

MR12

MONTHLY REPORT • ECONOMIC AND FINANCIAL MARKET OUTLOOK

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2015

ECONOMIC & FINANCIAL ENVIRONMENT

FINANCIAL MARKETS

The Fed and the ECB are going their separate ways, how long will they take to meet up again?

INTERNATIONAL ECONOMY

The TTIP: the free trade and investment treaty between the EU and the United States, a necessary agreement

EUROPEAN UNION

The sensitivity of the euro area's exports to exchange rate movements

SPANISH ECONOMY

The financial wealth of households: a buffer for consumption

DOSSIER: OUTLOOK 2015

Global recovery underway, with the permission of the US and the euro area

2015: monetary policy continues to set the tone for the financial markets

Weakness, shale and Saudi Arabia's strategy behind the upheaval in oil

Correcting the external deficit: high and low points



"la Caixa" Research

MONTHLY REPORT - ECONOMIC AND FINANCIAL MARKET OUTLOOK

December 2014

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Judit Montoriol-Garriga

2015, an important year for Europe's economy

Next year will once again be important for Europe's economy. After the doubts and disappointments brought by the year now coming to an end, with downward revisions for growth and dangerously low inflation, it is vital for the new year to start off on the right foot. Otherwise the socio-political situation in many member states might become unsteady, reinforcing extremist parties which have already made gains in the European Parliament elections.

Public policies will have to tread carefully in order to tackle, harmoniously but decisively, three big challenges. One is cyclical: to speed up the exit from the crisis. Another is structural: to boost competitiveness and potential growth. And another is institutional: to improve the design of the EMU and make it resistant to any future financial or economic crises.

The cyclical recovery is urgent. In the final part of a disappointing 2014, two key economic variables are experiencing trends that bode well for 2015. The first is the euro, which has depreciated significantly in response to the shift in direction of monetary policies by the main blocs. The second is the price of oil, which has fallen (in euros) by 30% due to various phenomena examined in the Dossier of this *Report*. If these factors consolidate in 2015, as we expect, they will be of significant support for the euro area's recovery.

The counterpoint to this support provided by accommodative monetary policy and the positive boost for supply from outside the euro area is the uncertainty surrounding fiscal policy and structural reforms. Negotiations between the European authorities and countries which, like France and Italy, are seeking a break to their fiscal consolidation are likely to end up with some concessions being made by Brussels in exchange for promises to carry out reforms. The outcome of this could also be positive in growth terms but it will ultimately depend on the details of the final agreement. Any relaxation in the adjustment must be perceived by investors as compatible with sustainable budgets while structural reforms need to inspire confidence: they must be seen as improving the country's long-term growth capacity and not merely as measures that weaken demand.

With regard to the institutional challenge, in Brussels the new heads of the Commission and Council are already at their posts, as is the new Parliament. Nevertheless, serious doubts regarding economic growth and the warning provided by the results of May's elections do not seem to have produced the wake-up call required by the project of European integration and particularly Monetary Union. Once again, only the ECB has taken decisive action to tackle this urgent problem, further proof that it is the only body in Europe that is truly executive; i.e. with the necessary capacity to react in difficult times.

The expected improvement in economic conditions in the coming year could actually end up leading to a postponement *sine die* of the changes that are badly needed by Europe's system of governance. These only seem urgent when the problems are pressing. In fact, the Commission seems to have concentrated all its efforts on the so-called Juncker Plan. Details of the plan have yet to be announced but this could provide extra investment equivalent to almost 1% of Europe's annual GDP over three years. However, whether this actually happens depends on the Plan's final design and how bold the authorities can be.

Beyond its financial boost, the Juncker Plan may also act as a catalyst for one of the key problems suffered by the euro area: the lack of private investment available to assume risk and launch and support new projects. For this to be the case, the Juncker Plan needs to encourage the public sector to assume more risk, for instance by accepting any potential initial losses made by investment projects, should there be any.

Such a policy would certainly increase the public sector's contingent liabilities in the euro area but it would not necessarily make public finances any less sustainable if the scheme was successful in boosting the economy. And, essentially, that is precisely the real role of the public sector: to share risk among citizens and thereby help to resolve the problems inherent in collective decision-making that sometimes paralyse the system.

Jordi Gual
Chief Economist
30 November 2014

CHRONOLOGY

NOVEMBER 2014

- 1 The **Federal Reserve's third asset purchase programme (QE3)** comes to an end. From now on, it will only reinvest capital from the bonds maturing in its portfolio.
- 21 The ECB starts its **asset-backed security purchase programme**.

OCTOBER 2014

- 20 The ECB starts its **third covered bond purchase programme**.
- 26 The ECB and EBA publish the **results from the stress tests carried out on 130 European banks**. 25 banks failed in total, with a capital deficit of 24.6 million euros at year-end 2013. This exercise was the precursor to the **start of the Single Supervisory Mechanism in November**.

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.

AGENDA

DECEMBER 2014

- 2 Registration with Social Security and registered unemployment (November).
- 4 Governing Council of the European Central Bank.
- 5 Industrial production index (October).
- 17 International trade (November).
Quarterly labour cost survey (third quarter).
Fed Open Market Committee.
- 18 Loans, deposits and NPL ratio (October).
European Council.
- 23 Actual expenditure of the central government (November).
- 30 Flash CPI (December).
Balance of payments (October).
Net international investment position (third quarter).

JANUARY 2015

- 8 Index of economic sentiment euro area (December).
Household savings rate (third quarter).
- 9 Industrial production index (November).
- 15 Financial accounts (third quarter).
- 16 Loans, deposits and NPL ratio (November).
- 22 Governing Council of the European Central Bank.
- 27 Fed Open Market Committee.
- 30 CPI flash estimate (January).
Flash GDP (fourth quarter).
- 31 Balance of payments (November).

Favourable winds for a good 2015

Cheap oil and fewer macroeconomic imbalances, two tailwinds that are supporting the global recovery.

World growth is continuing to speed up in the final part of 2014. According to national accounts data, almost all leading economies have posted growth figures in Q3 that are better or at least the same as the figures posted for the preceding quarter. It is true that the rate of this growth is notably disparate, ranging from the US's strong 1% quarter-on-quarter to Japan's disappointing -0.4% and with a meagre 0.2% for the euro area. The first few indicators for Q4 are also pointing in the same direction: activity is on the up. This should allow 2014 to end with global growth averaging 3.3%, similar to the figure for 2012, and to cement a more appreciable change in trend as 2015 advances, the year for which we forecast 3.9% growth. This course is being propelled by two big tailwinds; the need to carry out fewer adjustments due to the reduction in macroeconomic imbalances and the low price of oil (although the latter is actually a headwind for oil exporters). This last factor is crucial to keeping inflation in check, in turn helping the recovery to consolidate since the expansionary policies implemented by a large number of central banks can continue.

The United States is consolidating its recovery while China is engineering a gradual slowdown. The world's two largest economies are continuing along the paths plotted in previous months, with their eyes on the growth in activity although, as 2014 has advanced, some trends have come to light that are going to be important in 2015. In the case of the US, the Federal Reserve called a halt to its quantitative easing thanks to the good tone of indicators for business and the labour market. Although the market continues to assume that the Fed will not raise its reference rate until mid-2015, discussion in the US is now starting to take on the tone of more mature phases in the cycle. For example, the Fed's minutes are starting to reflect the concern of some members regarding the expected trend in inflation. The focus is also shifting in China. Its good growth figures for Q3 (up by 7.3% year-on-year) have shelved fears of a «hard landing» and helped the government to start conveying the message that growth of around 7% for 2015 would be acceptable. Nonetheless, and to stop activity from sliding too quickly

towards this new, relatively low rate of growth, the Chinese central bank decided to cut its official interest rate to 5.6%, an unexpected move and highly revealing after two years without any change.

A slow recovery for growth in the euro area. The growth figures for Q3 (0.2% compared with 0.1% previously, in quarter-on-quarter terms) have allayed the risk of a third recession but have also confirmed a relatively unattractive scenario: the euro area is recovering but at a slow pace and with significant differences between countries. While Spain is performing relatively well, Italy has disappointed again. Given this situation of a minimal recovery, inflation remains at a low level. Nonetheless, our forecasts point to a gradual improvement in tone for activity (and, in turn, inflation) in 2015, when the euro area should benefit more substantially from the increase in international trade (already reflected in the euro area's exports as a whole) and the gradual recovery in credit, boosted by the ECB's expansionary measures which should bring its balance sheet up to the size achieved in 2012.

The Spanish economy stands out within the European context. In 2015 Spain is on track to enjoy its best economic growth since 2007 (according to our forecasts, next year's GDP will grow by 1.9%). The national accounts figures for Q3 confirm that the economy grew by 0.5%, repeating the healthy tone of Q2, and we expect activity to continue increasing over the coming months, albeit at a slightly slower rate. As is happening with the rest of the euro area, the drop in oil prices and improved exports (Spain is noticeably benefitting from the euro's depreciation) will be essential to cement the recovery. Spain may also enjoy some support from moderate fiscal relaxation (the European Commission has warned that the country may not achieve its public deficit target for 2015 but, unlike France and Italy, it will not re-examine the situation in March). To complete the positive outlook, its competitiveness and the signs of stabilisation shown by the real estate market should also support its recovery. Nonetheless, particular attention will have to be paid to ensure that low inflation does not become entrenched, a situation which, in turn, will depend to quite a large extent on the euro area actually recovering as expected.

FORECASTS

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

International economy

	2013	2014	2015	2016	2014 Q2	2014 Q3	2014 Q4	2015 Q1	2015 Q2	2015 Q3
GDP GROWTH										
Global¹	3.2	3.2	3.9	4.0	3.3	3.1	3.3	3.9	3.9	3.9
Developed countries										
United States	2.2	2.3	3.1	2.7	2.6	2.4	2.1	3.4	3.1	2.8
Euro area	-0.4	0.8	1.3	1.6	0.8	0.8	0.8	0.9	1.2	1.5
Germany	0.2	1.5	1.5	1.8	1.4	1.2	1.1	0.8	1.4	1.8
France	0.4	0.4	0.8	1.1	0.0	0.4	0.3	0.6	0.9	0.9
Italy	-1.9	-0.3	0.5	1.0	-0.3	-0.4	-0.2	0.0	0.4	0.7
Spain	-1.2	1.3	1.9	2.0	1.3	1.6	1.7	1.9	1.9	1.9
Japan	1.5	0.4	1.2	1.2	-0.1	-1.1	0.1	-1.0	1.4	2.4
United Kingdom	1.7	3.0	2.2	2.2	3.2	3.0	2.9	2.5	2.1	2.1
Emerging countries										
China	7.7	7.5	7.2	6.7	7.5	7.3	7.6	7.8	7.4	7.0
India ²	4.7	5.8	6.2	6.2	5.7	5.3	6.0	5.9	6.2	6.5
Indonesia	5.8	5.1	5.7	6.1	5.1	5.0	5.3	5.5	5.8	5.7
Brazil	2.5	0.3	1.3	2.3	-0.9	-0.2	0.2	0.4	1.4	1.7
Mexico	1.4	2.3	3.6	3.8	1.6	2.2	3.5	3.5	3.6	3.7
Chile	4.1	2.1	3.4	4.4	1.9	1.9	2.0	2.7	3.2	4.2
Russia	1.3	0.5	0.8	1.5	0.8	0.7	-0.5	0.4	0.4	1.0
Turkey	4.1	2.7	3.5	4.6	2.1	2.1	2.1	2.6	3.2	4.0
Poland	1.6	3.3	3.4	3.9	3.4	3.4	2.8	3.0	3.3	3.5
South Africa	1.9	1.4	2.2	2.7	1.1	1.4	1.4	1.9	2.2	2.6
INFLATION										
Global¹	3.7	3.5	3.4	4.4	3.7	3.5	3.2	3.3	3.4	3.4
Developed countries										
United States	1.5	1.7	1.5	2.2	2.1	1.8	1.5	1.4	1.2	1.4
Euro area	1.4	0.5	0.9	1.4	0.6	0.4	0.4	0.6	0.8	0.9
Germany	1.6	0.9	1.4	1.8	0.9	0.8	0.9	1.0	1.3	1.5
France	1.0	0.7	0.8	1.1	0.8	0.5	0.6	0.5	0.7	0.9
Italy	1.7	0.2	0.7	0.9	0.4	-0.1	0.2	0.3	0.6	0.8
Spain	1.4	-0.1	0.9	1.5	0.2	-0.3	-0.2	0.2	0.6	1.1
Japan ³	0.4	2.8	2.0	2.3	3.6	3.3	2.8	3.1	1.0	1.5
United Kingdom	2.6	1.6	1.9	2.1	1.7	1.5	1.6	1.7	1.9	2.0
Emerging countries										
China	2.6	2.1	2.4	2.5	2.2	2.0	2.0	2.5	2.9	2.6
India ⁴	6.3	4.2	4.4	4.6	5.8	2.4	3.4	4.4	4.1	4.1
Indonesia	6.4	6.0	5.6	5.8	7.1	4.5	4.9	5.4	5.5	5.6
Brazil	6.2	6.3	5.7	5.6	6.4	6.6	6.5	6.0	5.8	5.5
Mexico	3.8	3.9	3.4	3.1	3.6	4.1	3.9	3.6	3.4	3.2
Chile	2.1	4.1	3.3	4.3	4.5	4.7	4.0	3.5	3.4	4.4
Russia	6.8	7.4	7.2	5.6	7.6	7.7	8.0	8.1	7.4	6.9
Turkey	7.5	8.9	6.9	6.3	9.4	9.2	8.8	7.3	6.9	6.7
Poland	1.2	0.4	1.4	2.3	0.5	-0.1	0.4	0.8	1.5	1.5
South Africa	5.8	6.1	5.0	5.3	6.5	5.9	6.3	4.4	4.9	5.1

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

Forecasts

Spanish economy

	2013	2014	2015	2016	2014 Q2	2014 Q3	2014 Q4	2015 Q1	2015 Q2	2015 Q3
Macroeconomic aggregates										
Household consumption	-2.3	2.3	2.0	1.5	2.3	2.7	2.9	2.6	2.1	1.7
General government consumption	-2.9	0.6	-0.6	-0.3	0.7	0.9	0.5	-0.5	-0.5	-0.8
Gross fixed capital formation	-3.7	2.7	4.9	4.5	3.2	3.1	3.9	5.0	4.7	4.9
Capital goods	5.6	11.8	8.5	5.8	12.7	9.5	9.7	9.7	8.0	8.3
Construction	-9.2	-2.8	2.6	3.6	-2.0	-1.2	0.1	2.4	2.4	2.6
Domestic demand (contr. Δ GDP)	-2.7	2.1	2.0	1.7	2.2	2.5	2.5	2.4	2.1	1.7
Exports of goods and services	4.3	4.6	6.0	4.7	1.5	4.6	6.1	7.4	7.2	4.7
Imports of goods and services	-0.4	7.8	6.8	4.1	4.8	8.2	9.3	10.0	8.2	4.6
Gross domestic product	-1.2	1.3	1.9	2.0	1.3	1.6	1.7	1.9	2.0	1.9
Other variables										
Employment	-3.2	0.9	1.6	1.8	0.8	1.4	2.0	2.1	1.7	1.3
Unemployment rate (% labour force)	26.1	24.5	23.0	21.7	24.5	23.7	23.9	24.1	22.7	22.4
Consumer price index	1.4	-0.1	0.9	1.5	0.2	-0.3	-0.2	0.2	0.6	1.1
Unit labour costs	-0.4	-0.5	0.4	0.8	-0.1	-0.4	-0.3	0.2	-0.2	0.6
Current account balance (cum., % GDP) ¹	0.8	-0.2	0.1	0.4	-0.2	-0.2	-0.2	-0.2	-0.1	0.0
Net lending or borrowing rest of the world (cum., % GDP) ¹	1.5	0.4	0.7	1.0	0.5	0.4	0.4	0.4	0.5	0.6
Fiscal balance (cum., % GDP) ¹	-6.8	-5.7	-4.5	-3.3						

Financial markets

INTEREST RATES										
Dollar										
Fed Funds	0.25	0.25	0.50	1.40	0.25	0.25	0.25	0.25	0.33	0.58
3-month Libor	0.27	0.24	0.73	1.65	0.23	0.23	0.29	0.34	0.56	0.88
12-month Libor	0.68	0.56	1.21	2.11	0.54	0.56	0.67	0.76	1.02	1.38
2-year government bonds	0.30	0.44	1.25	2.27	0.40	0.50	0.65	0.71	1.05	1.46
10-year government bonds	2.33	2.55	3.10	3.55	2.61	2.49	2.34	2.62	2.96	3.29
Euro										
ECB Refi	0.54	0.16	0.05	0.12	0.22	0.12	0.05	0.05	0.05	0.05
3-month Euribor	0.22	0.21	0.05	0.22	0.30	0.16	0.07	0.05	0.05	0.05
12-month Euribor	0.54	0.48	0.33	0.58	0.57	0.44	0.33	0.32	0.32	0.32
2-year government bonds (Germany)	0.13	0.05	0.09	0.63	0.10	-0.01	-0.04	-0.01	0.05	0.12
10-year government bonds (Germany)	1.62	1.25	1.18	1.86	1.43	1.06	0.83	0.95	1.10	1.25
EXCHANGE RATES										
\$/euro	1.33	1.33	1.23	1.21	1.37	1.33	1.28	1.24	1.23	1.23
¥/euro	129.65	139.09	136.39	133.56	140.11	137.68	137.58	137.06	136.72	136.16
£/euro	0.85	0.81	0.85	1.85	0.82	0.80	0.79	0.78	0.78	0.78
OIL										
Brent (\$/barrel)	108.47	100.44	83.78	94.47	109.65	103.38	80.98	77.37	82.72	86.10
Brent (euros/barrel)	81.67	75.52	68.16	78.13	79.96	78.02	64.64	62.56	67.16	70.19

Note: 1. Four quarter cumulative.

