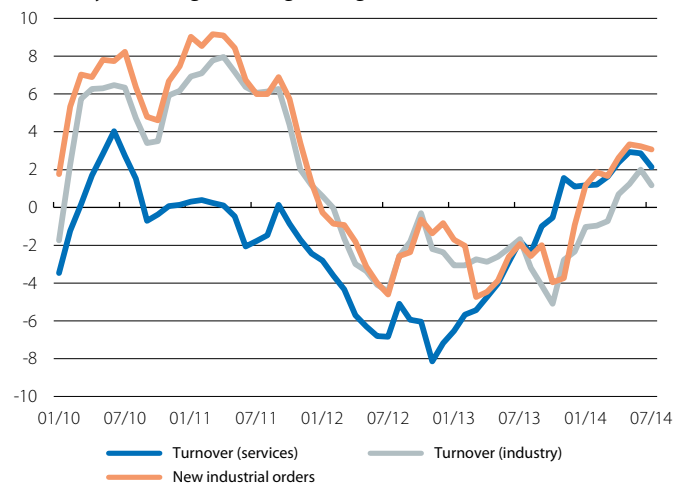
### Leading indicator of GDP: "la Caixa" Research Quarter-on-quarter change (%)



Note: \* The likelihood that GDP in 2014 Q3 will be within this range is 60%.  
Source: "la Caixa" Research.

### Activity indicators

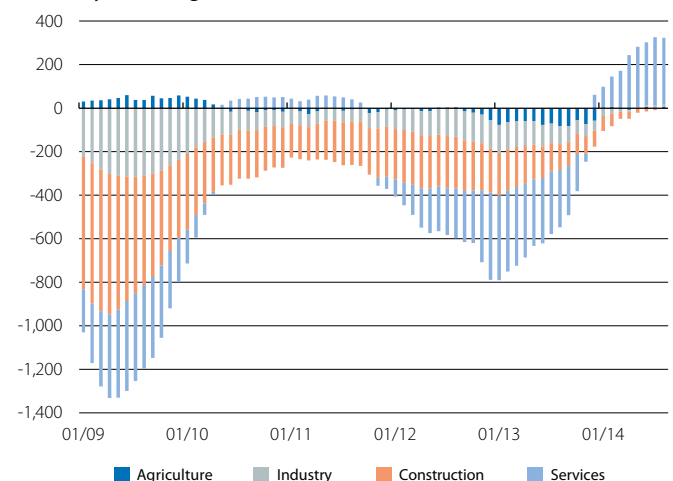
Year-on-year change, moving average of three months (%)



Note: Series seasonally adjusted.  
Source: "la Caixa" Research, based on INE data.

### Employment trend

Year-on-year change (thousands)



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

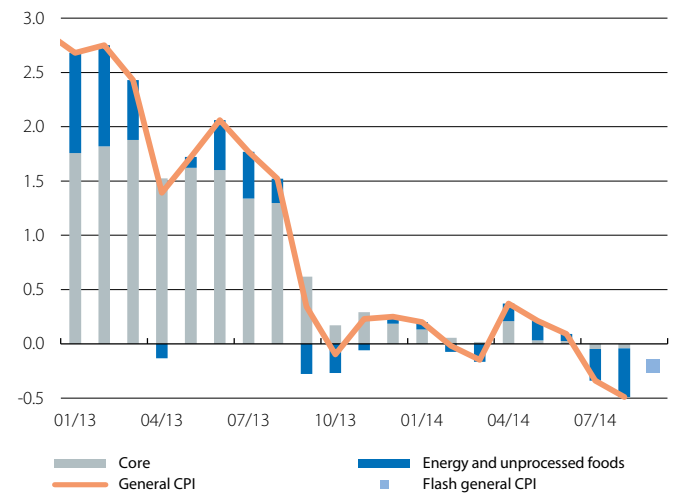
**Slight recovery in inflation.** As expected, the flash figure given by the Spanish Statistics Institute (INE) placed the inflation rate at  $-0.2\%$  in September ( $-0.5\%$  in August). This suggests that inflation may have bottomed out and will therefore start to rise again. In spite of economic growth, inflation has remained in negative terrain since July, pushed down by the drop in price for lubricants and fuels and other volatile components such as fresh foods. This can be seen by the fact that core inflation has not fallen below  $0\%$  and is not expected to decrease over the coming months, since the recovery in consumption and the euro's depreciation should help to push up prices again. However, inflation will be very slow to recover due to two factors. Firstly, although GDP has grown for four consecutive quarters, industrial capacity utilisation is still at a very low level. Secondly, wages remain contained, as shown by the data in the Quarterly Labour Cost Survey. In 2014 Q2 wage costs rose by  $0.4\%$  quarter-on-quarter ( $0.0\%$  in Q1), far below the average between 2000 and 2007, namely  $1.0\%$ . The moderate wage increase established in July's labour agreements, namely  $0.6\%$  annually, points to contained wage growth for the rest of the year, so there will not be any inflationary pressure from this quarter.

**Signs of stabilisation in the real estate market.** House prices stopped falling in 2014 Q2. This has been shown both by the data from the INE, with a  $1.8\%$  rise quarter-on-quarter, and also by the Ministry of Public Works, with a rate of  $0.0\%$ , marking the end of a decline that, since 2008, had gone beyond  $30\%$  in nominal terms. This incipient stabilisation in house prices is being accompanied by an upswing in demand. In July purchases of residential properties grew by  $10.7\%$  year-on-year ( $6.4\%$  in Q2). Demand for apartments was boosted by easier monetary conditions, leading to extremely low interest rates in the Spanish economy. July's interest rate for new loans to households to purchase residential property stood at  $2.9\%$  compared with  $5.7\%$  in 2008. The data also show a recovery, albeit very gradual, in the number of new loans being granted, increasing from the minimum level posted in September 2013. All this suggests that the correction in the real estate sector might be coming to an end.

**Exports are showing signs of improvement.** Exports of goods grew by  $8.7\%$  year-on-year in July, moving away from the weakness shown in the first half of the year and posting  $0.5\%$ . However, although exports seem to have picked up recently, the characteristic fluctuations in this series mean we must be cautious when evaluating this upswing. Undoubtedly the euro area's recovery will need to get stronger before the upward trend in exports can consolidate. On the other hand imports are still dynamic as the Spanish economy is growing thanks to domestic demand. The outcome is that the balance of goods has been deteriorating since the start of the year, reaching nearly  $-17.2$  billion euros in June, in cumulative terms over 12 months ( $-10.78$  billion euros in January 2014).

## CPI and main components

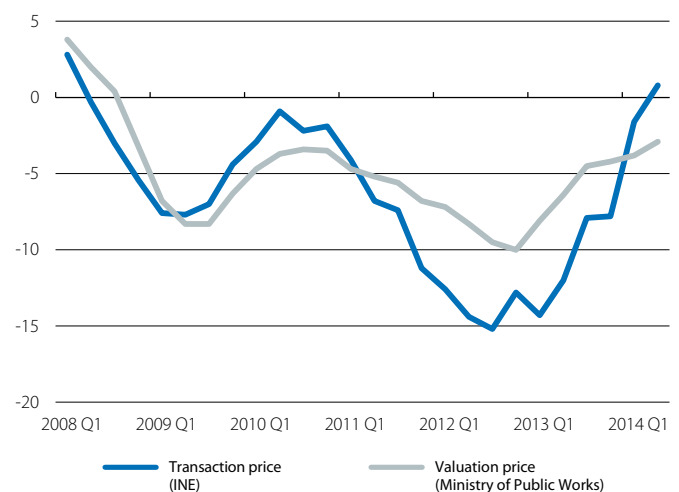
Contribution to the year-on-year change in CPI (p. p.)



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

## House prices

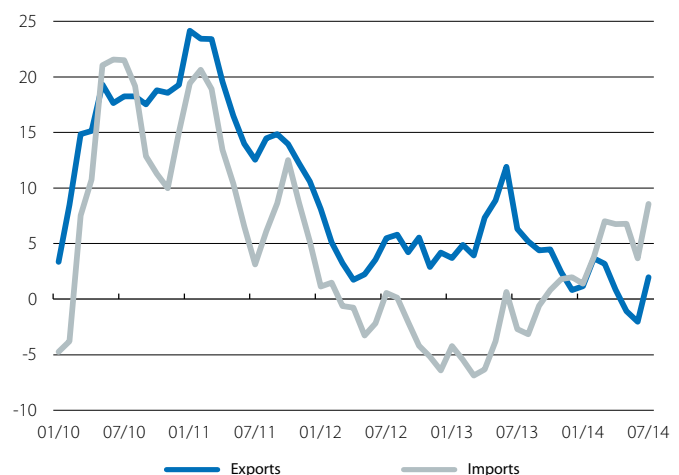
Year-on-year change (%)



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

## International trade of goods

Year-on-year change, moving average of three months (%)



Note: Nominal data.

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

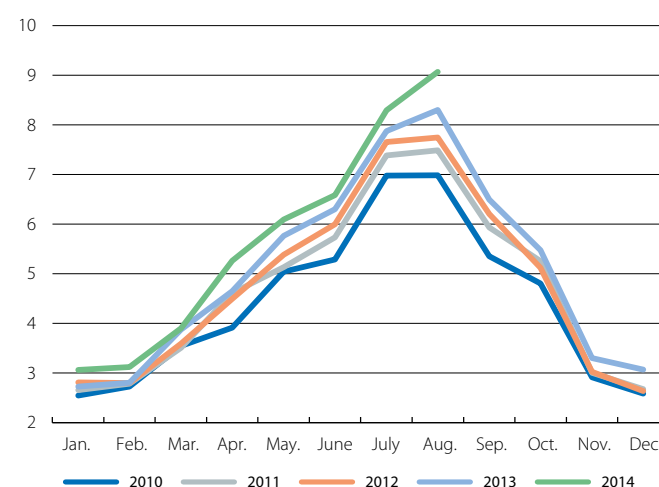


**Foreign tourism is growing at a record-breaking rate.** The number of visitors arriving in Spain speeded up in August (8.8% year-on-year) and raised the total number of tourists visiting the country this year so far to 45.4 million (compared with 42.3 million in 2013). The good economic situation enjoyed by the outbound markets (except Russia) means that we can remain optimistic in the short term. Foreign tourism's excellent performance over the last few months has been accompanied by a significant increase in income from this component. In June, revenue rose by 4.6% year-on-year, an upswing that is still not enough to offset the deterioration in the balance of goods and the income balance. In June the current balance was once again in negative terrain (–1 billion euros in cumulative terms over 12 months).

**The government has presented the state budget for 2015 with a plausible macroeconomic scenario.** On the whole, the growth forecasts used to set the targets for the main items on the public balance sheet are in line with the consensus of economists. Specifically, the budget is based on 1.3% growth in activity in 2014 and 2.0% growth in 2015. According to the Independent Fiscal Responsibility Agency (AIReF), which has evaluated the macroeconomic situation for the first time, the figures proposed are plausible although it notes that developments in the euro area could be somewhat worse than predicted. The proposed state budget assumes growth in activity and consumption that will increase tax revenue by 5.4% annually in 2015, even taking into account the impact of the fiscal reform. On the other hand expenditure will decrease by 3.2% as a result of the fall in interest payments and smaller contribution to Social Security and to the State Employment Service. All this will help to carry out a fiscal adjustment of 0.6 p.p. to 2.9% of GDP. However, it should be noted that a large part of the adjustment in the fiscal deficit budgeted, both via revenue and expenditure, depends on the growth forecasts being met; i.e. it depends on cyclical factors.

**For the moment, compliance of the fiscal target for 2014 seems feasible.** In August the government deficit stood at 3.3%, 0.2 p.p. above the target for this year and it does not seem complicated to reduce the deficit by this amount over the last four months of the year. Moreover, it should be noted that the recent revision of GDP, following the new European accounting regulations, has increased nominal GDP for 2013 by 2.6%, reducing the deficit for that year by 0.3 p.p., down to 6.3%. As a result, the fiscal adjustment required to meet the target deficit for 2014 for the public sector as a whole, namely 5.5% of GDP, has shrunk to 0.8 p.p., obviously making it easier to achieve.

### Foreign visitor arrivals (Millions)



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

### Government's macroeconomic table

Annual change, unless otherwise specified (%)

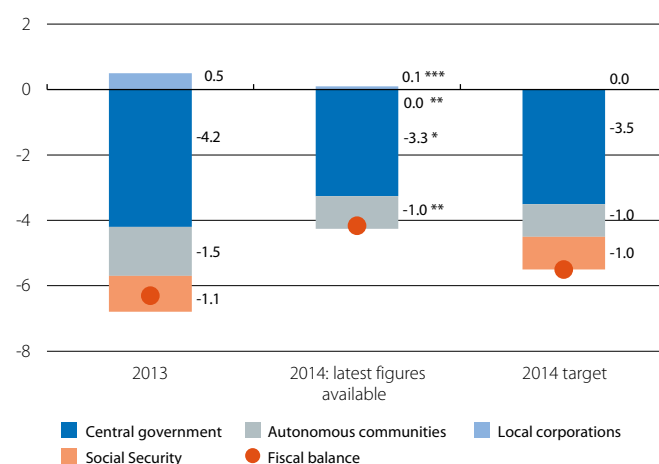
	2014	2015
GDP	1.3	2
Domestic demand *	1.4	1.8
Foreign demand *	–0.1	0.2
Employment	0.7	1.4
Unemployment rate **	24.7	22.9
Current balance (% of GDP)	0.9	1.1
Fiscal balance (% of GDP)	–5.5	–4.2

Notes: \* Contribution to growth. \*\* Percentage of the labour force.

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

### Breakdown of the fiscal balance

Cumulative figures for each year (% GDP)



Notes: \* August 2014. \*\* July 2014. \*\*\* 2014 Q2.

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

## FOCUS · On the upswing in household consumption in Spain

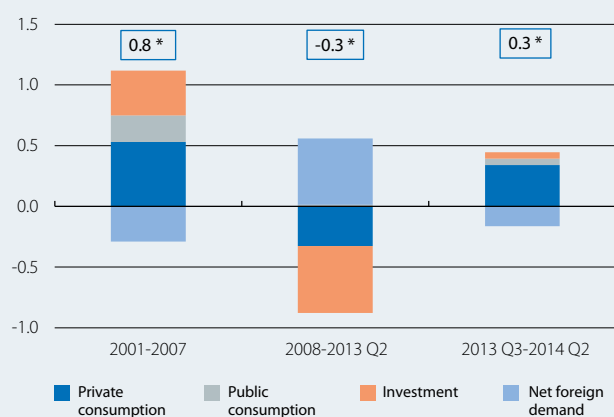
Private consumption is boosting Spain's economic growth. For the last four quarters it has advanced at an average rate of 0.6%, making it a key ally to the recovery. However, the sharp upswing in household consumption has not been accompanied by an increase in gross disposable household income (GDHI); in fact, this fell in 2013 to 1.8% and, in 2014 Q1, it was still falling, albeit at a slower rate (-1.1%). The increase in consumption has particularly occurred via a reduction in the savings rate. Specifically, between 2013 Q2 and 2014 Q2, this fell by 1.5 p.p. to 9.4%, an all-time low. Also of note is the marked rise in new loans granted for consumption, posting a 3.90% year-on-year growth rate in August (cumulative over 12 months). Consequently, if the factors supporting consumption remain the same, the rate of growth seen in the last few quarters is unlikely to continue. Let us analyse this in a little more detail.

GDHI is likely to progressively build up steam. Wage income, accounting for around 70% of the total gross disposable household income, will be helped by growth in employment, which we expect to be around 1% in 2014 while in 2015 it will probably rise to 1.4%. The outlook for non-wage income has also improved, partly due to the increase in the number of self-employed workers.

Although GDHI will benefit from the growing support of the labour market, household consumption is unlikely to maintain its growth rate in the first six months of 2014. By way of example, if its current rate of growth did continue, by 2016 the savings rate would be below 7%, a figure that does not seem very likely. The most reasonable scenario is for the rate of growth in consumption to moderate as those factors that have temporarily boosted it, such as taking decisions to consume that had been postponed during the crisis, gradually run out of steam. In fact, several indicators for 2014 Q3 already point to the growth rate for consumption easing. Retail sales in July and August, for example, recorded a 0.1% growth rate year-on-year while they had increased by an average of 0.6% in Q2.

The pattern of recovery being observed in consumption is similar to the one occurring in the early 1990s. Specifically, in 1994 Q2, after two years with an average quarter-on-quarter growth rate of -0.4%, this increased by an average of 0.9% for two quarters, while in the next two years it advanced by 0.3%. Our scenario predicts that, in the coming quarters, the growth in household consumption will remain significant but slightly less than the levels seen in the first half of 2014, around 0.4% quarter-on-quarter, a figure in line with the expected recovery in the labour market.

### Contribution to quarter-on-quarter growth in GDP (%)



Note: \* Average quarter-on-quarter change in GDP.  
Source: "la Caixa" Research, based on INE data.

### Determining factors of consumption \*

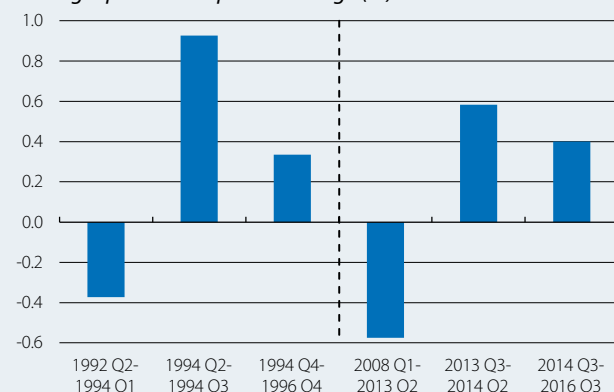
Average annual change (%)



Notes: \* Nominal data for hourly wage and gross disposable income (cumulative over four quarters). Level of savings rate. \*\* Latest data available: employment and hourly wage (2014 Q2); gross disposable income and savings rate (2014 Q1).  
Source: "la Caixa" Research, based on INE data.