Forecasts

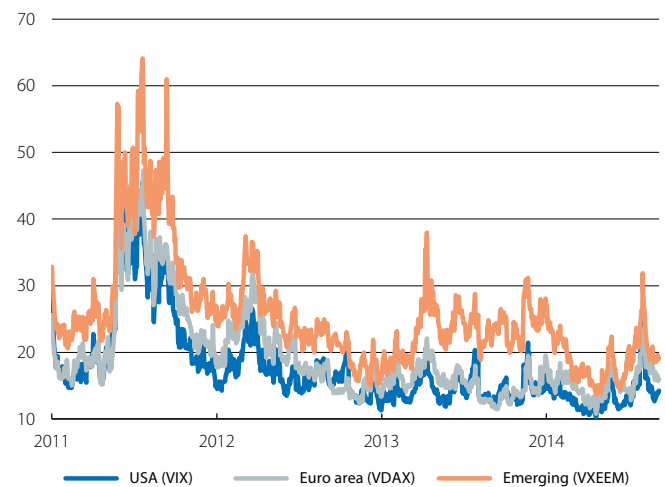
CURRENT SITUATION · In search of growth

Back to normal. Calm has reigned supreme in international markets during the month of November, leaving behind the tensions observed in October and resulting in gains among risk assets and a reduction in volatility. This increase in stability is primarily due to two factors: the good GDP figures published by the US in Q3 and the intensification of expansionary messages and the measures from the main central banks. While the Federal Reserve is discussing the strategy to be adopted concerning interest rate hikes, the ECB is insisting on its proposal to extend its asset purchases to other areas, including sovereign debt if necessary. For its part the People's Bank of China has extended the scope of its accommodative actions by cutting official interest rates, dispelling fears of a possible hard landing for its economy. This support of central banks and the good performance of the world economy expected in 2015 are helping to prolong the favourable pattern in risk assets observed over the last few weeks.

The Fed plans its monetary normalisation. Growing economic activity in the United States during Q3 and the improvement in the labour market were sufficient reasons for the Federal Reserve Committee (Fed) to decide to put an end to its QE3. The minutes from its penultimate meeting of the year also revealed some Fed members' concerns over the little inflationary pressure observed, explicitly mentioning the drop observed in long-term inflation expectations. The other internal debate is related to communication policy. Although the institution insists that interest rates will remain low for a considerable period of time, some are in favour of introducing some fine distinctions to this message as we approach what will be the first official interest rate hike in eight years.

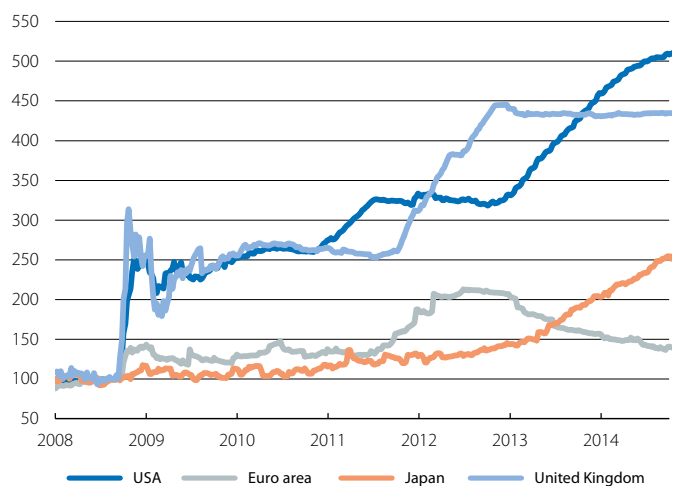
The ECB is ready to act. November's meeting of the central bank's Governing Council sent out two basis messages. The first is its commitment to the objective to expand the ECB's balance sheet up to levels close to those of March 2012 (which would entail an additional billion euros) by purchasing asset-backed securities (ABS) and covered bonds, as well as the liquidity tender procedures for banks (TLTRO). Second is that all Council members are in favour of adopting further unconventional measures, should this become necessary. Subsequently, several ECB members have referred to the possible assets the institution may purchase to increase its balance sheet, including corporate bonds and sovereign debt. In this respect, Draghi himself has insisted that the central bank will do whatever it takes to push up inflation and its expectations as quickly as possible. Overall these declarations have been well received by investors. However, there is some degree of scepticism due to the considerable legal obstacles to adopting a sovereign debt

Implied volatility of international stock markets (Index)



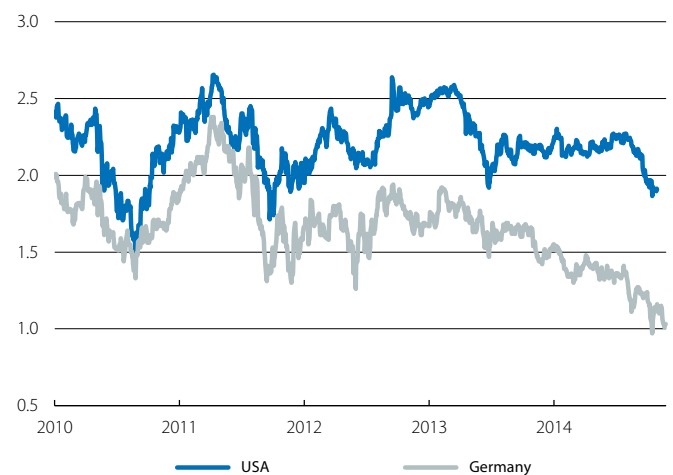
Source: "la Caixa" Research, based on Bloomberg data.

Balance sheets of the main central banks (Index (September 2008 = 100))



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

Inflation expectations: Germany and USA (%)



Note: Implied inflation expectations in 10-year inflation-indexed bonds.
Source: "la Caixa" Research, based on Bloomberg data.

purchase programme. The Bundesbank has made a statement along these lines, stating that it is in favour of alternative measures to asset purchases as a means of stimulating the region's growth. Following the announced script, and pending the second TLTRO, in November the ECB carried out purchases both of covered bonds and ABS from several countries in the euro area.

Emerging central banks redirect their strategies. For the first time in more than two years, the Chinese monetary authority has cut its official interest rates for loans and deposits (to 5.6% and 2.75%, respectively). This movement forms part of the plan to sustain economic growth and is in addition to measures to provide retail banks with liquidity and access to funding in the medium term. On the other hand, the central banks of Russia and Brazil have opted to toughen up their monetary policies as a means of tackling the unstable foreign exchange environment and an upward spiral in prices.

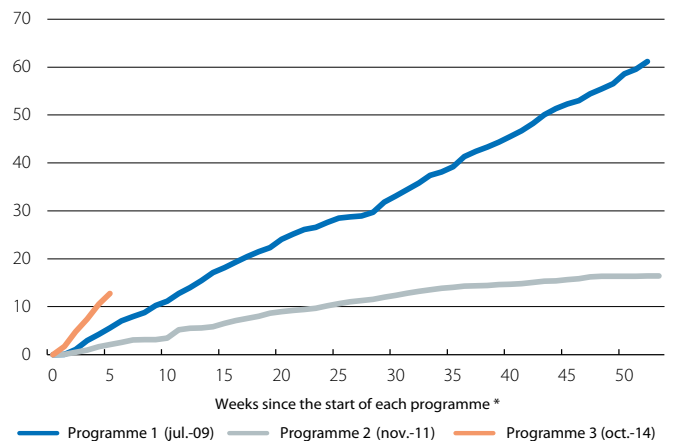
Slight upswing in Treasury yields. Now that October's volatility has dispersed, the combination of factors such as evidently solid growth in the US in Q3, the Fed's more optimistic tone and the end of tapering has helped to push up yields on US government bonds, albeit always within a narrow margin. However, several risks may alter the serenity of this market over the coming months. For example, the uncertainty regarding the Fed's «exit strategy» (on this issue, see the Focus «US Treasury term premiums: not yet, but likely») and the negotiations concerning the debt ceiling.

Yields on periphery debt fall, awaiting the ECB's decision. There has been an almost widespread drop in the yield on the sovereign debt of Europe's periphery countries, putting an end to the slight upswing observed during the recent turbulent episode in October. Investor confidence in the bonds of Italy, Portugal, Ireland and Spain has been boosted by the ECB potentially purchasing these countries' sovereign debt as a way to extend its balance sheet. In the case of Spain, one point in its favour has been the successful bond programme carried out by the Spanish Treasury in 2014, achieving a total of 133 billion euros. With regard to German debt, the IRR of the bund has also shown a clear downward trend in November. Nevertheless, the recovery in Europe's economy (boosted by aspects such as the euro's depreciation against the dollar, falling crude prices and accommodative monetary policy) is expected to help sustain a contained rise in German yields in 2015.

Stock markets make up lost ground. Albeit to differing degrees depending on the country, stock markets have been bullish after the corrections seen in October. In the US, the solidity of economic growth and the recovery in corporate earnings have pushed up the main indices, achieving all-time highs in the case of the S&P 500 and Dow Jones. In Japan, the announcement of new monetary stimuli by the central bank, the consequent depreciation of the yen and

Euro area: covered bond purchases through ECB programmes

Cumulative volume (billion euros)

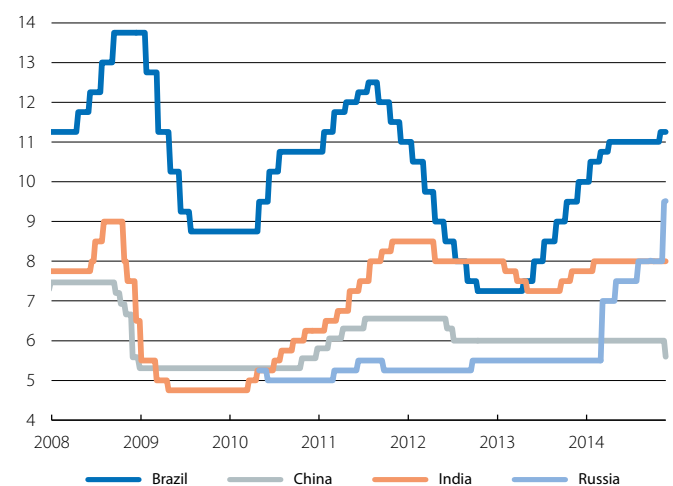


Note: * In brackets, the start date for each programme.

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

Emerging countries: official interest rates

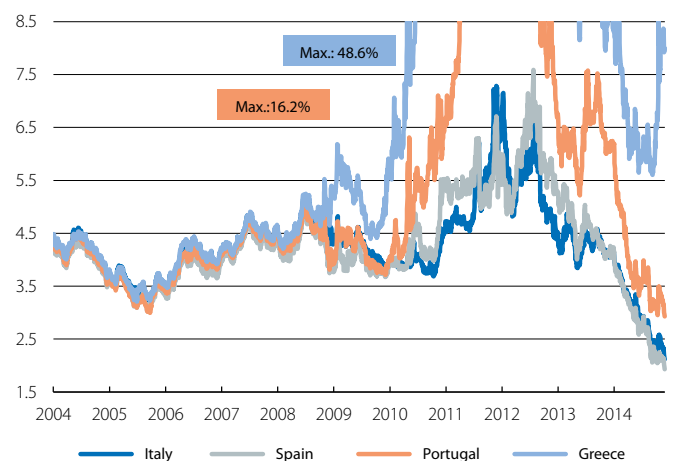
(%)



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

Euro area: yields on 10-year periphery sovereign bonds

(%)



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

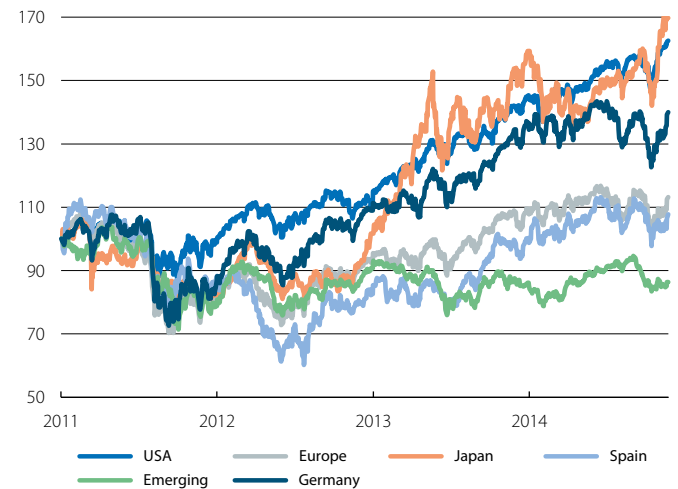
early presidential elections have pushed up the Nikkei 225 by more than 11% in one month. On the other hand, overselling has prevailed among Europe's stock markets. Doubts regarding the sustainability of economic growth in the euro area and the punishment meted out to bank shares have weakened the incipient recovery in margins for companies in Q3. Nonetheless, the Old Continent's stock markets bounced back towards the end of November and we expect this will continue in the short term due to the good trend in corporate earnings in the present and future.

Corporate bonds are in the firing line. Now that October's dip in confidence has been overcome, corporate bond spreads have narrowed again. The divergence in the monetary strategies adopted by the US, the euro area and Japan looks like becoming the key factor behind corporate debt yields over the coming months. In this final part of the year there has been an increase in bonds issued by financial institutions in the euro area, especially in the segment of convertible contingent bonds (CoCos). This behaviour is due to the ECB deciding to purchase covered bonds as a means of increasing its balance sheet and the possibility that it will extend the range of eligible assets to high quality corporate bonds.

The decisions taken by OPEC are exacerbating falling oil prices, which have reached their lowest level since mid-2010. The continued fall in the price of crude over the last few weeks centred attention on the oil cartel's meeting at the end of November. The decision taken by OPEC members to keep production at 30 million barrels a day has intensified this downward trend, pushing the price of Brent close to 70 dollars a barrel. Nevertheless, this trend is expected to reverse gradually over the coming months as the recovery in global growth is confirmed and oil speculation stabilises.

Trends in the main international stock markets

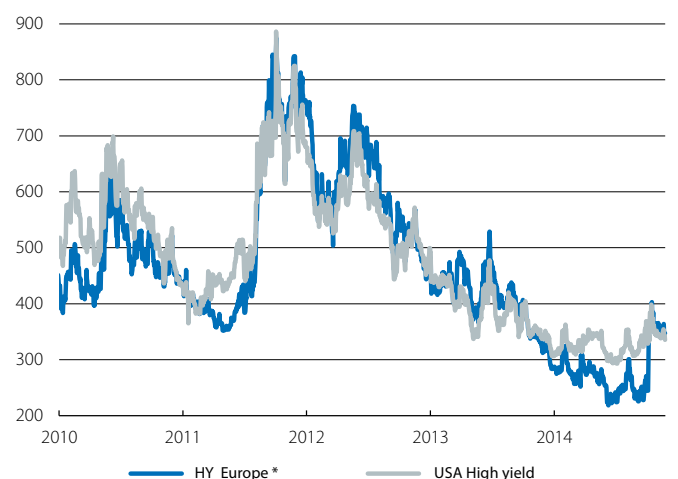
Index (January 2011 = 100)



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

CDS premia for corporate bonds

(bps)



Note: * October's upswing in the HY Europe series is due to methodological changes.

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

Trends in commodities

Index (January 2013 = 100)



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

FOCUS · US Treasury term premia: not yet, but likely

Throughout of the last quarter of a century, there has been a continued downward trend in long-term, risk-free nominal interest rates in developed countries. Many different factors lie behind this situation, affecting one or more of the three components that make up this interest rate: expected inflation, expected short-term real interest rates and the term premium. The role played by the latter has been as silent as it has been important and this role is likely to continue in the future.

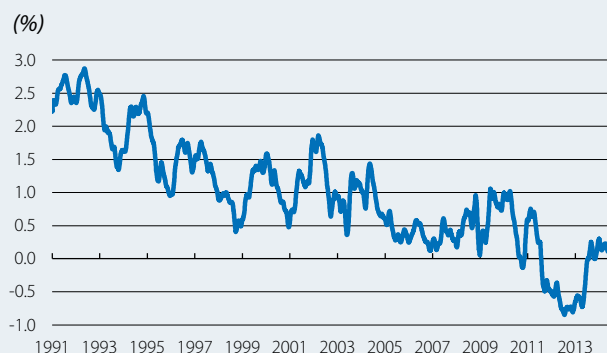
The term premium should be seen as the recompense or benefit of a return demanded by investors for investing in a bond (or another fixed yield instrument) over a long period instead of investing in a short-term security (and reinvesting during the life of the long-term bond). More precisely, the term premium is made up of two different elements: (i) a risk premium associated with the uncertainty of the expected trend in short-term real interest rates and (ii) a risk premium associated with the uncertainty of inflation expectations. Consequently, during periods of high uncertainty concerning the central bank's intentions regarding its official interest rate and/or when the central bank does not set specific, credible inflation targets, the term premium for long-term bonds will tend to be higher.

Although this premium cannot be observed directly, it can be estimated using econometric techniques or via surveys. Several studies agree that there was a considerable drop in the term premium for US government bonds (Treasury) between 2010 and 2013. They also agree about the main cause: the Fed's massive asset purchases (QE1, QE2 and QE3), the increase in the average maturity of its bond portfolio and its forward guidance strategy all pushed the term premium down to negative figures, an unusual situation in historical terms. However, other factors also contributed to this situation and the relative scarcity of assets considered to be safe after the outbreak of the global financial crisis was one of these, especially given the growing demand for financial institutions to meet new regulatory requirements in terms of solvency and liquidity.

Bernanke's advance notice of tapering in May 2013 resulted in a sudden upswing in the term premium until it returned to positive figures, remaining stable over the subsequent months. During 2015 we expect this upward trend to pick up again because of two factors; one short-term and the other medium-term in scope. Firstly, the (historically) slow upward path taken by the official interest rate, which is currently being ignored by agents, may change suddenly as the Fed is likely to bring forward its date for what will be the first interest rate hike in eight years. Such action will increase uncertainty regarding any

subsequent decisions. Secondly, the design and implementation of the Fed's strategy to sell off bonds from its portfolio is an extremely important element that will soon become a cause of concern for investors. Since the start of its quantitative easing programme, the Fed has increased its balance sheet fourfold, acquiring close to 4 trillion dollars in bonds. Moreover, a very large proportion of these are long-term (10 years or more). This means that the average life of outstanding public debt in the market (excluding the Fed's holdings) is currently much shorter than in previous years. Consequently, any expected rise in the number of Treasuries in the long tranche of the curve will push up long-term interest rates. After the calm that has prevailed in the Treasuries market in 2014, next year could see episodes of instability due to a probable upswing in the term premium and the size and duration of these episodes will largely depend on how specific and clear the Fed can make its communication policy.

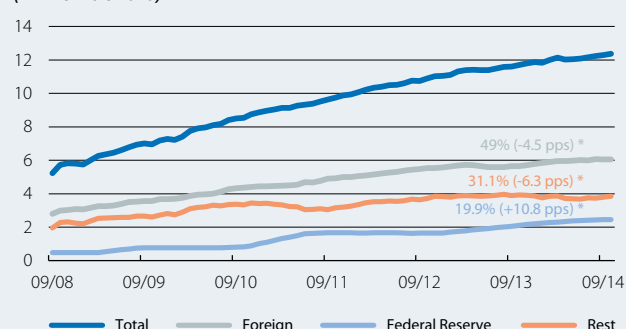
USA: Term premium for 10-year government Bonds *



Note: * Term premium estimated using a three-factor term structure model, Kim & Wright (2005).

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

USA: ownership of government bonds by agents (Trillion dollars)



Note: * Share of ownership of each group out of total US public debt (as of October 2014). In brackets, the absolute change in this share between October 2014 and September 2008.

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

FOCUS · The Fed and the ECB are going their separate ways, how long will they take to meet up again?

For some months now the monetary policies of the Federal Reserve (Fed) and the ECB have gradually diverged: the former is slowly moving towards the withdrawal of stimuli and the latter is attempting to implement even more. Ruling out any big surprises, 2015 will witness a milestone in this long goodbye: the Fed will start to raise its official interest rates while the ECB will attempt to keep theirs as low as possible. For obvious reasons, it is less certain just how far these two paths will diverge over time. An analysis of the risk-free asset interest rate curves in the US and the euro area throws some light onto this question.

Put simply, each of these curves is based on the (annualised) returns at different maturities observed at any particular point in time for financial assets whose default is considered to be very unlikely. Starting with the euro area, these assets may be, for instance, German government bonds or swaps on the one-day interbank rate, known as the EONIA. This curve can be used to estimate the expectations of lenders and borrowers regarding the future trend in interest rates. By way of example, if we have the yield on German six and eighteen month bonds, we can deduce the return expected by the market from a one-year bond within six months. This is known as the implied forward rate, which provides a good estimate of the expected interest rate.¹

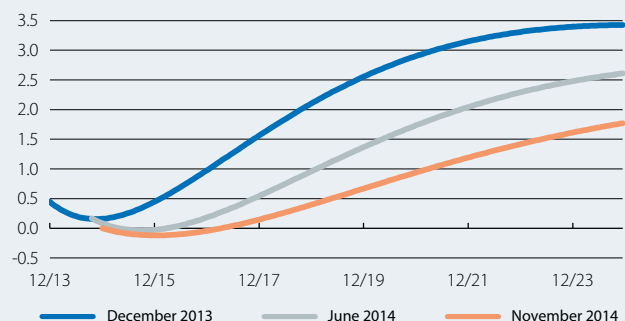
One very useful implied forward rate is the instantaneous forward (which should be seen as an extremely short-term implied forward rate, for example one day) obtained from the EONIA swaps curve. The reason is that it helps to estimate the market's expectations regarding the ECB's official interest rates (the refi rate and the deposit facility rate). The figures observed are extremely revealing: at mid-November this year, the instantaneous forward curve suggests that the ECB's official interest rates will not start to rise until the end of 2017, and that in 2024 (in 10 years' time!) they will still be below 2.0%. Expectation of such a slow interest rate rise reveals the dramatic change in expectations that has taken place over the last few months due to disappointing economic figures and the expansionary announcements made by the ECB. By contrast, in December 2013 expectations had pointed to interest rate hikes starting at the end of 2015 and reaching 2% around 2018. This «lower for longer» scenario of the ECB differs from expectations regarding the Fed's actions. In this case the same instantaneous

forward curve for the interbank rate anticipates an upward trend that may be slow compared with previous monetary cycles in the US but is fast compared with what is expected for the ECB. Specifically, the Fed's official interest rate would start to rise mid-2015 and would go above 2% by mid-2017. In fact, the spread between interest rates on both sides of the Atlantic will continue to widen up to 2019, when it will exceed 230 basis points (a level similar to the peaks seen in past episodes).

In short, interest rate curves currently project a scenario of prolonged divergence between the monetary policies of the US and euro area. The «singularity» lies in the extreme slowness expected for interest rate rises in the euro area. But if the recovery in Europe's economy is actually faster than currently predicted by the market, something we believe to be highly likely, then the rate of monetary policy normalisation by the ECB will not be so parsimonious and the paths taken by the two central banks will not take so long to come together again, or at least get closer.

Evolution of instantaneous forward rate curves of the euro area

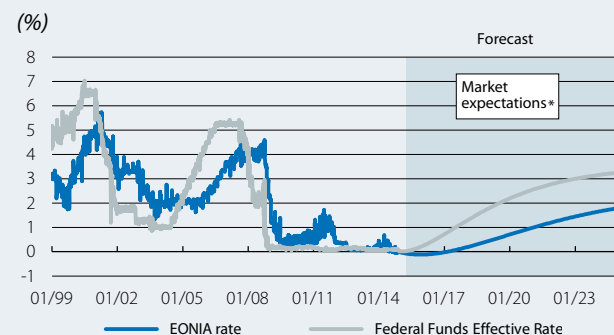
Yield (%)



Note: Forwards instantaneous forward rates calculated based on the OIS contract curve, using the methodology of the Nelson & Siegel - Svensson model.

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

Comparison of one-day interest rates in the euro area and the US



Note: * Instantaneous forward rates calculated based on the OIS contract curve for the euro area and government bonds for the US, using the methodology of the Nelson & Siegel - Svensson model.

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

1. A more accurate measurement of expectations would require the risk premium of long-term investments compared with short-term (term premium) to be taken into account. In this Focus, we are concentrating on the results obtained based on the implied forward rate. For more information on the term premium, see «US Treasury term premiums: not yet, but likely» in this Report.

KEY INDICATORS

Interest rates (%)

	28-Nov	31-Oct	Monthly change (bps)	Year-to-date (bps)	Year-on-year change (bps)
Euro					
ECB Refi	0.05	0.05	0	-20.0	-20.0
3-month Euribor	0.08	0.09	0	-20.5	-15.1
1-year Euribor	0.33	0.34	-1	-22.6	-17.0
1-year government bonds (Germany)	-0.07	-0.06	-1	-25.3	-16.4
2-year government bonds (Germany)	-0.03	-0.06	3	-24.3	-15.1
10-year government bonds (Germany)	0.70	0.84	-14	-122.9	-99.5
10-year government bonds (Spain)	1.90	2.08	-18	-225.1	-225.1
10-year spread (bps)	120	124	-4	-102.7	-126.2
Dollar					
Fed funds	0.25	0.25	0	0.0	0.0
3-month Libor	0.23	0.23	0	-1.6	-0.9
12-month Libor	0.56	0.55	1	-2.3	-1.8
1-year government bonds	0.12	0.09	3	0.8	0.8
2-year government bonds	0.47	0.49	-2	9.0	18.5
10-year government bonds	2.16	2.34	-18	-86.8	-57.7

Spreads corporate bonds (bps)

	28-Nov	31-Oct	Monthly change (bps)	Year-to-date (bps)	Year-on-year change (bps)
Itraxx Corporate	58	65	-7	-12.6	-19.9
Itraxx Financials Senior	59	67	-8	-27.6	-35.7
Itraxx Subordinated Financials	137	155	-17	8.5	-2.6

Exchange rates

	28-Nov	31-Oct	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
\$/euro	1.245	1.253	-0.6	-9.4	-8.5
¥/euro	147.720	140.680	5.0	2.1	6.1
£/euro	0.796	0.783	1.6	-4.1	-4.4
¥/\$	118.630	112.320	5.6	12.6	15.9

Commodities

	28-Nov	31-Oct	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
CRB Index	454.6	458.9	-0.9	-0.4	-1.6
Brent (\$/barrel)	69.0	84.8	-18.6	-37.7	-38.2
Gold (\$/ounce)	1,167.4	1,173.5	-0.5	-3.2	-6.2

Equity

	28-Nov	31-Oct	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
S&P 500	2,067.6	2,018.1	2.5	11.9	14.4
Eurostoxx 50	3,250.9	3,113.3	4.4	4.6	5.1
Ibex 35	10,770.7	10,477.8	2.8	8.6	9.2
Nikkei 225	17,459.9	16,413.8	6.4	7.2	11.0
MSCI Emerging	1,004.7	1,016.1	-1.1	0.2	-0.7
Nasdaq	4,791.6	4,630.7	3.5	14.7	18.5

CURRENT SITUATION ·

The international economy will build up steam in 2015

Global growth is en route to ending 2014 with average growth of 3.2%, the same figure as in 2013. In our central scenario, the world economy will build up steam in 2015, thanks to the good performance we expect from the United States whose economy has gradually improved throughout 2014, as well as the continuation of expansionary policies and the positive impact provided by falling oil prices for numerous economies in the euro area. The weakness of Japan's economy provides the counterpoint to this benign scenario while, in the group of emerging economies, we should differentiate between those countries enjoying a healthy macroeconomic situation with room for their economic policy to act, and those that do not. Whereas Mexico and India would be among the first group, of note among the latter are Brazil and Russia (inflationary pressures and added political uncertainty) and Turkey (also encountering problems with prices and its current account, simultaneously).

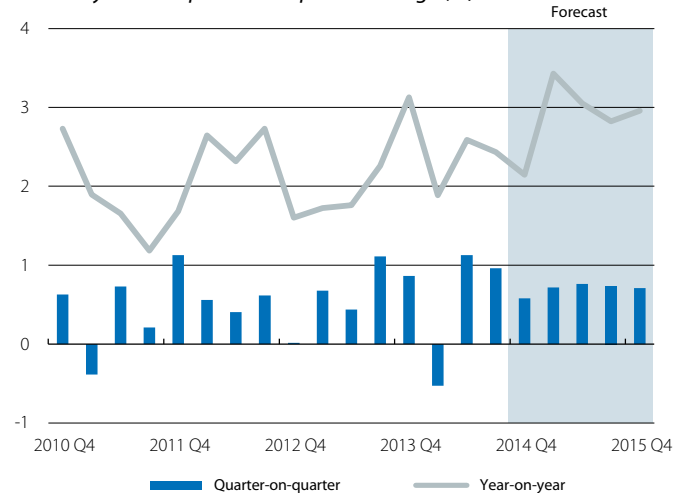
UNITED STATES

The US's GDP grew by a healthy 1.0% quarter-on-quarter in Q3. GDP increased more than initially calculated in Q3 according to the revised official figures (previously 0.9%). This figure brings year-on-year growth to 2.4% (previously 2.3%). The upward revision has once again come as a surprise and is mainly due to the improvement in non-residential investment and private consumption, tempering the concern we expressed the previous month regarding the moderation shown by both components of demand after the publication of the initial GDP figure. This improvement in growth also entails a slight rise in our growth forecast for 2014 to 2.3% (compared with 2.2% previously). In 2015, without the burden of the weak start to 2014, growth should reach 3.1%.

The latest data on activity confirm the expansion in the US. The business sentiment index (ISM) for manufacturing climbed to 59.0 points while the index for services stood at 57.1 points, both clearly above the 50 points that mark the expansionary zone. Along the same lines, the business sentiment index for small enterprises rose to 96.1 points in October (95.3 in September) and retail sales grew by a notable 0.3% month-on-month (2.8% year-on-year). On the other hand industrial production disappointed with a slight decline month-on-month of 0.1% (from 4.2% year-on-year in September to 4.0% in October). Falling oil prices continue to benefit the US economy (a net importer of crude oil) in external terms, although September's unexpected increase in the trade deficit for goods and services points to the external component making a lower contribution to growth in Q4.

USA: GDP

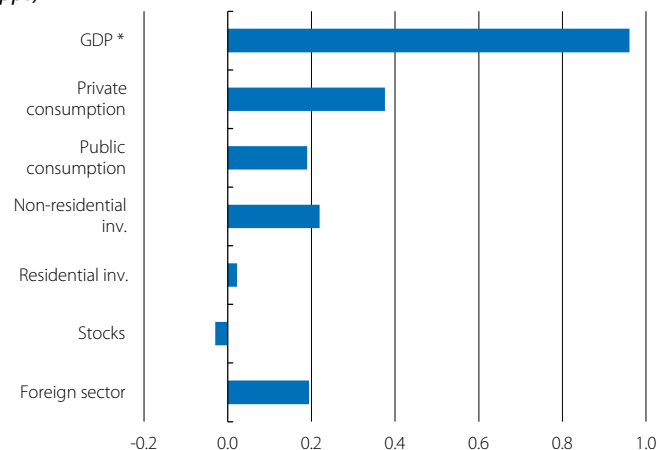
Year-on-year and quarter-on-quarter change (%)



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

USA: GDP

Contribution to quarter-on-quarter growth in GDP for Q3 (pps)

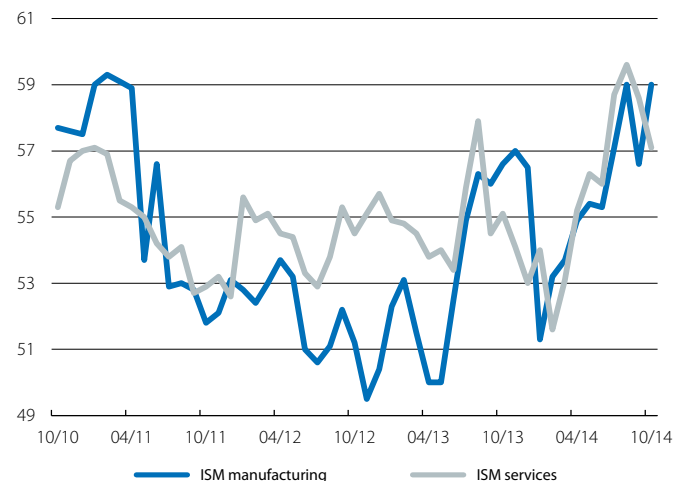


Note: * Quarter-on-quarter change.

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

USA: activity indicators

(Index)



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

Prices are under control. October's CPI remained flat at 1.7% year-on-year. Once again, the sharp drop in energy prices offset the widespread increase in the rest of the components. Core inflation rose by 0.2% month-on-month, bringing year-on-year growth to 1.8%, 0.1 pps above September's figure. In spite of price stability, the minutes of the Federal Reserve's last meeting revealed that some members are concerned about for inflation, recommending that the trend in long-term inflation expectations should be closely monitored, given the risk entailed for economic growth.

The labour market continues to improve while good news also comes from the real estate sector. 214,000 jobs were created in October, once again above the threshold of 200,000 that indicates a strong market. The unemployment rate also fell by 0.1 pps (5.8%). Such good news was somewhat spoilt by the participation rate (62.8%) which has hardly improved this year so far, indicating that the demotivating effect of the crisis has yet to be reversed. Demographic trends (with American baby boomers reaching retirement age) will not help this trend either. For its part, in the real estate sector the Case-Shiller price index that covers 20 metropolitan areas rose by 0.3% month-on-month in September after four consecutive months in decline. Along the same lines, sales of residential properties, both new and second hand, increased in October compared with the September figures (0.7% and 1.5%, respectively).