### Pattern of recovery in household consumption

Average quarter-on-quarter change (%)



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



## FOCUS · Changes in Spain's real estate sector

The real estate sector seems to have started a change in direction. Sales have seen positive growth rates for several months now and house prices stopped falling in 2014 Q2. The improvement in economic activity is finally starting to affect the sector hardest hit by the recession. However, although the outlook is more favourable we must still remain cautious. The adjustment in prices and activity has been significant but there is still an excess supply of residential properties.

There has clearly been a dramatic slump in activity. In 2013, the residential properties completed totalled just 60,000, two thirds of the households created that same year. This ratio is far from the 1.3 residential properties completed per household created observed on average between 1999 and 2004. Undoubtedly such low rates are only sustainable due to the existence of a large stock of housing.

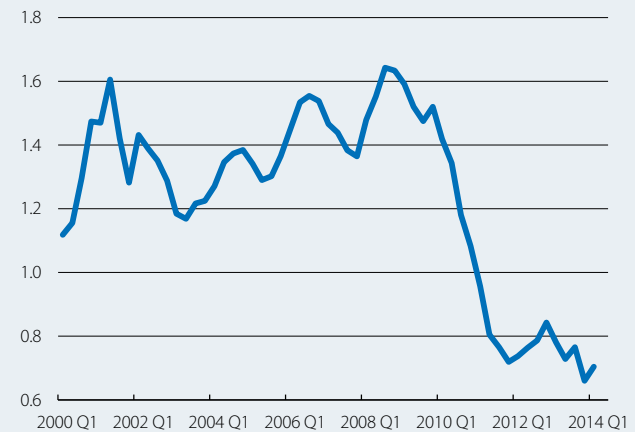
There has also been a significant adjustment in prices, falling by 38% in real terms since 2008. This can be seen in indicators that take into account households' capacity to pay. As seen in the second graph, the average household's share of gross disposable income used for the annual payment of a mortgage has changed substantially over the last few years, partly due to the fall in house prices although the drop in financing costs has also played a part. Nevertheless, this index is still slightly higher than what is considered to be the equilibrium level. House prices will need to increase at a slower rate than gross disposable household income for this adjustment to continue.

However, the most decisive factor for the sector's development over the coming years will be excess supply. According to our estimates, in 2013 Q4 the stock of new completed residential properties on sale was just above 600,000, which is 3.8 times the number of new residential property sales carried out in the last year, a figure very similar to the maximum posted in 2012. Although we expect the reduction in this ratio to speed up as the demand for housing improves, the large amount of stock accumulated will limit the extent to which activity and prices can recover in the short and medium term.

A broad analysis of the situation of the real estate sector must not forget the heterogeneous nature of this industry. A characteristic that is actually likely to intensify over the coming quarters. In those real estate sub-markets where excess supply is limited or non-existent, we are starting to see signs of upward pressure due to the recovery in demand and improved financing costs. However, in those sub-markets where supply is still excessive, the adjustment will continue to be slow.

### Activity indicator for the real estate sector

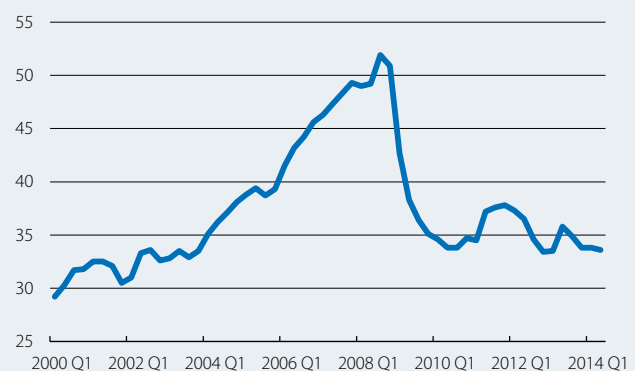
*Residences completed / households created*



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

### Indicator of the effort to buy housing

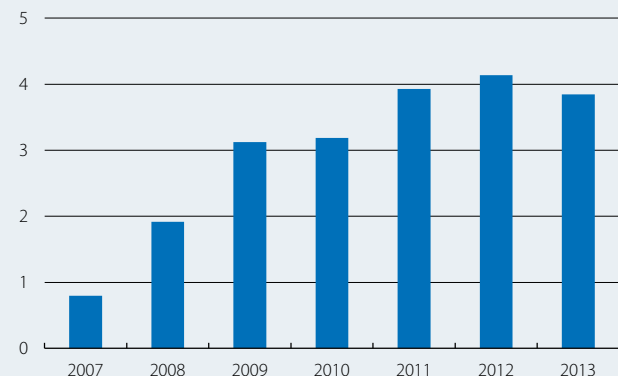
*Gross disposable income allocated to the annual mortgage payment (% of total gross disposable income)*



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

### Indicator of excess supply in the real estate sector

*Years of sales required to reduce the stock of new housing to zero*



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

## FOCUS · The deterioration in the income balance: reasons and trends

Current account adjustment has been substantial over the last few years but the trend has changed direction in the last few months. This is partly due to the deterioration in the balance of goods but the income balance is also playing a key role: the deficit rose by almost 5 billion euros during the first half of 2014 with 55% of the change occurring in the current account.

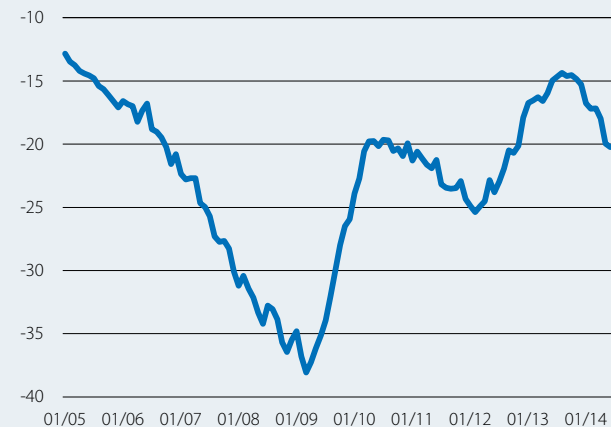
An important part of the increase in income deficit can be explained by the drop in yields from foreign assets held by Spanish individuals. The sharp fall in interest rates at a global level has been pushing down yields on Spanish investments abroad for several years now. Although foreign assets held by Spanish nationals have remained stable over the last few years, their lower returns reduced income by 17 billion euros between 2008 Q4 and 2014 Q1. As can be seen in the second graph, the fall in yield was particularly dramatic between September 2008 and September 2010. After a stable period, it then started to fall again in March 2012. Yield on national liabilities held by foreigners also fell but has remained stable over the last few quarters. This is due to the growing share of public debt among Spanish external liabilities (from 10.4% in June 2012 to 18.6% in March this year) as their yield is, on average, higher than that for other liabilities.

The second factor that lies behind the deterioration in the income balance is the larger volume of Spanish liabilities held by foreigners. In 2014 Q1 these rose more than total liabilities of the economy, increasing the percentage of Spanish liabilities held by foreigners to 23.1%. This level is similar to the one recorded between 2006 and 2010, highlighting the fact that foreign investors are regaining confidence in Spanish assets.

Two conclusions can be made from these factors behind the deterioration in the income deficit. (i) The fundamental reasons for this deterioration are not detrimental: it is not due to a disproportionate increase in external debt or to the sale of foreign assets held by Spanish nationals. (ii) The additional drop in the deterioration of the income deficit appears to be limited: the yield on Spanish assets abroad will not fall much further and the share of Spanish assets held by foreigners is almost back to normal. This last factor, however, is the one that is most uncertain and must therefore be closely monitored.

### Income balance

Cumulative over 12 months (billion euros)



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

### Implicit yield on assets and liabilities \*

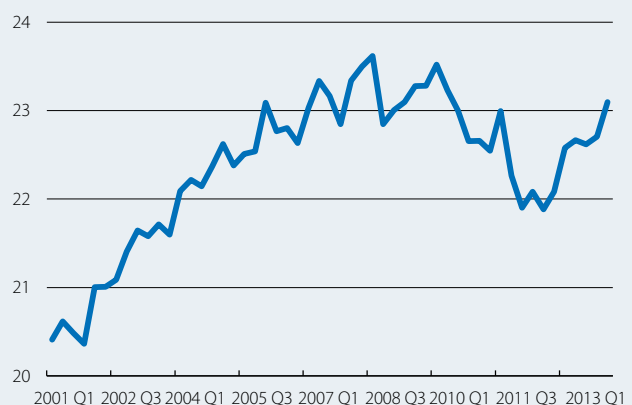


Note: \* In the case of assets, the ratio is calculated as income from investments abroad/assets abroad the previous year and, in the case of liabilities, as the ratio of income payments abroad/Spanish liabilities held by foreigners the previous year.