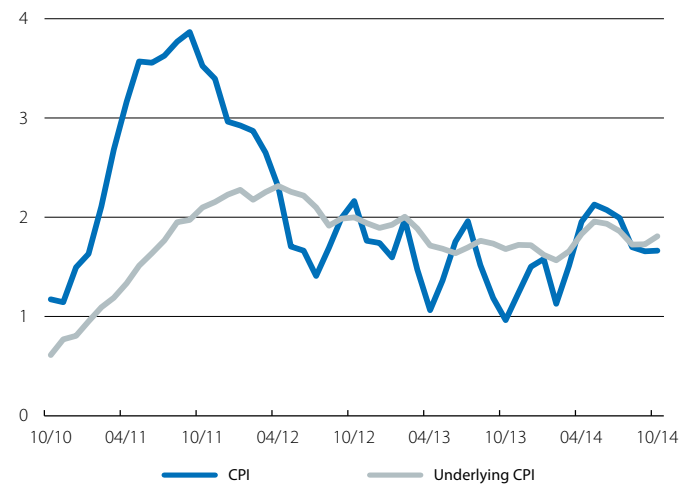
JAPAN

GDP falls in Q3, leaving Japan in a technical recession (two consecutive quarters of negative growth). The 0.4% drop quarter-on-quarter in Q3 (after decreasing by 1.9% in Q2) surprised even the most pessimistic, demonstrating that the consequences of April's VAT hike (from 5% to 8%) have been greater than expected. Although exports will pick up and a large part of this drop is due to an adjustment in stocks, the country's anaemic recovery and the lethargy of investors are of most concern. All this means that we have revised downwards our central scenario for growth in 2014 to 0.4% (previously 1.1%). With a view to 2015, and given the new expansionary economic policy measures, we have maintained our growth forecast at 1.2%. Given the bad figures, Japan's Prime Minister, Shinzo Abe, did not take long to announce that he would postpone the second VAT hike until April 2017 (previously planned for October 2015) and that general elections would be held on 14 December 2014. Abe hopes that these elections will provide him with a mandate for his economic initiatives (known as Abenomics and based on three basic pillars: monetary, fiscal and structural reforms) against rivals within his own party, the Liberal Democrats.

Inflation disappoints in October and moves away from the target set by the Bank of Japan (BoJ). October's CPI rose by 2.9% year-on-year (3.3% in September) although, discounting the effect of VAT, it remained at a moderate 0.9%, far from the 2.0% intended by the BoJ. The BoJ's decision to increase its

USA: CPI

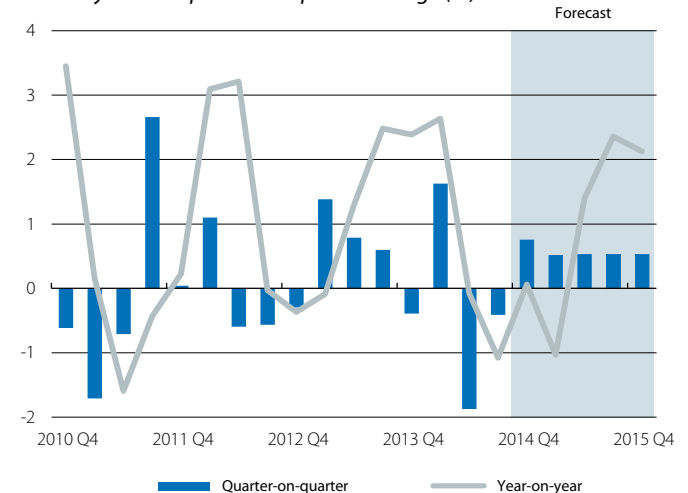
Year-on-year change (%)



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

Japan: GDP

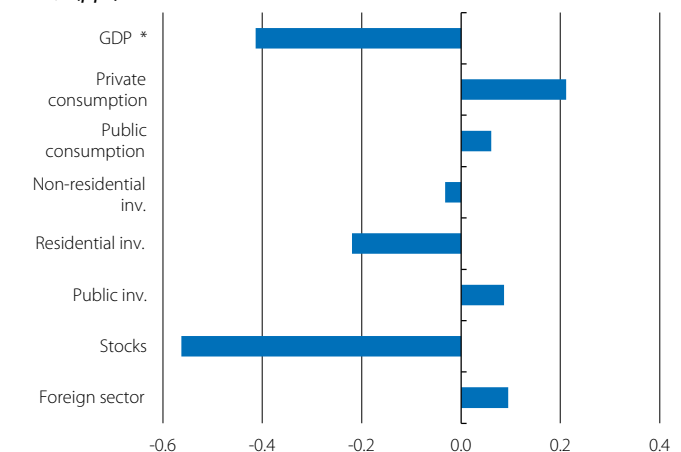
Year-on-year and quarter-on-quarter change (%)



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

Japan: GDP

Contribution to quarter-on-quarter growth in GDP for Q3 (pps)



Note: * Quarter-on-quarter change.

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

rate of asset purchases last 31 October already hinted at a certain concern for inflation, which the data have since confirmed. Nonetheless, to date the greatest success of Abenomics has been precisely in the monetary area, as it has managed to put an end to a problem of deflation which had affected the Japanese economy for the last 15 years.

EMERGING ECONOMIES

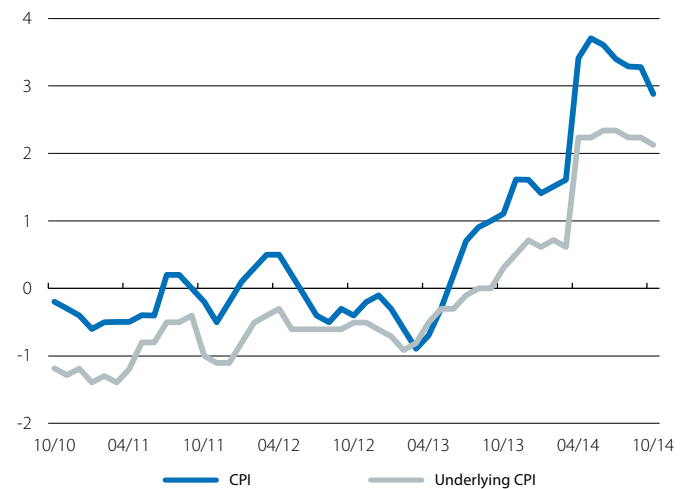
China's business indicators slow down slightly in October

although they still show significant growth. Specifically, industrial production was up 7.7% year-on-year (8.0% in September), retail sales grew by 11.5% (11.6% in September) and investment by 15.9% from January to October. Regarding foreign trade, Chinese exports continued to improve in October, growing by a strong 11.6% year-on-year, in line with the strength shown over the last few months. All this occurred in an environment of moderate prices (inflation stood at 1.6% in October). Although China's activity figures are still reasonable, we have revised downwards our growth forecast for 2015 (from 7.4% to 7.2%), encouraged by the words of the President, Xi Jinping, who believes a 7% growth target is feasible for 2015, suggesting that the government will tolerate a greater slowdown before implementing any more measures of support. The unexpected cut in the official interest rate (by 40 bps to 5.6%) by the country's central bank, the first in over two years, is yet another factor supporting this downward revision. This movement is interpreted as acknowledgement on the part of the Chinese authorities that the slowdown is taking place and a sign of their commitment to this process being gradual.

Disparities have increased in the rest of the emerging countries, with marked contrast between the relative stability of India and Mexico and the uncertainty presented by Russia and Brazil (with very little margin for expansionary policies). India remains on track with 5.3% GDP growth year-on-year in Q3, above consensus expectations. In addition to its good GDP figure, falling oil prices have also increased the government's room to manoeuvre in order to moderate inflation and the country's trade deficit. For its part Mexico picked up moderately in Q3 (2.3% year-on-year compared with 1.6% previously). The risks are greater in Brazil, whose inflation leaves no room to manoeuvre, although GDP improved in Q3 (-0.2% year-on-year compared with -0.9% in Q2) thanks to better performance by public consumption and investment. Along the same lines, Russia's figures came as a pleasant surprise with its GDP growing by 0.7% year-on-year in Q3, although we believe that the negative impact of falling oil prices will be felt in Q4.

Japan: CPI

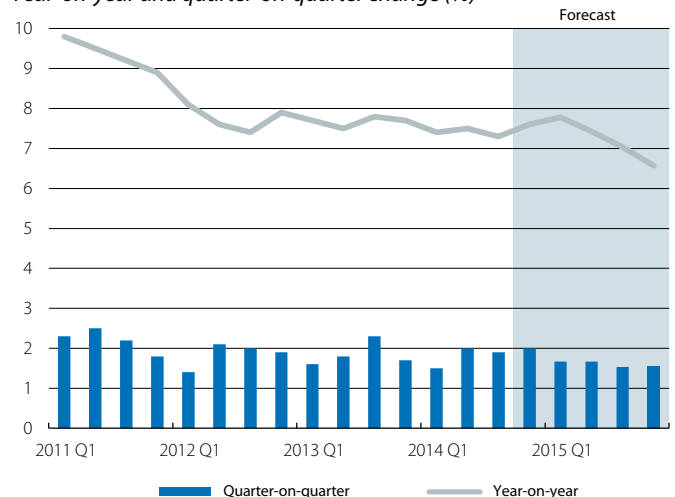
Year-on-year change (%)



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

China: GDP

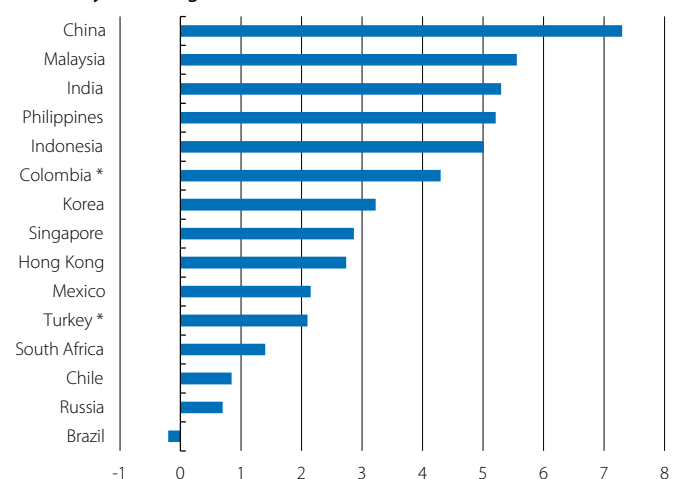
Year-on-year and quarter-on-quarter change (%)



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

Emerging countries: GDP growth in 2014 Q3

Year-on-year change (%)



Note: * Data for 2014 Q2.

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

FOCUS · Colombia: an advanced position in Latin America

According to our forecasts, Colombia's economy will grow by 4.8% per year on average in 2014-2015. This is a high figure that will bring it close to the GDP growth figures achieved by the most dynamic emerging economies and distances it from a Latin America that has lost some of its shine, although still prospering. While Emerging Asia will grow by 6.5%, Latin America will advance by 2.4% in this same period. Colombia's brilliant prospects are nevertheless paradoxical if we take into account the fact that it is suffering from a significant negative shock: a 25% drop since July in the price of Brent quality oil, a product that accounts for approximately 70% of its exports.

This apparent contradiction can be explained by various factors. Although Colombia is among the 20 largest oil producers in the world, the importance of oil in growth terms is moderate as its economy is only relatively open.¹ A recent report by the IMF analysing the impact in Latin America of different hypothetical drops in commodity prices concludes that Colombia belongs to the group of countries in the region whose growth would be least affected by a possible slump. If commodity prices fell by 10% in a given year, its GDP would shrink by 0.4 pps over the following three years while, in cases such as Peru, the same fall in commodity prices would lead to a reduction of 1.5 points.

Moreover, in the future Colombia will benefit from a reasonably prosperous international environment and especially from the good performance by its domestic demand to help it overcome the impact of falling oil prices. In this respect, it should be noted that, in the period 2012-2013 and the first half of 2014, the two fundamental components of domestic demand, public consumption and investment, grew by 4.5% and 7.3% annually on average, respectively.

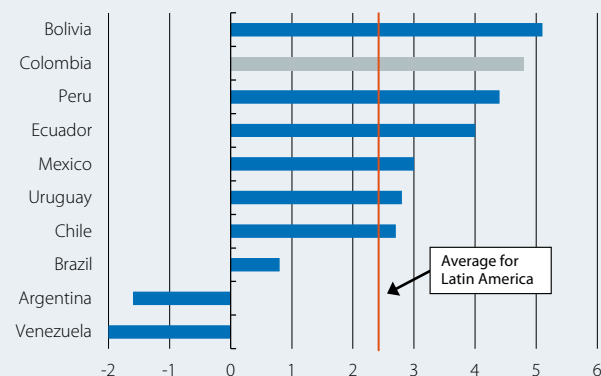
In the domestic scenario, such robust growth reflects the positive effect of different factors of a structural nature. One initial element suggesting a bright future for Colombia's domestic demand is its demographics as the population is expected to grow by an annual average of 1.0% over the next decade. A second notable aspect is that Colombia continues to be one of the countries making the most progress with reforms in Latin America. For example, in certain aspects Colombia's oil reform in 2003 has been the model for Mexico's reform in 2013.² But in addition to this emblematic reform, it is also worth noting the significant efforts being made to improve the legal framework for doing business (undergoing almost continuous reforms over the last decade), the fiscal reform of 2011 (reducing, precisely, the dependence of fiscal revenue on oil) and the tax reform of 2012. A third

positive factor is the existence of few macroeconomic imbalances, placing the country in a comfortable fiscal position (in 2014 its public deficit will be around 1.5% of GDP and public debt around 34% of GDP, and the trend is for these figures to improve during the period 2014-2016) as well as with inflation under control, moving within the 3% zone between 2014 and 2016.

All this, together with the institutional reforms of previous decades (particularly the reform increasing the central bank's independence) has meant that Colombia has now a better economic framework in terms of institutional quality than many countries in Latin America. One last factor supporting the improved tone of domestic activity is the slow but appreciable progress in the country's peace process. In short, Colombia has one of the best short and long-term outlooks in Latin America.

Latin America: growth forecast 2014-2015*

Year-on-year change (%)



Note: * Average for 2014 and 2015.

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

Colombia: main macroeconomic indicators

	2007-2011	2012	2013	2014 (f)	2015 (f)	2016 (f)
Real GDP growth (%)	4.5	4.0	4.7	4.9	4.7	4.5
CPI inflation (%) (y)	4.4	2.8	1.8	3.3	3.2	3.0
Current account balance (% GDP)	-2.5	-3.1	-3.3	-3.9	-3.8	-3.8
Fiscal balance (% of GDP)	-1.8	0.1	-0.9	-1.5	-1.3	-0.9
Public debt (% of GDP)	34.4	32.0	35.8	34.0	33.1	31.6

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

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

1. Less than 20% of public revenue comes from oil and gas (compared with the average of 54% for the group of 16 main oil and gas exporters). Moreover, Colombia's net exports of oil and gas account for less than 10% of its GDP (the average for the 16 main oil and gas exporters as a whole is 26%).

2. The reform included the creation of a National Hydrocarbon Agency (independent and with broad regulatory powers), favourable treatment in terms of royalties and taxes, incentives and permits for international oil extraction companies and the modernisation of ECOPETROL, the state oil company.

FOCUS · The TTIP: the free trade and investment treaty between the EU and the United States, a necessary agreement

The Transatlantic Trade and Investment Partnership or TTIP that is being negotiated between the White House and the European Commission to unite two of the most important regions in the world (the EU and the US) forms part of the current proliferation of free trade agreements, both bilateral and multilateral. The US economy itself is holding conversations to join the Trans-Pacific Partnership (TPP) together with Japan and another 10 economies from the Asia Pacific region, while China has agreed treaties with Australia, Mexico and even the United States this November.

Although the creation of the TTIP has been planned for some time, it was not until June 2013, and after intense consultations, that the President of the United States, Barack Obama, together with the President of the European Council, Herman Van Rompuy, and the then President of the European Commission, José Manuel Durao Barroso, announced the start of the present round of negotiations. The objective: to create an integrated economic area without customs tariffs for manufacturing and agricultural products and with standardised regulations to encourage investment and trade in services. In short, the TTIP is attempting to become an agreement that significantly boosts the flows of trade and investment on both sides of the Atlantic. Should it come about, it would be the biggest agreement in history in terms of the economic weight of both parties: they represent close to 50% of the world's GDP, account for around 30% of international trade for manufacturers and 40% for services, and receive over 30% of the world's direct investment.

Both regions share a past that, combined with their copious dealings today, makes them natural partners. The US is the main trading partner of the EU and vice versa (see the first graph), and the US invests half its annual FDI in the EU while the EU's investment in the US accounts for two thirds of the FDI received by the United States.

Although their economic relationship is substantial, different barriers hinder greater transatlantic links, especially barriers beyond the customs border as customs tariffs between both regions are generally moderate (on average below 3%). These non-customs obstacles consist of factors such as quality and labelling standards, taxation and policies regarding competition and the environment, to name just a few. Their diversity and complexity means that it will be a much more complicated task to reduce or eliminate them than merely reducing custom tariffs. In addition to the difficult goal of achieving common regulatory standards is the thorny issue of protecting the rights of investors in the host state without affecting the sovereignty of the EU or US itself regarding regulations

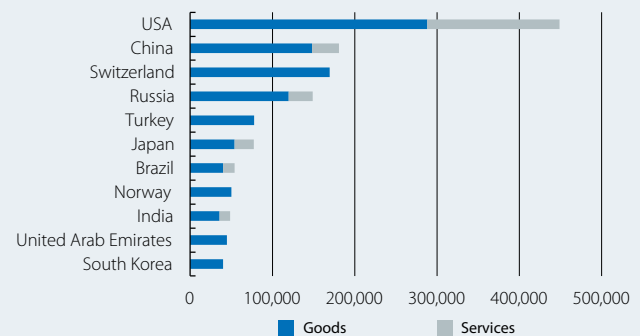
1. The European Commission itself opened a public consultation to deal with this point (http://trade.ec.europa.eu/consultations/index.cfm?consul_id=179).

that affect their own citizens.¹ It is precisely because of such problems that conversations are still ongoing today.

Regarding the economic consequences, and according to a recent study by CEPR, if barriers were extensively reduced (mainly non-customs), both regions would benefit from the agreement. Specifically, the EU would see its GDP increase by 119 billion euros (0.5% of GDP), the equivalent of 545 euros per European household, while the US would increase its GDP by 95 billion (0.4% of GDP) or 655 euros per household (see the second graph).² Moreover, according to a study by the Fundación Bertelsmann Spain would be one of the countries to benefit the most from such an agreement being reached (together with the United Kingdom, Ireland and the Scandinavian countries), gaining access to a market that is particularly competitive for the kind of products it imports.³ At a time when Europe's recovery still appears to be lukewarm, such an agreement would represent an additional support.

Main destinations of EU-27 exports

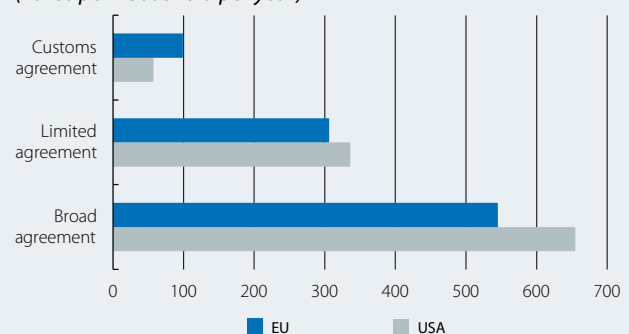
(Million euros)



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

Increase in household income resulting from the TTIP *

(Euros per household per year)



Note: * 2027 horizon in current prices.

Source: "la Caixa" Research, based on data from the study by François et al. (CEPR, 2013) cited in the text.

2. See Francois, Joseph, et al. (2013), «Reducing transatlantic barriers to trade and investment: An economic assessment», no. 20130401, Institute for International and Development Economics.

3. See «Who benefits from a transatlantic free trade agreement», Policy Brief 2013/04, Fundación Bertelsmann Stiftung, 2013.

KEY INDICATORS

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

UNITED STATES

	2012	2013	2013 Q4	2014 Q1	2014 Q2	2014 Q3	10/14	11/14
Activity								
Real GDP	2.3	2.2	3.1	1.9	2.6	2.4	–	...
Retail sales (excluding cars and petrol)	4.2	3.5	3.5	2.3	4.1	4.4	4.4	...
Consumer confidence (value)	67.1	73.2	74.0	80.5	83.4	90.9	94.1	88.7
Industrial production	3.8	2.9	3.3	3.3	4.2	4.4	4.0	...
Manufacturing activity index (ISM) (value)	51.8	53.9	56.7	52.7	55.2	57.6	59.0	...
Housing starts (thousands)	783.8	929.7	1,025	925	985	1,033	1,009	...
Case-Shiller home price index (value)	141.3	158.2	165	170	171	170	...	...
Unemployment rate (% lab. force)	8.1	7.4	7.0	6.7	6.2	6.1	5.8	...
Employment-population ratio (% pop. > 16 years)	58.6	58.6	58.5	58.8	58.9	59.0	59.2	...
Trade balance ¹ (% GDP)	–3.3	–2.8	–2.8	–2.8	–2.9	–2.8	...	...
Prices								
Consumer prices	2.1	1.5	1.2	1.4	2.1	1.8	1.7	...
Core consumer prices	2.1	1.8	1.7	1.6	1.9	1.8	1.8	...

Note: 1. Cumulative figure over last 12 months.

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

JAPAN

	2012	2013	2013 Q4	2014 Q1	2014 Q2	2014 Q3	10/14
Activity							
Real GDP	1.5	1.5	2.4	2.6	–0.1	–1.1	–
Consumer confidence (value)	40.0	43.6	41.7	38.8	39.1	40.9	38.9
Industrial production	0.2	–0.6	5.8	8.3	2.6	–1.1	–1.0
Business activity index (Tankan) (value)	–5.0	6.0	16.0	17.0	12.0	13.0	–
Unemployment rate (% lab. force)	4.3	4.0	3.9	3.6	3.6	3.6	3.5
Trade balance ¹ (% GDP)	–1.4	–2.4	–2.4	–2.8	–2.9	–2.9	–2.8
Prices							
Consumer prices	0.0	0.4	1.4	1.5	3.6	3.3	2.9
Core consumer prices	–0.6	–0.2	0.5	0.6	2.3	2.3	2.1

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 Q4	2014 Q1	2014 Q2	2014 Q3	10/14
Activity							
Real GDP	7.7	7.7	7.7	7.4	7.5	7.3	–
Retail sales	14.3	13.1	13.5	11.9	12.3	11.9	11.5
Industrial production	10.0	9.9	10.0	8.7	8.9	8.0	7.7
PMI manufacturing (value)	50.8	50.8	51.3	50.3	50.7	51.3	50.8
Foreign sector							
Trade balance ¹ (value)	230	258	258	233	253	321	335
Exports	8.0	7.8	7.4	–3.4	5.0	13.0	11.6
Imports	4.3	7.3	7.1	1.7	1.4	1.1	4.6
Prices							
Consumer prices	2.7	2.6	2.9	2.3	2.2	2.0	1.6
Official interest rate ² (value)	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Renminbi per dollar (value)	6.3	6.1	6.1	6.1	6.2	6.2	6.1

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 of China and Thomson Reuters Datastream.

CURRENT SITUATION · Slow but sustained growth

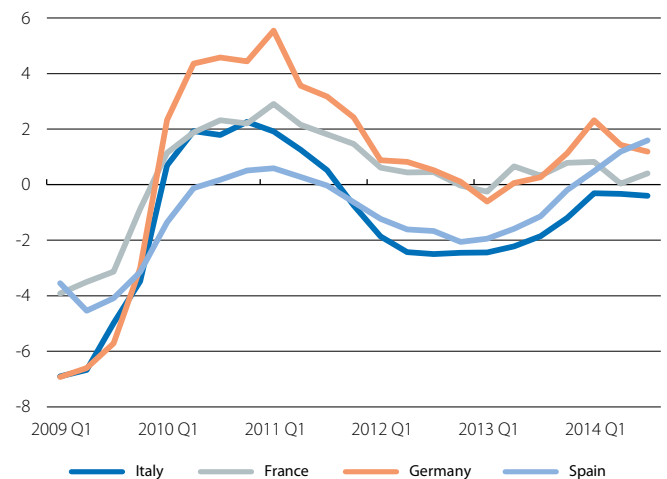
The euro area's recovery is advancing according to expectations: slowly and with differences between countries. The GDP figures for Q3 showed weak growth in the euro area of 0.2% quarter-on-quarter (0.1% in Q2). Of note is the progress being made by Spain of 0.5% quarter-on-quarter, far above the figure for the euro area as a whole, whereas the Italian economy continued to shrink. This time the figures came as a pleasant surprise for France, with higher growth than expected albeit thanks to public spending and the accumulation of stocks, difficult motors to sustain. Germany grew by 0.1%, allaying fears of a recession after its slight dip in Q2. Over the next few months we expect the euro area's recovery to continue, supported gradually by falling oil prices, the depreciation of the euro and the revival in credit (due to monetary policy measures and the publication of the results from the bank asset quality review, as well as the stress tests carried out by the ECB).

The European Commission revises its growth for the euro area downwards. Specifically it predicts that the euro area will grow by 0.8% in 2014 and 1.1% in 2015. Domestic demand, less vigorous than expected, and the materialisation of risks that existed in the first half of the year (a drop off in world trade, conflicts in the Ukraine and Middle East) have led to this revision. The EC expects a slow recovery in 2015 supported by domestic demand and in particular by investment given the situation of accommodative monetary policy, the improvement in financing costs and less need for deleveraging. The EC itself will boost this recovery via the Juncker plan whose measures aim to encourage private and public investment, within an environment of abundant liquidity that is nevertheless not resulting in funding for new projects. The plan creates the European Fund for Strategic Investments (EFSI) with an expected financial capacity of 315 billion euros to invest in long-term projects (strategic infrastructures, transport, R&D, etc.) as well as to support loans for SMEs. Nevertheless, the success of the EFSI will depend both on how the plan operates and selects projects as well as the capacity to absorb losses of any public capital invested, which is *a priori* limited. In its European Semester, the EC has warned seven countries that they may not meet their public deficit targets for 2015, while Belgium, France and Italy are also open to sanctions if they do not take additional measures to correct their deficit levels (see the Focus «Are France and Italy taking the right measures?»).

Moderate growth in euro area activity. In the EC's opinion surveys carried out on the manufacturing sector, companies have reported a slight slowdown in industrial orders although these are still in positive figures. The same conclusion of

GDP growth

Year-on-year change (%)



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

European Commission's GDP growth forecasts

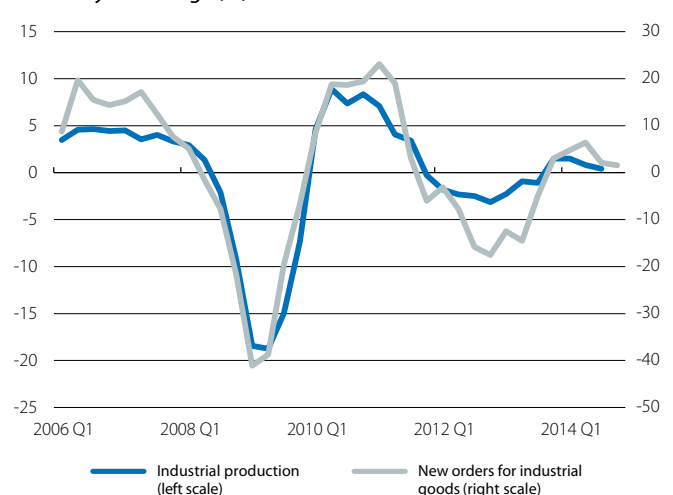
Year-on-year change (%)

	GDP forecast			Change compared with spring 2014 forecast	
	2013	2014	2015	2014	2015
Euro area	-0.5	0.8	1.1	▼ 0.4	▼ 0.6
Germany	0.1	1.3	1.1	▼ 0.5	▼ 0.9
France	0.3	0.3	0.7	▼ 0.7	▼ 0.8
Italy	-1.9	-0.4	0.6	▼ 1.0	▼ 0.6
Spain	-1.2	1.2	1.7	▲ 0.1	▼ 0.4

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

Euro area: activity indicators

Year-on-year change (%)



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

moderate growth can be drawn from the composite PMI for the euro area which is still in the expansionary zone but below its average for Q3. This stability hides different trends depending on the sector (growth in industry and retail activity, no change in services and deterioration in construction) and country (improvements in France and Spain, a decline in Germany and Italy).

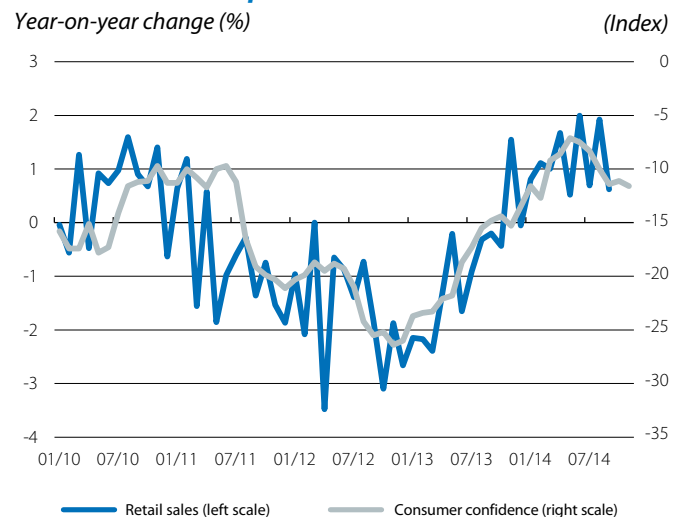
Demand indicators stabilise. In September, retail sales moderated their rate of growth but remained in positive figures while the series' trend shows that sales have risen by close to 1% year-on-year since the start of the year. Nevertheless, the slowness of the euro area's recovery does not seem to be producing more optimistic consumers, whose confidence indicator fell in November. This pessimism should dissipate as the recovery consolidates and the labour market improves. For the moment, however, the unemployment rate is falling very slowly. In October unemployment held steady at 11.5%, below the figure of 11.9% recorded a year ago but unchanged compared with the two previous months. Unemployment expectations are not pointing to any significant improvement over the coming months either.

Germany: private consumption is driving the recovery.

Details of Germany's GDP growth in Q3 allow us to be optimistic. Although quarter-on-quarter growth was moderate, both private consumption and exports grew strongly. The negative contribution by investment and stock changes caused the country's exceedingly moderate growth rate in Q3. However, judging by the more favourable trend in November's higher frequency indicators, such as the IFO and ZEW, investment should pick up in the last quarter of the year. Moreover the breakdown of German GDP in Q3 shows more balanced growth (the contribution by domestic and foreign demand was 0.3 pps and 0.2 pps, respectively). The dynamism of private consumption should continue given the good performance by Germany's labour market with unemployment at an all-time low (4.9% in November) and low interest rates for new loans to households for housing and consumption (also rock bottom), dispelling concerns that German activity, the driving force of the euro area, might stagnate.

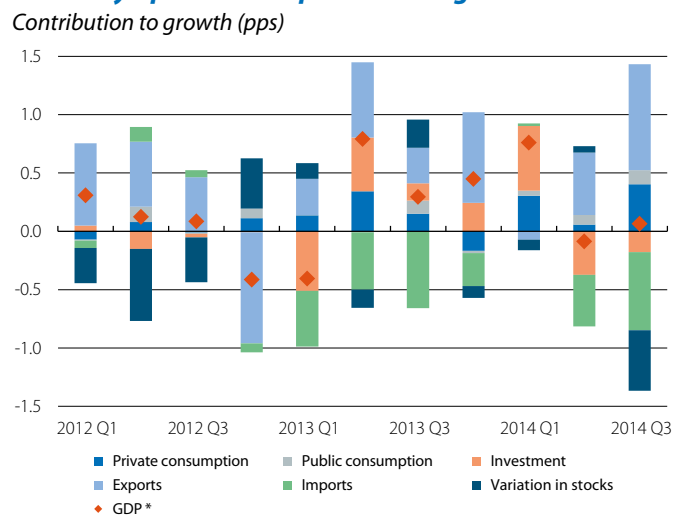
Robust growth in emerging Europe. In spite of the uncertainty caused by the Russia-Ukraine conflict and the relatively moderate economic tone of the euro area, the recovery being made by emerging Europe is surprisingly robust. One significant reason is the resistance of its domestic demand and particularly investment. The rise in Germany's private consumption may have also played its part in this good performance by emerging Europe due to their close ties. With a view to the coming year, we expect this group of countries to continue growing by about 3% as a whole, supported especially by Poland's dynamism, the largest of these economies.

Euro area: consumption indicators



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

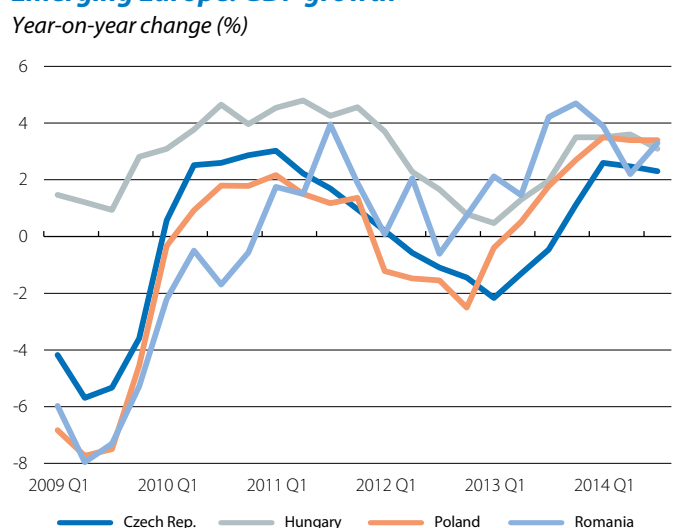
Germany: quarter-on-quarter GDP growth



Note: * Quarter-on-quarter change (%).