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

### Spanish liabilities held by foreign investors

Percentage of total liabilities (%)



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

## KEY INDICATORS

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

### Activity indicators

	2012	2013	2013 Q4	2014 Q1	2014 Q2	07/14	08/14	09/14
<b>Industry</b>								
Electricity consumption	-2.2	-2.1	0.1	-0.4	0.8	0.1	0.1	...
Industrial production index	-6.6	-1.5	1.1	1.5	2.6	0.7	...	...
Indicator of confidence in industry (value)	-17.5	-13.9	-11.6	-9.1	-8.2	-5.7	-5.7	-5.7
Manufacturing PMI (value)	43.8	48.5	50.1	52.5	53.4	53.9	52.8	...
<b>Construction</b>								
Building permits	-42.7	-21.4	-6.5	-8.9	14.4	16.4	...	...
House sales	-8.7	-2.4	-9.8	-9.3	6.5	10.7	...	...
<b>Services</b>								
Foreign tourists	2.0	5.6	10.8	8.1	7.8	5.9	8.8	...
Services PMI (value)	43.1	48.3	51.8	54.2	55.7	56.2	58.1	...
<b>Consumption</b>								
Retail sales	-7.1	-3.7	0.4	-0.1	0.7	-0.3	0.6	...
Car registrations	-13.5	5.6	22.6	11.8	23.2	10.9	13.7	...
Consumer confidence index	-31.7	-25.3	-19.4	-11.8	-6.1	-7.7	-6.4	-9.6

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 Q4	2014 Q1	2014 Q2	06/14	07/14	08/14
<b>Registered as employed with Social Security<sup>1</sup></b>								
Employment by industry sector								
Manufacturing	-5.3	-4.3	-2.5	-1.3	0.0	0.3	0.6	0.6
Construction	-17.0	-12.1	-7.9	-5.3	-2.3	-1.6	-1.1	-0.4
Services	-1.7	-2.0	-0.4	1.1	2.2	2.4	2.6	2.5
Employment by professional status								
Employees	-3.8	-3.8	-1.8	0.1	1.4	1.6	1.9	1.9
Self-employed and others	-1.4	-0.6	0.4	1.4	2.3	2.4	2.4	2.5
<b>TOTAL</b>	<b>-3.4</b>	<b>-3.2</b>	<b>-1.4</b>	<b>0.4</b>	<b>1.5</b>	<b>1.8</b>	<b>2.0</b>	<b>2.0</b>
<b>Employment<sup>2</sup></b>	<b>-4.3</b>	<b>-2.8</b>	<b>-1.2</b>	<b>-0.5</b>	<b>1.1</b>	<b>-</b>	<b>-</b>	<b>...</b>
<b>Hiring contracts registered<sup>3</sup></b>								
Permanent	29.7	-14.2	-2.1	6.8	24.0	26.2	18.4	16.8
Temporary	-4.0	6.4	15.0	19.4	14.2	18.4	8.5	8.3
<b>TOTAL</b>	<b>-1.6</b>	<b>4.0</b>	<b>13.5</b>	<b>18.2</b>	<b>15.0</b>	<b>18.9</b>	<b>9.1</b>	<b>8.8</b>
<b>Unemployment claimant count<sup>3</sup></b>								
Under 25	4.5	-6.2	-8.0	-9.4	-10.9	-9.2	-5.8	-4.9
All aged 25 and over	11.7	3.7	-1.2	-3.7	-5.9	-6.3	-6.0	-5.8
<b>TOTAL</b>	<b>10.9</b>	<b>2.7</b>	<b>-1.8</b>	<b>-4.2</b>	<b>-6.4</b>	<b>-6.6</b>	<b>-5.9</b>	<b>-5.8</b>

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 Q4	2014 Q1	2014 Q2	07/14	08/14	09/14
<b>General</b>	<b>2.4</b>	<b>1.4</b>	<b>0.1</b>	<b>0.0</b>	<b>0.2</b>	<b>-0.3</b>	<b>-0.5</b>	<b>-0.2</b>
Core	1.6	1.5	0.3	0.1	0.1	0.0	0.0	...
Unprocessed foods	2.3	3.6	0.7	0.7	-2.3	-5.2	-5.4	...
Energy products	8.8	0.1	-1.1	-1.0	2.4	0.3	-0.9	...

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 Q3	2013 Q4	2014 Q1	2014 Q2	06/14	07/14
<b>Trade of goods</b>								
Exports (year-on-year change)	3.8	5.2	4.4	0.8	3.2	-2.0	-1.2	8.7
Imports (year-on-year change)	-2.8	-1.3	-0.6	2.0	7.0	3.7	5.4	13.4
<b>Current balance</b>	<b>-12.4</b>	<b>8.0</b>	<b>7.7</b>	<b>8.0</b>	<b>4.0</b>	<b>-1.0</b>	<b>-1.0</b>	<b>...</b>
Goods	-27.8	-11.6	-11.5	-11.6	-13.9	-17.2	-17.2	...
Services	37.6	40.9	39.3	40.9	41.6	42.5	42.5	...
Income	-17.9	-15.3	-14.6	-15.3	-17.2	-20.2	-20.2	...
Transfers	-4.3	-6.0	-5.5	-6.0	-6.4	-6.1	-6.1	...
<b>Net lending (+) / borrowing (-) capacity</b>	<b>-5.8</b>	<b>15.8</b>	<b>15.6</b>	<b>15.8</b>	<b>12.5</b>	<b>6.9</b>	<b>6.9</b>	<b>...</b>

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	2014 Q2	06/14	07/14	08/14
<b>Net lending (+) / borrowing (-) capacity</b>	<b>-6.6</b>	<b>-6.3</b>	<b>-4.7</b>	<b>-6.8</b>	<b>-0.6</b>	<b>-3.4</b>	<b>-3.4</b>	<b>-</b>	<b>...</b>
Central government <sup>1</sup>	-8.1	-4.9	-4.1	-4.9	-0.9	-2.6	-2.6	-3.2	-3.3
Autonomous regions	-1.8	-1.5	-0.9	-1.5	-0.3	-1.1	-1.1	-1.0	...
Local government	0.3	0.5	0.4	0.5	0.2	0.1	0.1	-	...
Social Security	-1.0	-1.1	-0.3	-1.1	0.3	-0.2	-0.2	0.0	...
<b>Public debt (% GDP)</b>	<b>84.4</b>	<b>92.1</b>	<b>91.6</b>	<b>92.1</b>	<b>95.0</b>	<b>96.4</b>	<b>96.4</b>	<b>-</b>	<b>...</b>

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	2014 Q2	06/14	07/14	Balance 07/14 <sup>1</sup>
<b>Financing of non-financial sectors<sup>2</sup></b>									
Private sector	-4.0	-7.8	-8.1	-7.4	-6.2	-5.7	-5.6	-5.6	1,796.3
Non-financial firms	-4.1	-9.8	-10.2	-8.7	-6.6	-6.2	-6.0	-5.9	1,031.3
Households <sup>3</sup>	-3.8	-4.9	-5.0	-5.5	-5.6	-5.2	-5.0	-5.1	765.0
General government <sup>4</sup>	14.9	17.0	17.4	13.0	8.5	6.6	6.5	5.4	1,005.7
<b>TOTAL</b>	<b>0.6</b>	<b>-0.9</b>	<b>-0.9</b>	<b>-1.4</b>	<b>-1.5</b>	<b>-1.7</b>	<b>-1.6</b>	<b>-1.9</b>	<b>2,802.0</b>
<b>Liabilities of financial institutions due to firms and households</b>									
Total deposits	-4.5	2.1	4.7	2.2	0.2	-0.8	-0.7	-0.7	1,174.9
On demand deposits	0.2	4.2	4.6	8.1	7.4	7.4	10.7	13.8	307.3
Savings deposits	-2.8	-0.1	-0.2	1.4	3.8	5.9	5.5	6.6	214.0
Term deposits	-6.7	1.7	5.7	0.2	-3.6	-6.1	-7.1	-8.5	632.8
Deposits in foreign currency	-4.0	16.8	24.1	-0.1	-1.1	0.1	-0.9	0.1	20.7
Rest of liabilities <sup>5</sup>	-13.2	-16.8	-15.3	-12.7	-11.1	-8.3	-5.1	-0.2	122.6
<b>TOTAL</b>	<b>-5.7</b>	<b>-0.2</b>	<b>2.3</b>	<b>0.5</b>	<b>-1.1</b>	<b>-1.6</b>	<b>-1.1</b>	<b>-0.7</b>	<b>1,297.5</b>
<b>NPL ratio (%)<sup>6</sup></b>	<b>10.4</b>	<b>13.6</b>	<b>12.7</b>	<b>13.6</b>	<b>13.4</b>	<b>13.1</b>	<b>13.1</b>	<b>13.2</b>	<b>-</b>
<b>Coverage ratio (%)<sup>6</sup></b>	<b>73.8</b>	<b>58.0</b>	<b>63.8</b>	<b>58.0</b>	<b>58.6</b>	<b>59.4</b>	<b>59.4</b>	<b>59.4</b>	<b>-</b>

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.