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

Emerging Europe: GDP growth



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

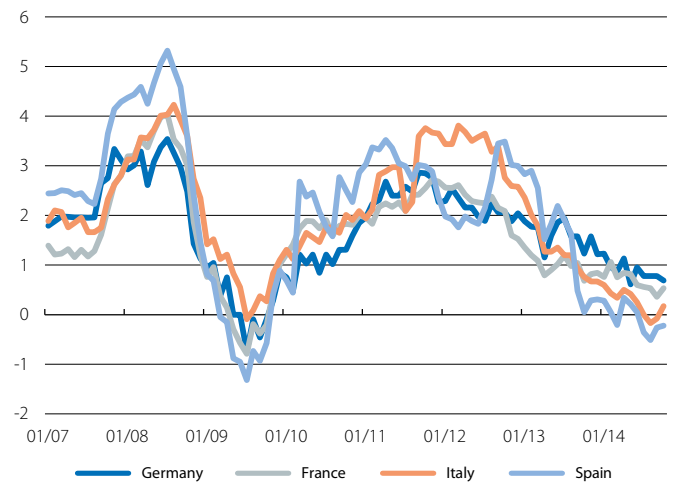
Inflation remains weak. In November inflation fell by 0.1 pps to 0.3% due to the drop in energy prices. By country, the data for October, the latest figures available, showed notable differences, this being lower in Italy and Spain (negative for the latter). In the short term the drop in oil prices is expected to continue pushing down inflation, especially given the lack of agreement to restrict production by the OPEC countries. Core inflation, not affected by the energy, remained low at 0.7%, reflecting the weak tone of economic activity. However, in spite of it pushing down inflation, cheaper oil is not bad news for the euro area which is a net imp importer of oil, as this considerably reduces production costs, improving its competitive position and households' purchasing power.

The foreign sector is picking up. The euro area's trade balance posted a surplus of 2.5% of GDP in September (cumulative over 12 months), continuing the improvement of August. This growth is partly due to the increase in the surplus of goods (thanks to improved exports) and, to a lesser extent, to services, bolstering the foreign sector's role as the driving force behind the recovery. Moreover the recent depreciation of the euro against the dollar should help to boost sales abroad, reducing the final price of the goods produced, especially in countries such as France and Italy (see the Focus «The sensitivity of the euro area's exports to exchange rate movements»). The foreign sector will therefore become more important again over the next few months. This more positive prospect can also be inferred from the latest EC opinion surveys. In general, companies are more optimistic about their export expectations, with indices above the historical average.

The improvement in credit capacity will support the recovery. The results of the survey on companies' access to financing in the euro area suggests that their financial situation has improved over the last six months, partly as a result of the rise in the number of firms, up by 10%, that have increased their turnover. At the same time the ECB's more expansionary monetary policy has helped the cost of loans for companies and households to fall gradually (also narrowing the gap between countries). Although financial fragmentation is still notable, it is much less than a few months ago. For example, while German enterprises paid 2.6% interest on their loans below one million euros in September, Spanish firms paid 4.2%. One year ago the interest rates were higher and more disparate, namely 2.8% and 5.0% respectively. Over the next few months we expect the credit capacity of the banking sector to go on improving and the defragmentation process to continue. Improved credibility in the banking sector as a result of the favourable results from the stress tests carried out by the ECB on banks will help this to be the case.

Inflation

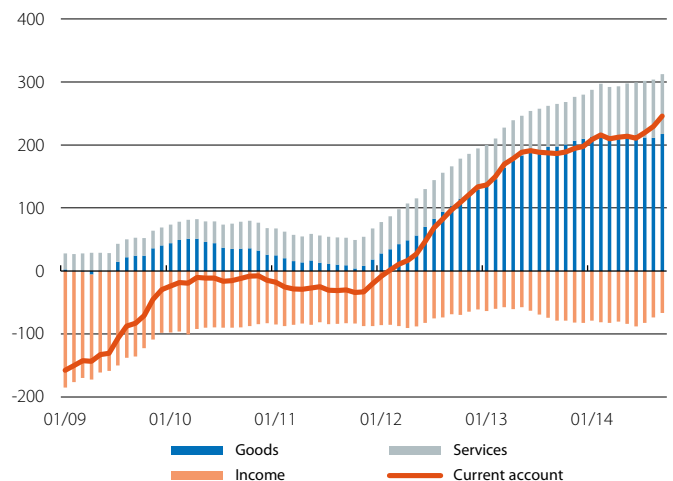
Year-on-year change (%)



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

Euro area: current account balance

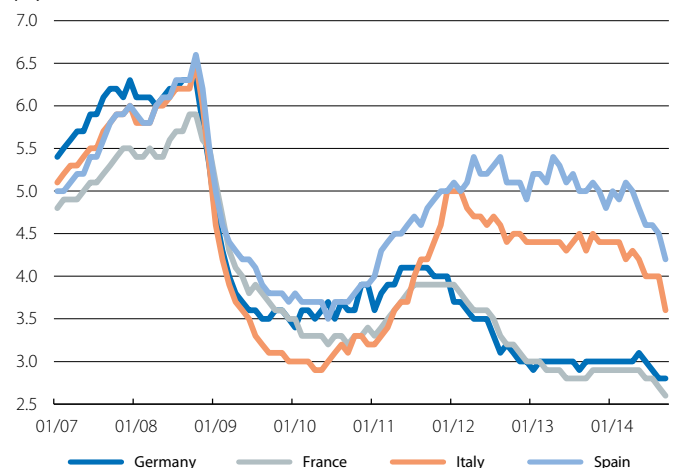
Billion euros (cumulative over 12 months)



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

Interest rate on loans to enterprises under 1 million euros

(%)



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

FOCUS · Are France and Italy taking the right measures?

In the end, no country in the euro area has been fined by the European Commission after its detailed analysis of their state budgets but the Commission has warned seven countries of their possible deviation from their deficit targets. The situation is particularly delicate for France and Italy as they will have to go through a second review in March and face potential sanctions should specific actions not be taken, with precise schedules, to speed up deficit adjustment and implement structural reforms. Both countries have justified their slow progress by the huge effort they will have to make after the deterioration in the expected macroeconomic scenario and the structural reforms announced. But how far is this actually the case?

In France, the measures to contain government spending included in its 2015 budget have been estimated at 21 billion euros and this effort is shared by all administrations; central government, local government and Social Security. In spite of these measures, public expenditure is still expected to rise by 0.2% in real terms although we should note that such a low figure is unusual in France: in 2012 the increase was 1.1% and in 2013 it was 1.3%. The government also expects GDP to grow by 1% next year which, should it happen, would help to reduce the share of public expenditure in GDP.

The government spending cuts in Italy's budget total 15 billion euros. The details regarding how the country will achieve such savings, however, have not been as fully specified as the French case, at least at present. More details have been released, however, regarding the considerable reduction planned for the tax burden, which will cost 18 billion euros. The main beneficiaries will be more modest households, which will pay 80 euros less per month in tax.

Consequently, the measures announced to cut government spending are not minor. Nevertheless, it is equally noticeable that, once all these measures are taken into account (including those of tax reductions), the resulting reduction in the deficit is very limited in both cases. The French government forecasts a deficit of 4.3% (4.4% in 2014) when the target initially agreed with Brussels was 3.0% while in Italy the deficit is expected to be 2.6% (3.3% in 2014) compared with a target of 2.2%. Albeit unwillingly, Brussels has accepted these deviations to a certain extent without imposing economic sanctions at present but, in exchange, an agreement has been reached to implement an ambitious agenda of structural reforms. Let us therefore examine this other aspect of the economic situation.

This year France approved its Responsibility and Solidarity Pact which reduces Social Security contributions and corporation tax, on top of the «*crédit d'impôt pour la compétitivité et l'emploi*» (tax deductions approved in 2013) to make firms more competitive. Moreover, additional measures were announced in October such as a cut in the tax levied on regulated sectors, less bureaucracy for start-ups and a reduction in the number of regions.

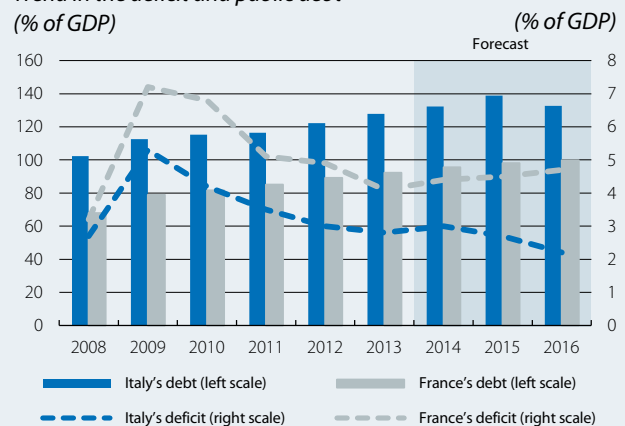
For its part Italy plans to simplify its tax system in 2015 (known as the «*delega fiscale*») as well as carrying out fiscal reforms. Matteo Renzi has also promised to approve the reform of the judicial system, in addition to ambitious labour reforms. The latter have already overcome their first obstacle with the Senate passing the draft bill last October.

The list of reforms seems ambitious in both countries. According to OECD estimates, in France the growth rate could increase by 0.3 pps a year over the next five years should the reforms announced be implemented in their entirety. In the case of Italy, the government estimates that all the reforms presented would increase growth by 0.1 pps in 2015 and by 0.3 pps in 2016.

In short, it seems as if France and Italy are gradually changing the direction of their economic policy and starting to take measures to boost their economic growth. We should remember, however, that many of the reforms announced have yet to be approved and implemented. Moreover, both countries still have very high levels of debt. They will have to get a move on if they want to stop attracting so much attention.

Deficit and public debt in France and Italy

Trend in the deficit and public debt
(% of GDP)



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

FOCUS · The sensitivity of the euro area's exports to exchange rate movements

The euro's recent depreciation could not have come at a better time for the euro area. A cheaper euro makes exports more competitive, providing a considerable boost for a recovery that, at present, appears to be more fragile than expected. According to the ECB's estimates, a long-lasting 10% depreciation in the nominal effective exchange rate of the euro (twice the depreciation occurring between January and November) would result in an increase of GDP of 0.2 pps in the short term and 0.6 pps in the long term.¹ However, this effect is expected to be very different between countries. In fact, those economies looking less dynamic recently (such as France and Italy) should benefit the most from the euro's depreciation.

In particular, according to a recent study by the European Commission the elasticity of French exports to exchange rate movements doubles that of Germany and the Italian one triples it.² The advanced technological level of German exports is one of the most frequently used arguments to explain the relative immunity of its exports to fluctuations in the price of the euro. More technologically advanced products generally enjoy greater differentiation and, as a result, their demand tends to be less sensitive to price variations. But when we look at the technological content of German and French exports overall, no great differences can be detected. There are differences between the two countries at a sector level, however. Industries with high technological content in France are different from those in Germany and such sector differences seem to lie behind part of the disparity between the degree of sensitivity of both countries' exports.³

Nevertheless, a more relevant force than sector differences, although it may seem counter-intuitive, is Germany's openness. Germany's greater degree of trade with countries outside the euro area, particularly in the transport equipment industry (the main export sector for both countries) gives exports more stability. Because, in spite of its relatively high technological content, the transport equipment industry is very sensitive to exchange rate movements. Unlike France, Germany has reduced this by improving the integration of its companies in the global value chain. Its trading relations are particularly close to numerous countries in Central Europe, most of which do not have the euro as their currency, and German vehicle exports contain a

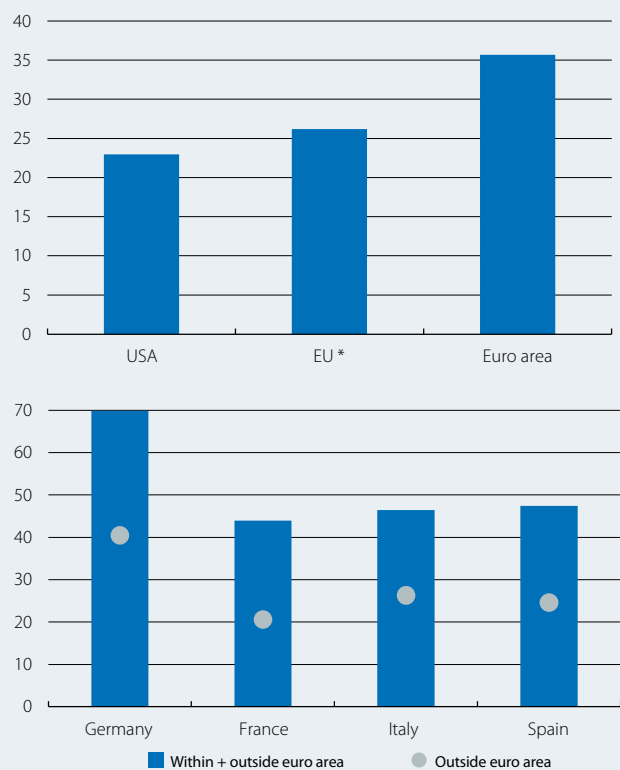
considerable part of intermediate goods from Central Europe, whose costs are established in the local currency.⁴

One example of this is the high percentage of imported intermediate goods that Germany ends up re-exporting, specifically 51%, a percentage that is much higher than in France, Italy or Spain with around 35%. So although exchange rate movements generally have more of an effect on countries that export the most, greater integration in global value chains reduces this sensitivity as the exchange rate also affects the cost of imported products.

In short, although it is the euro area's most open country, Germany will benefit relatively little from the euro's depreciation while this will be of great help to the rest of the countries, especially France and Italy (see the graph). These countries must take advantage of this boost to approve and implement an ambitious agenda of structural reforms to relaunch their long-term growth capacity. And time is short; even more so considering that the current account surplus the euro area looks like maintaining will limit any further depreciation in the future.

Trade openness

Exports plus imports of goods (% of GDP)



Note: * The EU consists of the 28 countries currently in the European Union.

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

1. See Di Mauro, F., Rüffer, R. and Bunda, I. (2008), «The changing role of the exchange rate in a globalised economy», ECB Occasional Paper, (94).

2. See the European Commission (2014), «Quarterly Report on the Euro Area», Volume 13, No. 3. The elasticity of export demand to exchange rate movements is -0.81, -1.44 and -2.56 for Germany, France and Italy, respectively.

3. See Berthou, A. (2008), «An investigation on the effect of real exchange rate movements on OECD bilateral exports».

4. See IMF (2013), «German-Central European Supply Chain – Cluster Report» and IMF (2014), article IV on France, «Selected Issues».

KEY INDICATORS

Activity and employment indicators

Values, unless otherwise specified

	2012	2013	2013 Q4	2014 Q1	2014 Q2	2014 Q3	09/14	10/14	11/14
Retail sales (year-on-year change)	-1.6	-0.9	0.4	1.0	1.4	1.1	0.6	...	...
Industrial production (year-on-year change)	-2.5	-0.7	1.5	1.3	1.0	0.6	0.7	...	...
Consumer confidence	-22.1	-18.7	-14.4	-11.2	-7.7	-9.9	-11.4	-11.1	-11.6
Economic sentiment	90.8	93.8	99.1	101.6	102.2	100.9	99.9	100.7	100.8
Manufacturing PMI	46.2	49.6	51.9	53.4	52.5	50.9	50.3	50.6	...
Services PMI	47.6	49.3	51.3	52.1	53.0	53.2	52.4	52.3	...
Labour market									
Employment (people) (year-on-year change)	-0.6	-0.8	-0.4	0.1	0.5	...	-	-	...
Unemployment rate: euro area (% labour force)	11.3	12.0	11.9	11.8	11.6	11.5	11.5	11.5	...
Germany (% labour force)	5.4	5.2	5.1	5.1	5.0	5.0	5.0	4.9	...
France (% labour force)	9.8	10.3	10.2	10.1	10.2	10.5	10.5	10.5	...
Italy (% labour force)	10.7	12.2	12.5	12.6	12.6	12.8	12.9	13.2	...
Spain (% labour force)	24.8	26.1	25.8	25.2	24.7	24.2	24.1	24.0	...

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	2014 Q3	09/14	10/14
Current balance: euro area	1.4	2.1	2.1	2.2	2.2	2.5	2.5	...
Germany	7.1	6.7	6.7	6.8	6.8	7.2	7.2	...
France ¹	-1.5	-1.4	-1.4	-1.5	-1.7	-1.4	-1.4	...
Italy	-0.5	1.0	1.0	1.3	1.3	1.6	1.6	...
Spain	-0.3	1.4	1.4	1.1	0.4	0.2	0.2	...
Nominal effective exchange rate² (value)	97.8	101.6	103.1	103.8	103.8	101.6	100.3	99.5

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	2014 Q3	09/14	10/14
Private sector financing								
Credit to non-financial firms ¹	-0.3	-2.3	-2.9	-3.1	-2.5	-2.0	-1.8	-1.6
Credit to households ^{1,2}	1.2	0.3	0.3	0.3	0.5	0.5	0.5	0.6
Interest rate on loans to non-financial firms ³ (%)	2.4	2.2	2.3	2.2	2.1	1.9	1.9	...
Interest rate on loans to households for house purchases ⁴ (%)	3.1	2.8	2.8	2.8	2.7	2.6	2.5	...
Deposits								
On demand deposits	4.1	7.9	6.6	5.9	5.2	5.9	6.2	6.3
Other short-term deposits	2.0	0.0	-1.5	-2.5	-2.0	-1.7	-1.6	-2.1
Marketable instruments	0.5	-14.8	-16.8	-12.7	-11.6	-6.0	-4.4	-1.0
Interest rate on deposits up to 1 year from households (%)	2.8	2.0	1.6	1.6	1.4	1.3	1.2	...