## THE KEYS TO THE RECOVERY IN CREDIT

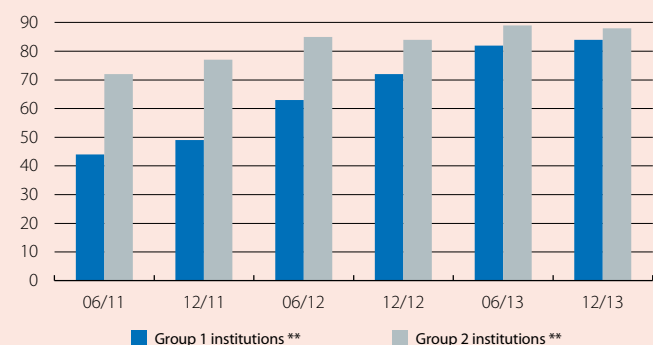
## The credit of credit

The trend in credit has been monitored with some concern during the crisis and no-one has been satisfied with it. Financial institutions have seen their core business and therefore their main source of income shrink year after year while, for households and firms, the slump in credit has represented an additional handicap in an already difficult economic situation. However, credit finally seems to be taking a different course.

One of the key factors limiting the credit capacity of financial institutions over the last few years has been due to the regulation of the sector itself or, more specifically, to the changes occurring to this regulation. The start of the crisis highlighted the fact that the regulation of the time, known as Basel II, had not been able to prevent the collapse of a large number of banks, calling into question the solvency of the sector as a whole. The process quickly put in place to reformulate this regulation culminated with the start-up of Basel III in January 2014. Put very briefly, the overall principle behind this new regulatory framework is that banks should have a larger and better quality capital buffer to be able to handle adverse scenarios. The minimum capital requirements institutions must meet are to be raised gradually, going from a core capital of 2% of risk-weighted assets (RWA) to 7.0% by 2018. Moreover, this new framework requires banks to create an additional capital buffer during boom periods in the cycle which can be used, if necessary, during recessions. The new regulation therefore contains a very important principle, widely demanded both by the academic world and by the sector itself: it recognises that increasing capital is an expensive business for financial institutions and that, if they have to do so quickly, this might end up harming their capacity to grant loans. That is why the new regulation establishes that minimum capital requirements should increase gradually and that the additional capital buffer should be created during the expansionary phase of the cycle. The aim is to improve bank solvency in the long term without affecting their credit capacity in the short term.

## Euro area institutions meeting the Basel III capital requirements for 2018 \*

(% of all institutions)



Notes: \* Institutions with a CET1 BIS III fully-loaded capital ratio above 7% of their RWA.

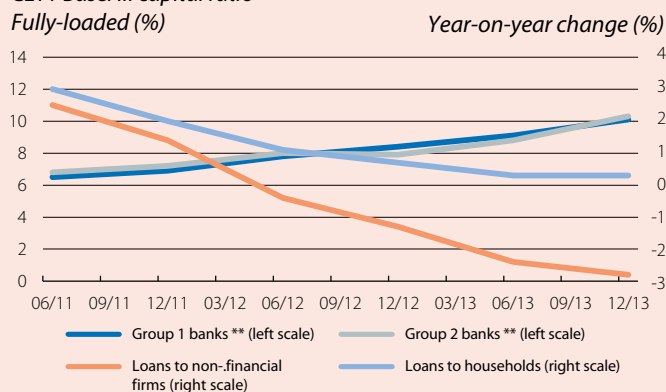
\*\* Banks under ECB supervision. Group 1 banks are those that have Tier 1 capital in excess of €3 billion and are internationally active. All other banks are considered Group 2 banks.

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

## Trend in capital ratios of euro area banks and in credit

CET1 Basel III capital ratio

Fully-loaded (%)



Note: \* Banks under ECB supervision. Group 1 banks are those that have Tier 1 capital in excess of €3 billion and are internationally active. All other banks are considered Group 2 banks.

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

However, although the principle that lies behind this new regulation is well-intentioned, its application has had the opposite effect. The new regulatory framework has been applied too soon and during a situation of economic weakness, with continuing doubts regarding the solvency of some institutions. And, given that it is often difficult to determine the health of each institution sufficiently clearly, banks have been forced to rapidly increase their capital ratios in order to demonstrate their strength. In addition to market pressure, indices have also been published that encourage a comparison of whether institutions already meet the requirements coming into force in 2018. The report published by the Bank for International Settlements every six months shows that more than 80% of banks already meet these requirements, a high figure which has visibly risen over the last few quarters (as can be seen in the graph). In short, while economic activity was almost at a standstill and even in recession in some quarters, financial institutions were increasing their capital ratio, which has almost certainly worsened the drop in credit seen in the euro area as a whole.

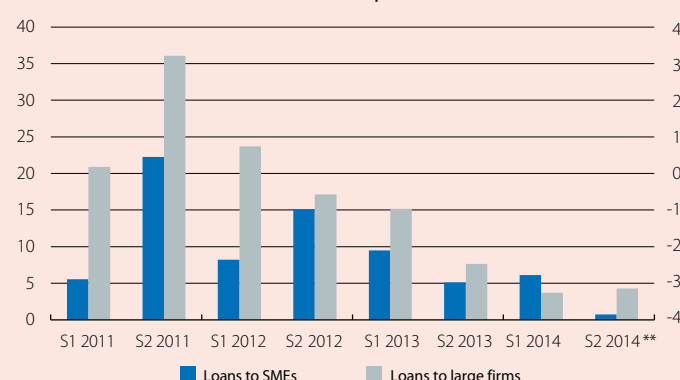
Another aspect that has also hindered the recovery in banks' credit capacity is regulatory uncertainty, a widespread phenomenon in developed countries but especially acute in the euro area. Apart from the insecurity involved in constant redefining the sector's regulatory framework, the various stress tests carried out have been a significant source of further uncertainty. There are two reasons for this.

Firstly, although carrying out stress tests should, conceptually, be positive for confidence in the financial sector, they have been badly implemented. Theoretically, stress tests are useful for analysing whether banks could successfully handle a highly adverse economic scenario. Should this scenario come about, it is assumed that institutions can use their available capital to overcome it. In other words, it is not supposed that banks should maintain a level of capital above the legally required minimum in an adverse scenario because, if this were the case, institutions would implicitly be required, during periods of normal economic activity, to have a level of capital far above the regulatory minimum. Although this may seem paradoxical, this is actually what has happened in the euro area. Over the last few years the economic scenario has been similar to the one proposed for the stress scenarios carried out by the EBA in 2011. However, when this stress scenario actually materialised, instead of allowing banks to use their capital and liquidity margins to cushion the impact of the recession on their credit capacity, they have had to keep their capital ratios above the minimum required and, in fact, have increased them and have been subjected to further stress tests.

Secondly, significant methodological changes have occurred in the stress tests in terms of calculating the minimum capital banks must hold. The most notorious case occurred in the 2011 stress tests, when it was announced that the probability of public debt default was positive and, therefore, capital should be allocated for such an event.

### Credit conditions of regulatory origin

(Net % of euro area banks with stricter positions) \*



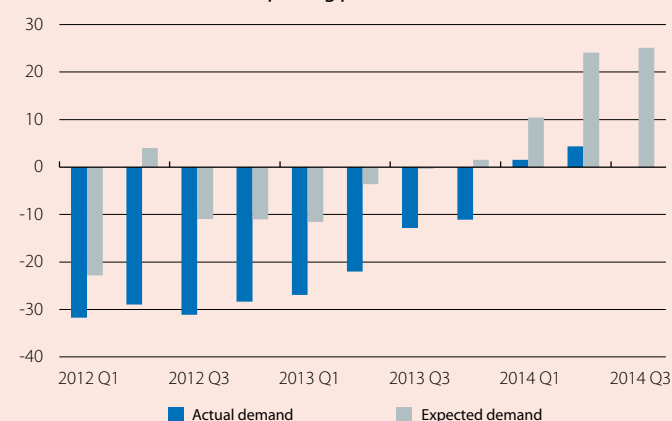
Notes: \* Net percentages are defined as the difference between the sum of the percentages of banks responding «tightened considerably» and «tightened somewhat» and the sum of the percentages of banks responding «eased somewhat» and «eased considerably».

\*\* Value predicted by banks for 2S 2014.

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

### Changes in demand for loans to enterprises

(Net % of euro area banks reporting positive demand) \*



Note: \* Actual values are changes that have occurred over the previous three months while expected values are changes anticipated by banks over the coming three months.

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

Fortunately, it seems as if the negative regulatory impact on banks' credit capacity is coming to an end. One of the last elements that has yet to be clarified, the results of the examinations carried out by the ECB on banks before becoming their sole supervisor will be announced in October. The bulk of the evidence suggests that, in general, the outcome will be satisfactory. In fact, the bank lending survey already shows that, over the coming months, regulation and supervision will no longer be the factors limiting the credit granted.

An improvement in the credit capacity of banks could not come at a better time. Although the economic recovery is expected to be slow in the euro area, the demand for credit finally appears to be picking up. Given this situation, it is particularly important for banks to be ready in order to support economic activity. Credit must regain credit.

Oriol Aspachs  
European Unit, Research Department, "la Caixa"



## The ECB: another step forward in consolidating the euro area's recovery

Doubts regarding another relapse in the euro area have led its top monetary authority to make a move and implement an extensive package of unconventional monetary stimuli. The ECB hopes to revive growth in credit as the lynchpin to consolidating the economic recovery, reducing unemployment and, ultimately, normalising inflation. The ECB still has to combat significant elements but the firmness of its actions, slow but categorical (and in several cases surprising), means that it still has a decisive role in creating expectations of growth for the euro area.

To be able to analyse, in some depth, to what extent the latest measures announced might help to revitalise Europe's economy, it is useful to briefly review how the ECB's decisions affect the region's economic performance. In general, the most widely used monetary policy instrument is the interest rate for short-term refinancing operations, also known as the Refi rate. The cost of this liquidity affects the price at which banks can offer loans and reward savings. Under normal economic conditions, lowering the interest rate ends up encouraging consumption and investment as it reduces the return on savings and financing costs. However, the ECB has been forced to come up with imaginative formulas to continue stimulating economic activity as, with interest rates at their lowest possible level, the economy has yet to show any convincing signs of recovery. Following the same path taken by the Fed and Bank of England to raise the cost of savings, the ECB has not only cut interest rates to an all-time low but has also promised to maintain these rates at their current level for an extended period of time, commonly known as forward guidance. Through such action, the ECB hopes to reduce the return on savings even further, as well as the cost of long-term financing. The aim is still the same: to encourage consumption and investment as the necessary steps prior to a recovery in activity and, ultimately, inflation.

Given that credit plays a crucial role in this equation, in June the ECB took another step forward by announcing that, between September 2014 and March 2016, it would hold eight long-term refinancing operations (to be paid back in September 2018) at a very low interest rate (10 BPS above the Refi rate). This time, moreover, to ensure the liquidity injected reaches the so-called real economy, the amount each bank can borrow depends on the trend in credit. The first two targeted long-term refinancing operations or TLTROs (namely the one held in September and the one planned for December) have a maximum allocation of 7% of loans granted to the private sector<sup>1</sup> at the end of April 2014. For the euro area as a whole, this totals 400 billion euros, 21% of which was already covered by the first operation. In the next few TLTROs, the amount that can be borrowed will depend directly on each bank's net lending during the months prior to the operation. Similarly, as an additional guarantee that the liquidity provided is used to improve the flow of credit to the private sector, those banks borrowing through these TLTROs must exceed specified benchmarks that will vary depending on each institution's loan portfolio.

Given that the economic outlook for the euro area as a whole not only did not improve but actually deteriorated significantly during the summer, in September the ECB surprised most analysts by announcing a corporate bond asset purchase programme, specifically asset and mortgage-backed securities. With regard to the former, which are the most innovative, Draghi stated that the ECB would consider purchasing simple and transparent securities backed by mortgages, loans to SMEs and consumer credit. He also stressed its readiness to buy from low-risk senior tranches to higher risk mezzanine tranches, but only if there is a guarantee for the latter. A lot of details still need to be clarified so that it is difficult to evaluate the real scope of this programme's impact. However, two relevant considerations can be made. Firstly, although Europe's securitisation market is

### Latest monetary policy actions by the ECB

	June 14	September 14
Interest rates	↓ Refi rate: from 0.25% to 0.15%.	↓ Refi rate: from 0.15% to 0.05%.
	↓ Deposit facility: from 0% to -0.1%.	↓ Deposit facility: from -0.1% to -0.2%.
	↓ Marginal lending facility: from 0.75% to 0.4%.	↓ Marginal lending facility: from 0.4% to 0.3%.
Liquidity	Prolongation to 12/2016 of fixed rate, full allotment tender procedures (MROs).	Implementation of an asset and mortgage-backed security purchase programme as from October.
	Completion of the SMP programme's sterilisation operations.	
	Announcement of 8 targeted longer-term refinancing operations (TLTROs).	

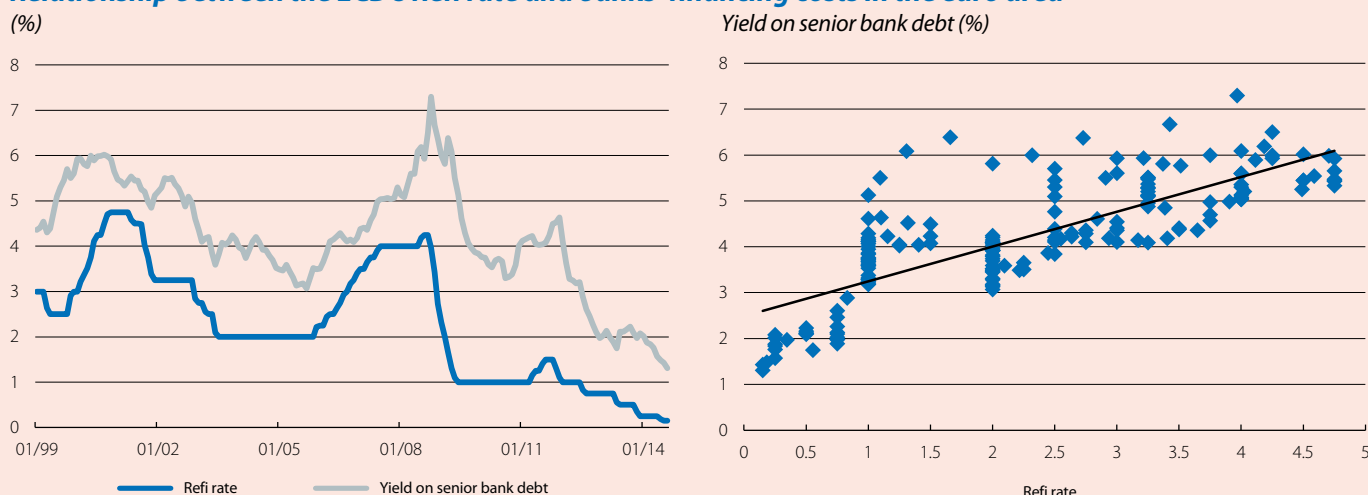
Source: "la Caixa" Research, based on ECB data.

1. Specifically the eligible portfolio includes loans to the non-financial private sector, excluding mortgages to individuals.



small, especially when compared with the US, the ECB's actions could be the trigger required for considerable progress to be made over the next few years. Secondly, the success of this programme will depend on how far it manages to reactivate the credit capacity of financial institutions and one decisive factor will be whether banks can pass on a substantial level of risk with this programme.

### Relationship between the ECB's Refi rate and banks' financing costs in the euro area



Source: "la Caixa" Research, based on data from the ECB and Markit Iboxx.

Pending more details on the different measures the ECB has announced, a relatively simple and intuitive way to evaluate the impact these may have on credit is to analyse the trend in bank financing costs. We can use as a reference the trend in yield on senior debt which, as can be seen in the graph, very closely follows the movements in the Refi rate. Historically, a 100 BPS drop in the Refi rate has been associated with a 70 BPS drop in yield on bank senior debt. Since the aforementioned unconventional monetary policy measures were announced, yield on Europe's bank senior debt has fallen by 0.7 p.p.. Historically, a drop of this size, associated with a reduction in the Refi rate of 1 p.p., would lead to cumulative growth in loans to enterprises of 5.6 p.p. over two years.<sup>2</sup> However, it is important to bear in mind several restrictions that would reduce such an impact. These figures were estimated during the period before the crisis, when the monetary policy transmission mechanism was fully functional, something which is not the case at present. This is precisely one of the reasons why the ECB has decided to act. Restrictions can currently be observed in both demand and supply. In the first case, the private sector is still deleveraging so that growth in credit would be seen in new loans while the loan portfolio will continue to shrink. On the supply side the restrictions are due to the recapitalisation taking place in European banks in order to meet the requirements of new regulations (see the article «The credit of credit» in this Dossier). All this means that the boost given to growth in credit will be less than if such restrictions had not existed.

In short, the ECB has gradually but firmly extended its battery of monetary policy measures to such an extent that it is now using tools that would have been unthinkable until quite recently. The bulk of the evidence suggests that their impact will not be negligible and they will help the incipient recovery in credit to consolidate over the coming quarters.