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 · Growth with contained inflation

The Spanish economy withstands the autumn storm.

Although the recovery is progressing very slowly in most European countries, the Spanish economy continues to stand out with a growth rate that is at a clearly higher level. GDP increased by 0.5% quarter-on-quarter in Q3, the same rate as in Q2 and higher than the 0.3% recorded in Q1. The country has now enjoyed five consecutive quarters of positive growth and its year-on-year growth rate is now 1.6%. Moreover, in the coming quarters we expect the recovery to be strengthened further thanks to two sources of support: falling oil prices (see the Focus «On the impact of falling oil prices on the current balance» in this Report) and the depreciation of the euro. The European Commission also notes that some support might come from moderate fiscal relaxation. This has led us to revise upwards our growth forecast for 2015, to 1.9% (previously 1.7%). For 2016 we expect growth of 2.0%. This improvement in forecasts for the Spanish economy can also be seen among international organisations such as the OECD which, in its November report, improved its forecast for 2014 by 0.3 pps to 1.3%, and by 0.2 pps for 2015, to 1.7%.

The recovery continues, thanks to domestic demand.

Domestic demand contributed 0.8 pps to quarter-on-quarter growth in GDP thanks to the increase in private consumption, whose strength continues to surprise (0.8% quarter-on-quarter), and to the progress made by investment, especially in equipment but also in construction. The other component of domestic demand, public consumption, is still contained due to the adjustment of public accounts. In the coming quarters we expect household consumption to moderate its rate of growth and post figures more in line with the trend in its gross disposable income. In fact, some consumption indicators for Q4 are already pointing in this direction: retail sales dropped by 0.8% in October and, in November, consumer confidence fell to -11.8 points, a level similar to that of Q1. However, other indicators such as automobile sales show no signs of fatigue.

The foreign sector is showing some signs of improvement after a very weak first half of the year. Although foreign demand deducted 0.3 pps from quarter-on-quarter GDP growth, it is important to note the good performance by exports, growing by 3.5% in Q3. However, the strong growth in imports (4.7% quarter-on-quarter) meant that the current account balance continued to deteriorate: in September it posted a surplus of 1.7 billion euros (cumulative over 12 months), a figure that contrasts with the surplus of 15.8 billion euros one year ago. Nonetheless, the good performance by tourism, which continues to set all-time records, and the more favourable trend in goods exports point to a slight improvement in the current account in 2015.

Breakdown of GDP and forecasts

Quarter-on-quarter change (%)

	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1	2015 Q2
Private consumption	0.6	0.9	0.8	0.5	0.4	0.4
Public consumption	1.1	0.1	0.1	-0.5	0.1	-0.2
Investment	0.1	1.7	1.0	1.0	1.2	1.4
Capital goods investment	2.0	3.8	1.7	1.9	2.0	2.2
Investment in construction	-1.7	0.6	0.6	0.4	0.6	0.8
Exports	0.0	1.3	3.5	1.3	1.2	1.1
Imports	0.5	2.6	4.7	1.2	1.2	0.9
GDP	0.3	0.5	0.5	0.4	0.5	0.6

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

Forecast

Demand indicators

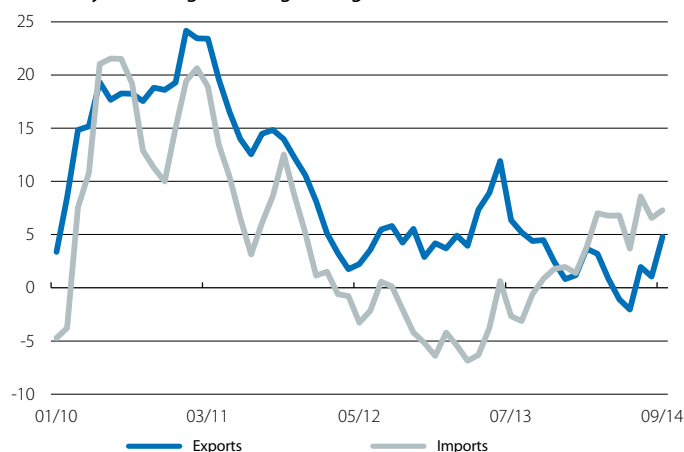
Year-on-year change (%) and value



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

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.

Q4 supply indicators continue to improve. The PMI for services advanced by 0.1 pps in October to 55.9 points while the index for manufacturing remained at the level of 52.6 points. Both, therefore, are still above 50, the borderline between expansion and contraction. New orders are the main driving force for both sectors: although a certain slowdown can be seen in those from the euro area, this is being offset by higher growth in domestic orders. Industrial production grew by 1.1% year-on-year in September, boosted by capital goods. Moreover, the industrial confidence index posted its highest level since January 2008. These good figures for the industrial sector suggests that investment in equipment will perform well in Q4.

The labour market continues to provide good news.

According to data from the National Accounts system for Q3, employment grew for the third consecutive quarter, specifically by 0.5% quarter-on-quarter (0.7% in Q2 and 0.2% in Q1). All branches of activity created jobs except for finance and insurance, still undergoing adjustment, and agriculture, a highly volatile sector. Construction, another branch severely affected by the crisis, has created jobs for two consecutive quarters, showing that its resizing process is finally coming to an end. The number of registered workers affiliated to Social Security in October suggests that the improvement in the labour market will continue in Q4.

Contained wages support improvements in competitiveness.

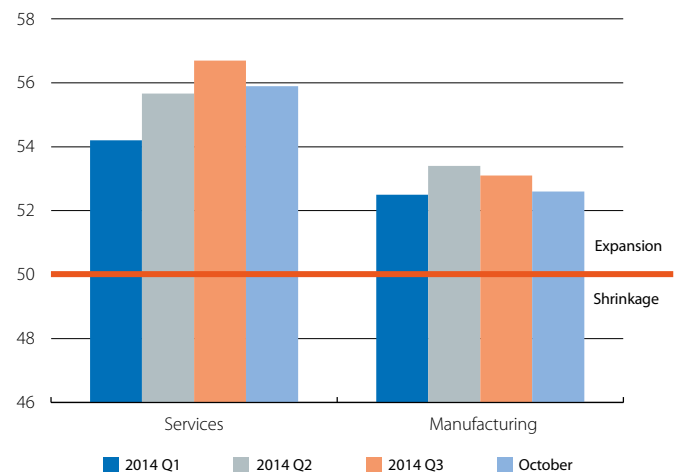
In Q3 salaries fell by 0.5% quarter-on-quarter, helping to reduce unit labour costs (–0.5% quarter-on-quarter). Judging by the wage rises contained in collective agreements, stable at 0.6% year-on-year between January and October, wage moderation is continuing. Until there is a significant increase in productivity, wage containment is vital in order to continue making gains in competitiveness.

Energy is pushing down prices. Inflation fell by 0.3 pps to –0.4% in November. Almost all this drop can be explained by the fall in the price of energy products (both oil and electricity). Although inflation has been in negative figures for five months, we expect it to embark on a moderate upward trend supported by the recovery in domestic demand and the depreciation of the euro. Moreover, next year we predict that oil prices, which are already at a minimal level, will stop pushing down prices. We forecast –0.1% inflation for the whole of 2014, which should increase to 0.9% in 2015 and 1.5% in 2016.

The European Commission warns that Spain might not achieve its deficit target in 2015. The latest budget expenditure data for 2014 show that, for public administration as a whole, the public deficit is 3.9% (target: 5.5%). In September the autonomous communities already deviated from their annual target of 1% by 0.1 pps, while central government and Social Security still have some margin regarding their deficit target and local corporations might post a surplus again, as happened in 2013. We have placed our deficit forecast for 2014 at 5.7%. With a view to 2015 the

Activity indicators

Purchasing Managers' Index (value)

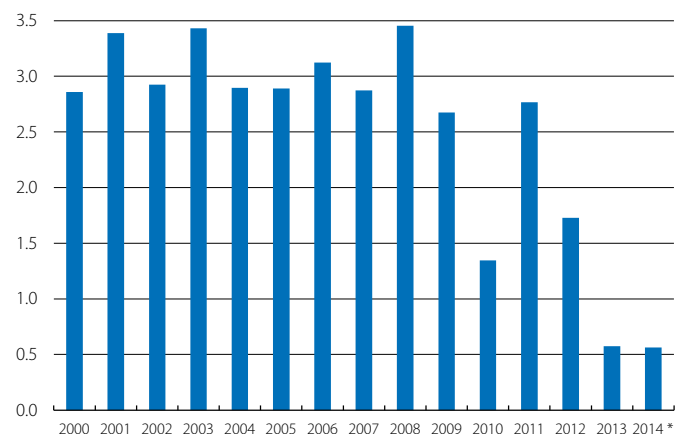


Note: Values above 50 points are usually related to positive GDP growth rates.

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

Wages agreed in collective agreements

Average change (%)

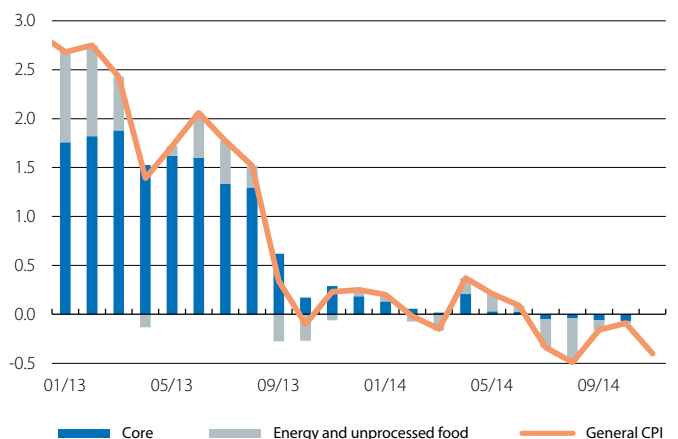


Note: * Average from January to October.

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

Contribution to inflation by component

(pps)



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

EC, in its opinion report on the 2015 Budget, believes that the country is in danger of missing its deficit target due to uncertainty regarding the expected reduction in spending, as well as the effects of fiscal reform, and therefore suggests that more measures should be taken. The EC places its deficit forecast for 2015 at 4.6%, 0.1 pps above ours and 0.4 pps above the target.

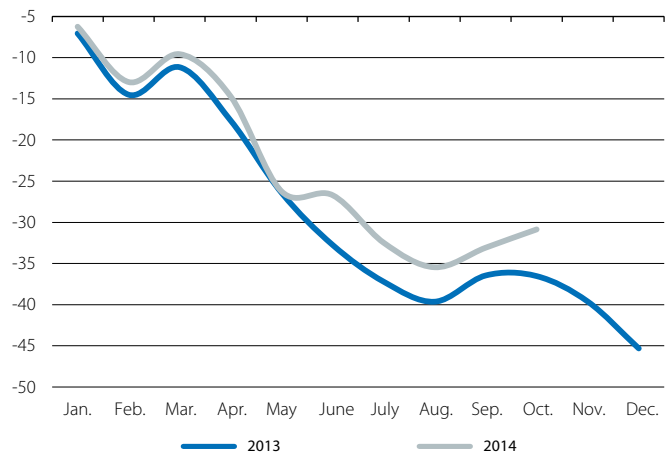
The real estate market is showing signs of stabilising.

House prices fell by 0.2% quarter-on-quarter in Q3 (0.0% in Q2), bringing the year-on-year rate to -2.6%, the lowest rate of contraction since 2008. In the coming quarters we expect prices to remain stable, perhaps with slight erratic movements upwards or downwards as befitting a moment of a change in trend but, little by little, gradually embarking on an upward trend. Nonetheless the real estate market still has a large stock of residential properties to sell and, moreover, many households are still deleveraging, factors that will limit any rise in prices. With regard to demand, the growth in house sales in September (13.7% year-on-year) points to the year ending with the number of transactions just over 300,000, a relatively optimistic note for the recovery of an activity which is currently at rock bottom. Another positive note is provided by the growth in residential investment, in Q3 increasing for the first time since 2007 Q2.

The Single Supervisory Mechanism (SSM) is starting to supervise larger Spanish banks, which account for 90% of the sector's assets. Smaller banks are still under the supervision of the Bank of Spain, albeit guided by the ECB. For these smaller financial institutions, on 28 November the Spanish cabinet approved a Bank Resolution bill establishing mechanisms for prompt action and definitive resolution, as well as the framework of action for the competent authorities. While progress is still being made in creating banking union, the data from the banking sector are showing signs of improvement. On the one hand, the NPL ratio, which is still at a very high level compared with its historical average, posted its biggest drop for the year to date, down to 13.0% in September. On the other hand, the rate of decrease in the credit balance slowed down compared with previous months (-7.9% in October compared with -8.1% in September).

Central government balance

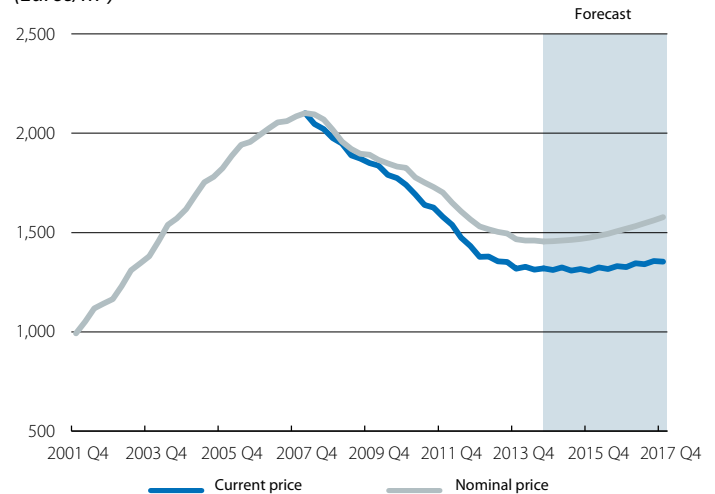
Cumulative figures for the year to date
(billion euros)



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

Housing prices

(Euros/m²)



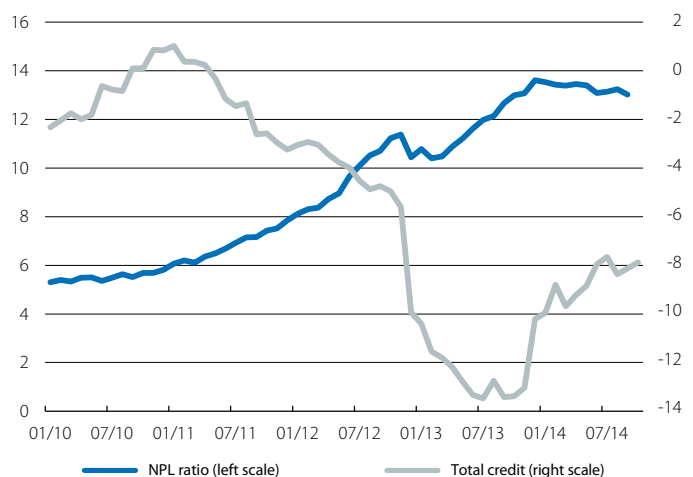
Note: Real price is equal to the CPI-deflated nominal price.

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

NPL ratio and bank credit

Doubtful loans out of total credit (%)

Year-on-year change (%)



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

FOCUS · On the impact of falling oil prices on the current balance

The sharp drop in oil prices over the last few months has surprised both those in the know and others. The price of a barrel of Brent oil, Europe's benchmark, went from 83 euros in January 2014 to below 70 euros in November, down by 16%. Less conspicuous but also important has been the fall in the price of gas, with the price falling by 4% between the first half of 2013 and the same period in 2014.¹ This will undoubtedly be of great help to the main countries in the euro area, all with considerable energy deficits.

In Spain, specifically, gross imports of crude oil reached 34.8 billion euros in 2013 (35 million barrels a month at 82 euros per barrel on average) while gross imports of gas, the second in importance, totalled 10.7 billion euros. Both together represent 97.6% of the total gross energy imports.²

The energy deficit has increased substantially over the last few years, going from 15 billion euros in 2002 to 34.5 billion euros in 2013, an all-time record. This increase was particularly due to the rising price of energy goods and especially higher oil prices. Unlike most consumer goods, demand for energy products does not depend much on their price and it is therefore not surprising that the value of energy imports is closely linked to the Brent barrel price. In fact, since 2002 the consumption of crude oil in real terms has only increased by 4%.

The recent fall in oil prices has therefore created a lot of expectation, especially because several factors suggest this is not a temporary phenomenon (although commodities are the epitome of a volatile and unpredictable market). One of the factors helping to push down commodity prices in general and oil in particular is the appreciation of the dollar: with a lower price in dollars, producers get the same income in their own local currency even though the price may have fallen. Moreover, supply factors are also having an effect in the specific case of oil, such as the increase in production in the US and the behaviour of OPEC (see the article in the Dossier «Weakness, shale and Saudi Arabia's strategy behind the upheaval in oil» for a more detailed explanation of these factors).