Ariadna Vidal Martínez  
European Unit, Research Department, "la Caixa"

2. See Sorensen, C. K., Marqués, D. and Rossi, C., «Modelling loans to non-financial corporations in the euro area», ECB Working Paper Series, no. 989, January 2009.

## The cost of bank debt: a thing of the past

One of the most immediate consequences of the Lehman Brothers bankruptcy at the end of 2008 was the closure of wholesale financing markets for banks. Huge doubts regarding the losses banks might suffer, as well as their capacity to absorb them, scared off investors and pushed the cost of wholesale debt up to prohibitive levels. Since then, tensions in the debt markets are not what they used to be. But, in this new regulatory context, neither should we expect the cost of wholesale debt to get back to its pre-crisis level.

Let's start by defining the concept of wholesale funding. This usually refers to the part of banks' funding that does not come from customer deposits. Neither does it include central bank funding which, under normal situations, should only represent a small part of the balance sheet. Wholesale funding is made up of a wide range of instruments such as interbank deposits, mortgage-backed securities, senior and subordinated debt. Each of these instruments has different features (in terms of liquidity, maturity, guarantees or seniority of the debt should the bank go bankrupt) which make them more or less attractive to investors. The cost of each one for banks will depend on how investors value these different characteristics at any given time, in line with their expectations regarding macroeconomic trends and the bank's performance.

So how are prices formed for such instruments? Apart from the instrument's maturity or liquidity, two of the most important features for investors are the presence (or lack thereof) of guarantees that the amount borrowed will be repaid and the priority of this payment in the case of bankruptcy. Both factors determine the amount investors might get back should the bank become insolvent and, together with the likelihood of this event occurring, determine the expected return from the instrument. Intuitively, this expected return must be sufficiently attractive compared with the yields offered by other, lower risk assets such as public debt.

Throughout the financial crisis, as well as the subsequent recessions and sovereign debt crisis, the cost of the different wholesale funding instruments rose substantially on several occasions. On the one hand, doubts regarding bank losses, the quality of the assets used as collateral as well as the real capacity of governments to bail out insolvent banks worsened the expectations of investors regarding the probability of financial institutions going bankrupt and whether they would be repaid should this happen. On the other hand, in the periphery countries bank debt was compared with the ever-rising yields offered by the country's sovereign debt. In Spain, for example, the spread between five-year senior bank debt and German public debt with the same maturity reached more than 4 p.p. on more than one occasion during this period. Banks have reacted by changing the composition of their liabilities, reducing the share of sources of wholesale funding (from 37% at the end of 2007 to 24% currently, in the case of Spanish banks) and replacing this with ECB funding. Nonetheless, this substitution is not perfect as it is exceptional in nature and cannot really be considered a stable source of financing for mortgages or loans to enterprises over the medium to long term.

In the coming years, financial institutions are going to have to reshuffle their funding structure. Not only because they need to gradually replace ECB funding but also because of the imposition of different regulatory ratios on liquidity and leveraging, as well as the framework for banks with solvency problems.<sup>1</sup> This last issue, in particular, involves the introduction of the so-called bail-in to minimise the use of public resources in such cases. Essentially, when a bank is in difficulty, the bail-in rules force its shareholders and creditors without a guarantee to assume losses equivalent to at least 8% of the bank's total liabilities (including own funds), following a pre-established seniority, before capital can be injected by the Resolution Fund. This encourages banks to issue capital and hybrid instruments (subordinated debt or convertible securities) until this 8% has been covered. The bail-in rules also state that national resolution authorities must establish the minimum requirement for eligible liabilities (MREL) for each institution, in line with its risk, size and business model. As such liabilities are unsecured, banks are likely to achieve the MREL by issuing senior debt.

The introduction of the bail-in represents a firm commitment not to bail out banks in difficulty and consequently means that creditors are more likely to suffer losses. We might therefore expect senior debt to become more expensive. The banks most affected should be those that are currently more leveraged as the risk for senior bondholders is even greater if the bank's

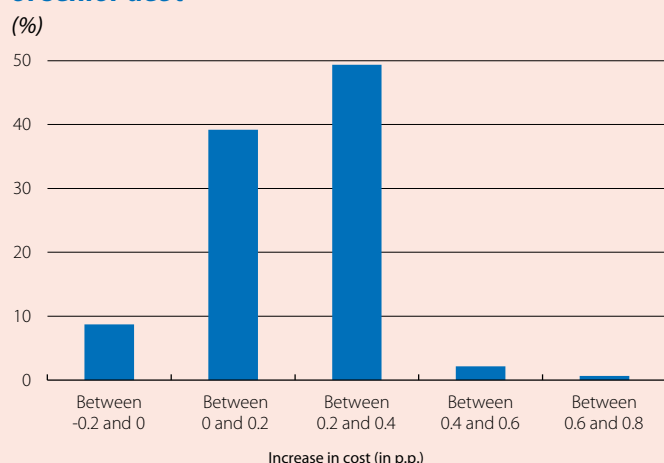
1. In the case of the European Union, this framework has been defined by Bank Recovery and Resolution Directive (Directive 2014/59/EU of the European Parliament and of the Council, of 15 May 2014).

capital and subordinated instruments do not reach 8% of its assets. On the other hand, those banks whose own funds are already above this figure and are considered to be sufficient to cover unexpected losses should not see any great change in their senior debt.

Although the bail-in will not come into force until 2016, the rising cost of senior debt can already be observed in the price of such instruments. To quantify this, we have analysed changes after the bail-in rules were approved by the European Council in August 2013, in the spread between yields on bank debt and public debt with the same maturity. This spread will depend on the characteristics of the bond (years to maturity or the subordinated nature of the debt, for example), on the bank issuing it (its specific risk, degree of leveraging, whether it's systemic, its return on assets, etc.) and on macroeconomic trends. Once all these factors have been taken into account, an increase in the spread after introducing the bail-in rules can be interpreted as a higher return demanded by investors because they are now more likely to suffer losses.

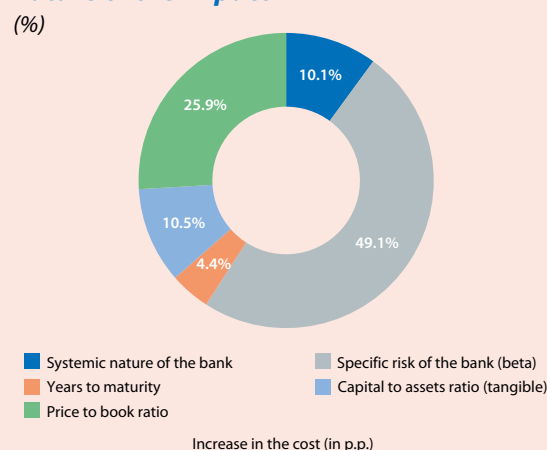
Following this reasoning,<sup>2</sup> we have taken a sample of 633 outstanding issuances of bank bonds issued by 19 different institutions and have analysed the monthly trend in their yields from December 2007 to March 2014. The results show that, on average, the introduction of the bail-in has increased the cost of senior debt by 19 basis points, although for some banks this rise has been as high as 72 basis points. In general, and as seems logical, the greater the risk of the bond, the higher this increase in cost. This is reflected in the fact that both the specific risk of the issuing bank and the years to maturity of the bond or the bank's price to book ratio increase the impact of the bail-in. It is also interesting to note that senior debt becomes even more expensive for those banks that can be considered systemic (those which would be more likely to be bailed out in the case of difficulty). These findings therefore suggest that this regulatory reform has managed to increase investor sensitivity to risk and will help to correct, at least in part, the advantageous situation enjoyed by some large banks which were bound to be bailed out if they had problems.

### Impact of the bail-in on the cost of senior debt \*



**Note:** \* Distribution of the impact on outstanding bonds.  
**Source:** "la Caixa" Research, based on Bloomberg data.

### Factors behind the heterogeneous nature of the impact \*



**Note:** \* Contribution to the impact.  
**Source:** "la Caixa" Research, based on Bloomberg data.

In summary, with this new regulatory framework the cost of debt will be higher, reflecting an assessment on the capital adequacy of the issuing bank. In itself, this is very positive. However, we should question whether this was the best time to implement such changes, given that banks now have to adapt to them before they have managed to completely repair their balance sheets and before debt markets have got back to normal.

Sandra Jódar-Rosell  
 Economic Analysis Unit, Research Department, "la Caixa"

2. More detailed findings from this exercise can be consulted in Gual, J., Jódar-Rosell, S. «Prudential regulation and the cost of bank funding», Working document presented at SUERF, The European Money & Finance Forum, Milan, 5 June 2014. The exercise follows the methodology proposed by Acharya, V. *et al.* (2014), «The end of market discipline? Investor expectations of implicit state guarantees», available at SSRN: <http://ssrn.com/abstract=1961656>.

## A lower cost of equity for banks

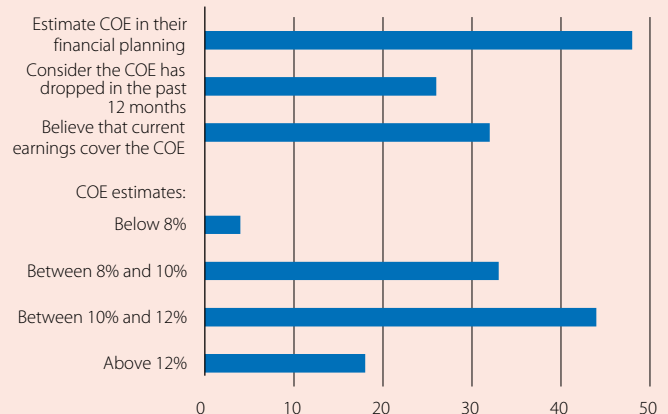
Cost of equity (COE) is the return a shareholder can expect from funds invested in a company. These expected returns obviously have an effect on companies' financing costs and managers need to take them into account to value investments and efficiently assign resources. In the case of financial institutions, a higher cost of equity will tend to reduce the supply of credit and push up interest rates. Moreover, an environment with regulatory pressures, such as that of recent years, may have encouraged banks to improve their solvency by reducing the size of their balance sheets.

In spite of its importance, COE is not directly observable and therefore difficult to quantify. Only half Europe's financial institutions estimate the cost of equity in their planning, as shown by the latest survey carried out in June by the European Banking Authority (EBA). Most banks place their cost of equity at between 10% and the 12% and acknowledge a certain downward trend in the last few quarters. Nonetheless, only 30% of the banks believe that their current earnings are covering the COE. The adverse trend in the share prices of many banks therefore comes as no surprise.

It is reasonable to assume that the return demanded by shareholders will depend on the risk they assume. We can therefore infer that the COE must be at least the same as the return offered by assets considered to be risk-free (such as German public debt), plus a premium to compensate any risk assumed. The capital asset pricing model (CAPM), one of the most widely used for calculating the cost of equity, is based on this assumption. This approach defines COE as the sum of the return on the risk-free asset plus a premium for market risk, adjusted by the specific risk (or beta coefficient) of the industry or company in question. The beta coefficient is a risk measure that compares the volatility of a company's share value with the market's typical variability. Betas higher than one must be interpreted as a specific risk higher than the market risk and, to compensate this, the cost of equity of a company or bank must also be higher. In spite of being criticised due to its oversimplification and other factors, the Federal Reserve<sup>1</sup> uses the CAPM as an acceptable estimate of bank cost of equity and does not include other aspects in the model which might be deemed important, as they are

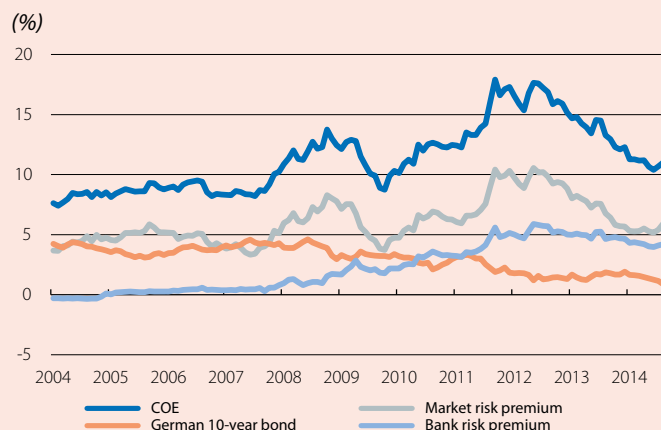
### EBA survey on the cost of equity in European banks

June 2014, banks (% of total)



Source: "la Caixa" Research, based on EBA, «Risk assessment of the European banking system» (June 2014).

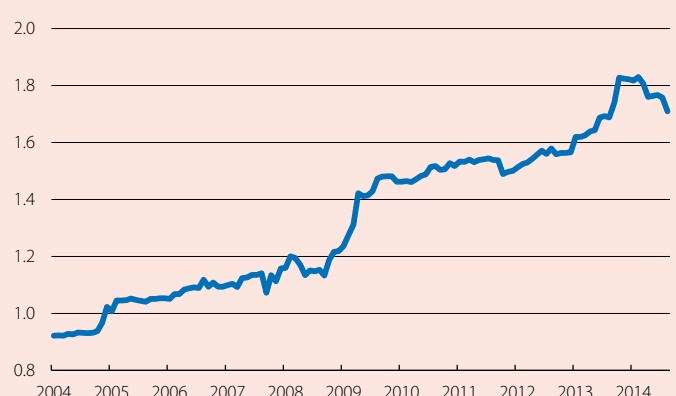
### Breakdown of COE for banks of the euro area



Note: We use the German 10-year Bund as a risk-free asset and calculate the market risk premium based on the inverse of the cyclically adjusted P/E ratio of the Eurostoxx index for the euro area. The beta is calculated by applying a 5-year window. The bank risk premium is  $(\beta - 1) \times$  the market risk premium.

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

### Beta coefficient for banks of the euro area



1. See Barnes, M. L. and Lopez, J. A., (2005), «Alternative measures of the Federal Reserve Banks' cost of equity capital», Public policy Discussion Papers, Federal Reserve Bank of Boston, no. 05.2.

not very statistically significant. Among others, fiscal impact, the institution's leveraging or the sector's degree of concentration, as these are not very statistically significant.

Following this methodology,<sup>2</sup> our estimates place the average cost of equity of Europe's financial institutions at around 11% in mid-2014, in line with the level given for the sector in the EBA survey. However, the return demanded has fluctuated substantially over the last few years. Before the financial crisis, cost of equity remained very stable at 8%-9% while yields for the equity of European banks were above 15%, thereby exceeding investors' expectations. This scenario was cut short in 2008 when the cost of equity started to rise, briefly interrupted by the incipient recovery in 2010, until it went above 16% in 2012, a year affected by strong tensions in the sector and the sovereign debt crisis.

Variations in COE have important consequences for the interest rates demanded by banks for their loans. One revealing example consists of analysing how much capital is required from financial institutions when granting loans to enterprises. Assuming a minimum capital requirement of 8% and that the risk weighting for this type of asset is 75%, the capital requirement comes to 6%; i.e. banks must allocate at least 6 million euros of equity to grant a loan of 100 million euros. An increase of 7.6 p.p. in the COE, as happened for European banks between 2007 and 2012, would therefore lead to a 0.46 p.p. rise in the cost of credit. On the other hand, the 5.5 p.p. drop in the COE that has occurred over the last two years would reduce financing costs by 0.33 p.p.

This fall in the cost of equity since 2012 is entirely due to the drop in the stock market risk premium and to lower interest rates for the risk-free asset, this last factor being very much encouraged by the ECB's expansionary policies. However, the specific risk of the financial sector (the beta coefficient) has risen almost non-stop in the last ten years. A beta that was below one in 2004 has now practically doubled and reached a level close to 1.8. This growing volatility of European banking relative to the market, seen as higher specific risk, is in line with the fact that the industry has been one of the most heavily affected by the financial crisis and economic recession. However, apart from banks' problems in this adverse cycle, regulatory uncertainty has created even more doubts regarding how banking business will develop. Moreover, the regulatory reforms introduced to lessen implicit public guarantees may have also contributed to a perception of greater risk on the part of shareholders.

It is also useful to note that this increase in the beta coefficient has taken place in spite of the reduction in bank leveraging, when the regulatory framework was attempting to do just the opposite. Since 2010, regulatory pressures (especially Basel III) have resulted in a 26% reduction in the leverage ratio. It would be reasonable to conclude that, when the share of equity increases in a bank's balance sheet, the risk borne by an investor is less and, consequently, the return demanded should also be lower. However, the growth in the beta coefficient did not start to moderate until the end of 2013, and then only very slightly. One possible explanation is that, although the capital buffer has indeed been increased to cover possible losses, the incentives to assume risk may have also changed.<sup>3</sup> Some theoretical arguments point to banks incurring more risks that cannot be verified by the supervisor to maintain earnings on capital and offset the tougher regulatory requirements. In this respect, empirical studies fail to provide conclusive proof that greater solvency requirements reduce the real risk borne by banks. The impact of less leveraging on the cost of equity is therefore not obvious.

In any case, bank risk will probably consolidate and even diminish in the medium term thanks to the publication of the results from the ECB examinations in October and the establishment of the regulatory framework. At a time such as the present, with interest rates at an all-time low, cost of equity may return to its levels of 2007-2008 and reach 9%. In short, the falling cost of equity capital, a reduction that may intensify in the medium term, should encourage banks to grant loans and halt their deleveraging by reducing their balance sheets. Good news for the real economy.

*Pau Labró Vila*  
*Economic Analysis Unit, Research Department, "la Caixa"*

2. For details on the calculations, see Gual, J., Jódar-Rosell, S. «Prudential regulation and the cost of bank funding», Working document presented at SUERF-The European Money & Finance Forum, Milan, 5 June 2014.

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



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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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