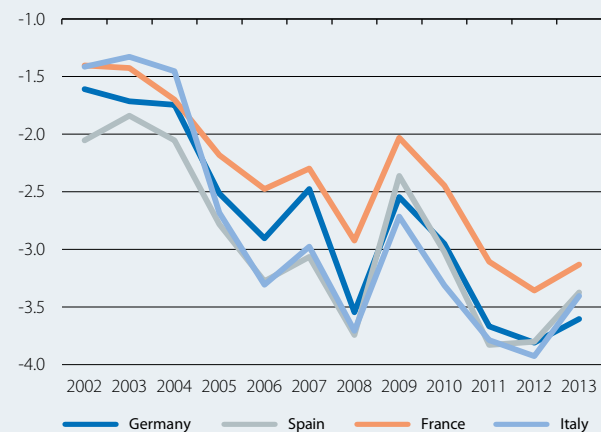
Should it consolidate, this scenario of lower oil prices might result in significant savings for the Spanish economy. For example, in our central forecast scenario,

which assumes an average Brent barrel price of 68 euros/barrel in 2015 (11% lower than the average price of 76 euros we expect for the end of 2014), the savings would be around 3.4 billion euros.³ In a more benevolent scenario as far as Spain is concerned, a drop of 18% (62 euros/barrel, the current level) would represent savings of nearly 6 billion euros.

In short, the fall in oil prices will provide considerable support for Spain's economic recovery, recently threatened by weakness in the euro area. Moreover, it will also help the adjustment in the external balance which, over the last few months, has changed direction and is now approaching negative figures again.

Energy balance by country

(% of GDP)

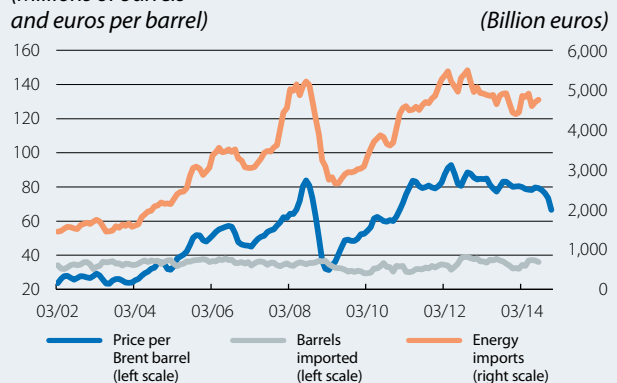


Source: "la Caixa" Research, based on Eurostat data.

Price of Brent barrel, value of energy imports and barrels imported

Moving average of three months

(Millions of barrels and euros per barrel)



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

1. Eurostat figures: price of gas excluding tariffs for industrial consumption, band I3.

2. Figures published by Datacomex and JODI. These differ from Eurostat's estimates as the latter uses a methodology that harmonises data for all countries in the euro area.

3. For 2015 we expect the euro/dollar exchange rate to be around 1.23 on average.

FOCUS · The German *Mittelstand*, a benchmark for Spanish SMEs

The hallmark of German SMEs (or *Mittelstand*) is a long-term view of business. They therefore prioritise both product quality and after sales service. This strategy, recognised as a benchmark for decades now, has stood out even further in recent years as it has proved to be crucial to successfully handling the effects of the crisis: between 2008 and 2013, the gross value added (GVA) of German SMEs increased by 18% and the number of employees grew by 19%. These figures contrast with those of Spanish SMEs, where both the GVA and the number of workers fell by almost 25% over the same period.¹ Although many factors lie behind this gap between German and Spanish SMEs, a simple comparison of both models provides useful pointers that could help make Spain's businesses more robust.

One of the main features of German SMEs is their larger share of medium-sized firms (between 50 and 500 employees) compared with small enterprises (between 1 and 20 workers). Company size is important, at least for three reasons. Firstly because it is closely related to the longevity of the company, a desirable feature as the older a company gets, the more it tends to consolidate its production capacity and improve its market penetration. For example, in January 2014, only 14% of Spanish companies employing 20 or less workers had been in business for more than 20 years while this percentage climbs to 43% in companies with more than 20 employees (see the first graph).

The second factor to take into account is that larger companies also tend to export more. It therefore comes as no surprise that, on the whole, a larger percentage of German SMEs sell abroad, specifically 11% compared with 4% in Spain. However, it is also notable that Spanish medium-sized companies have a higher export rate than German companies (see the second graph). Another encouraging figure is the significant increase in exports by Spanish SMEs as a proportion of their total sales, going from 11.9% in 2007 to 18.2% in 2011.² Although more recent data are not available, it is very likely that this trend has intensified in the last few years, given the good performance by exports.

Lastly, larger company size also helps German SMEs to diversify their sources of financing to a greater degree, something that is especially useful in prolonged periods of financial stress, such as the last few years. Efforts are being made in this area in Spain, for instance by creating the MARF (alternative fixed income market) and the MAB (alternative stock market).

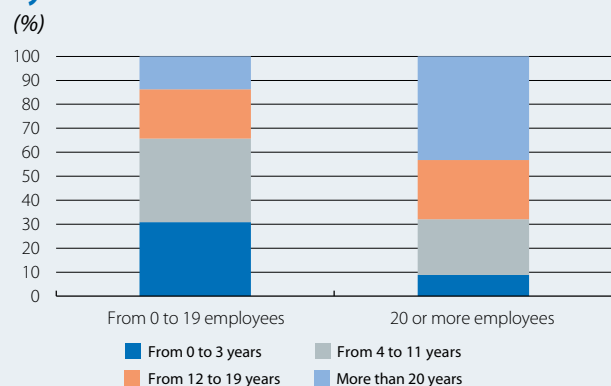
The resilience of German SMEs as a whole is also due to their wide range of sectors whereas, in Spain, the share of SMEs in the construction industry was obviously considerable, up until the crisis. However, after the

adjustment carried out by this sector over the last few years (close to 100,000 construction SMEs closed down between 2008 and 2012), the diversification of German and Spanish SMEs is now similar. The relative weight of retail is slightly higher in Spain, a relatively reasonable feature given the country's greater importance as a tourist destination, while the sector of professional, scientific and technical service firms stands out in Germany.

The production processes of German SMEs also tend to have a high technological content, helping to increase their value added and employment quality. For example, in 2012 the percentage of people employed in medium and high technology-intensive manufacturing SMEs was 5.4% in Germany, higher than Spain's figure of 2.9%. With regard to the services sector, in German SMEs 16.4% of the workers belong to knowledge-intensive sectors, compared with 13.5% in Spain.³

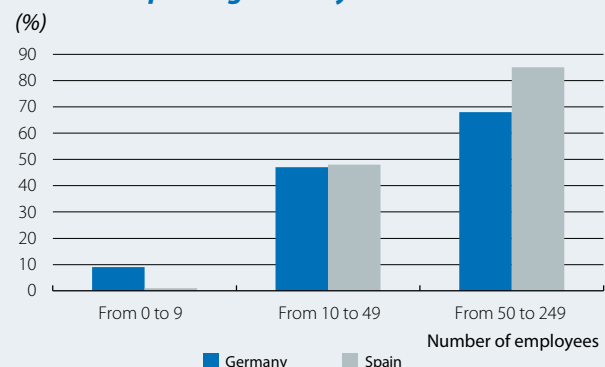
In short, a more internationalised, innovative and diversified SME sector is key to the success of the *Mittelstand*. On the whole, Spanish SMEs are still far from achieving the records set by their German peers but the progress they have made over the last few years gives us cause to be optimistic.

Spain: breakdown of company age by size



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

Ratio of exporting firms by size



Source: "la Caixa" Research, based on data from the «Annual Report on European SMEs 2013/2014 - A Partial and Fragile Recovery», European Commission.

1. See «A Partial and Fragile Recovery», Annual Report on European SMEs 2013/2014, European Commission.

2. Data from the SEPI Foundation for industry on enterprises with fewer than 200 employees.

3. See «Situación actual y retos de futuro de las pymes españolas» by the Instituto de Estudios Económicos (2014).

FOCUS · The financial wealth of households: a buffer for consumption

Over the last few years, households' decisions to consume and save have been affected by the uncertainty surrounding the economic situation. At the start of the crisis, households decided to increase their savings to be able to tackle any possible eventualities. The savings rate therefore rose sharply (from 8.3% in 2008 Q4 to 15.1% in 2009 Q4) in detriment to private consumption which slumped much more than gross disposable income. Most of these savings were concentrated in liquid assets, readily available should they be required. In fact, the share of cash and deposits within households' financial balances went from 37% in 2007 to 50% in 2009 Q1.

Now that the recovery has begun, households have also started to consume again and have done so at a considerable rate, much more than the modest rise in their disposable income, leading to a sharp fall in the savings rate: in 2014 Q2 it stood at 9.1%. Nevertheless, in spite of saving a smaller proportion of their gross disposable income, households' stock of net financial assets has increased substantially in the last few quarters, reaching 1.1 trillion euros in 2014 Q2, an all-time high. This increase can be partly explained by a lower investment in real estate assets, falling by 67% since the peak reached in 2007 Q4. But it is also due to the higher value of financial assets and a reduction in financial liabilities through deleveraging. Consequently, households have high financial wealth overall although this is obviously not distributed evenly. Moreover the percentage of liquid assets in their financial balances, in spite of having fallen to 44%, is still higher than its pre-crisis level.

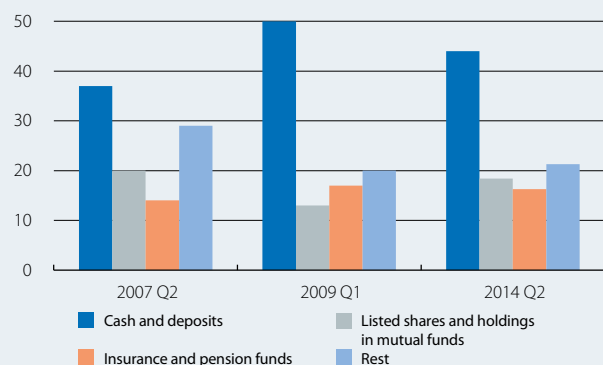
As the economic outlook improves and uncertainty dissipates, households are likely to start using the resources they accumulated during the years of crisis. When this happens, household consumption might surprise with higher growth than suggested by an environment of gradual recovery in the labour market and wage containment. To assess the potential scope of this phenomenon more accurately, we need a benchmark for the proportion of household savings set up as a precaution. One relatively simple and intuitive way to calculate this is by assuming that, if the macroeconomic context had been «normal» between 2009 and 2011, the savings rate would have remained at 11.5%, 1.9 pps below the actual average savings rate observed (13.4%).¹ In this scenario of lower savings, the net financial wealth of households would be 50 billion euros lower than the current figure.

1. We assume a rate of 1.1 pps above the historical average (10.4%) to obtain a conservative benchmark. After the strong recession, households may have revised upwards the level of savings they want to maintain in order to tackle any eventualities.

This buffer created by households during the years of recession, and which they still have, seems to be quite considerable. For example, a 1 pp fall in the savings rate over the next two years, equivalent to a reduction in financial wealth of approximately 20 billion euros, would result in a 0.8 pp increase in consumption per year. But the effect could be less if households decide to invest in real estate assets instead of consumption, a plausible hypothesis given the lower propensity to consume of wealthier households.

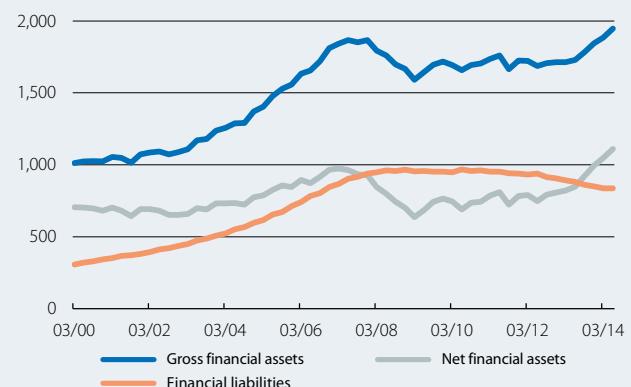
In short, although the recovery is expected to be gradual, different factors could accelerate this over the coming quarters. The use of resources accumulated by many households during the years of recession is one of these factors. However, for households to reduce their savings, it is crucial for the uncertainty still surrounding the macroeconomic scenario to diminish. Continual warnings of a possible third recession by several international organisations are not helping in this respect.

Breakdown of household financial assets (% of all assets)



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

Household financial assets and liabilities (Billion euros)



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	2014 Q3	09/14	10/14	11/14
Industry									
Electricity consumption	-2.2	-2.2	0.1	-0.4	0.8	0.3	1.1	-1.0	...
Industrial production index	-6.6	-1.5	1.1	1.5	2.6	0.7	1.1	...	...
Indicator of confidence in industry (value)	-17.5	-13.9	-11.6	-9.1	-8.2	-5.7	-5.7	-6.0	-4.0
Manufacturing PMI (value)	43.8	48.5	50.1	52.5	53.4	53.1	52.6	52.6	...
Construction									
Building permits	-42.7	-21.4	-6.5	-8.9	14.4	26.5	31.6	...	...
House sales	-8.7	-2.4	-9.8	-9.3	6.5	7.8	13.7	...	...
Services									
Foreign tourists	2.0	5.6	10.8	8.1	7.8	7.6	8.1	7.8	...
Services PMI (value)	43.1	48.3	51.8	54.2	55.7	56.7	55.8	55.9	...
Consumption									
Retail sales	-7.1	-3.7	0.4	-0.1	0.7	0.4	0.9	0.8	...
Car registrations	-13.5	5.6	22.6	11.8	23.2	17.0	26.2	26.1	...
Consumer confidence index	-31.7	-25.3	-19.4	-11.8	-6.1	-7.9	-9.6	-10.0	-11.8

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	2014 Q3	08/14	09/14	10/14
Registered as employed with Social Security¹									
Employment by industry sector									
Manufacturing	-5.3	-4.3	-2.5	-1.3	0.0	0.6	0.6	0.7	0.6
Construction	-17.0	-12.1	-7.9	-5.3	-2.3	-0.5	-0.4	-0.2	0.5
Services	-1.7	-2.0	-0.4	1.1	2.2	2.6	2.5	2.7	2.7
Employment by professional status									
Employees	-3.8	-3.8	-1.8	0.1	1.4	1.9	1.9	2.1	1.9
Self-employed and others	-1.4	-0.6	0.4	1.4	2.3	2.5	2.5	2.6	2.6
TOTAL	-3.4	-3.2	-1.4	0.4	1.5	2.0	2.0	2.2	2.0
Employment²	-4.3	-2.8	-1.2	-0.5	1.1	1.6	1.6	-	-
Hiring contracts registered³									
Permanent	29.7	-14.2	-2.1	6.8	24.0	21.5	16.8	29.3	24.7
Temporary	-4.0	6.4	15.0	19.4	14.2	11.1	8.3	16.4	6.2
TOTAL	-1.6	4.0	13.5	18.2	15.0	11.8	8.8	17.4	7.6
Unemployment claimant count³									
Under 25	4.5	-6.2	-8.0	-9.4	-10.9	-5.5	-4.9	-5.7	-6.9
All aged 25 and over	11.7	3.7	-1.2	-3.7	-5.9	-5.9	-5.8	-5.9	-5.8
TOTAL	10.9	2.7	-1.8	-4.2	-6.4	-5.9	-5.8	-5.9	-5.9

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

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

Prices

	2012	2013	2013 Q4	2014 Q1	2014 Q2	2014 Q3	09/14	10/14	11/14
General	2.4	1.4	0.1	0.0	0.2	-0.3	-0.2	-0.1	-0.4
Core	1.6	1.5	0.3	0.1	0.1	0.0	-0.1	-0.1	...
Unprocessed foods	2.3	3.6	0.7	0.7	-2.3	-4.1	-1.5	1.7	...
Energy products	8.8	0.1	-1.1	-1.0	2.4	-0.2	0.0	-1.1	...

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 Q4	2014 Q1	2014 Q2	2014 Q3	08/14	09/14
Trade of goods								
Exports (year-on-year change)	3.8	5.2	0.8	3.2	-2.0	4.8	-5.1	9.6
Imports (year-on-year change)	-2.8	-1.3	2.0	7.0	3.7	7.3	0.5	7.5
Current balance	-3.0	15.1	15.1	11.2	4.4	1.7	1.8	1.7
Goods and services	16.5	35.7	35.7	33.6	29.1	26.7	26.7	26.7
Primary and secondary income	-19.4	-20.6	-20.6	-22.4	-24.8	-25.0	-24.9	-25.0
Net lending (+) / borrowing (-) capacity	2.3	22.0	22.0	18.3	10.8	7.7	7.8	7.7

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

Public sector

Percentage GDP, cumulative in the year, unless otherwise specified

	2012	2013	2013 Q4	2014 Q1	2014 Q2	2014 Q3	09/14	10/14
Net lending (+) / borrowing (-) capacity	-10.3	-6.9	-6.4	-0.7	-3.7	...	-	-
Central government ¹	-7.9	-4.8	-4.3	-0.9	-2.5	-3.1	-3.1	-2.9
Autonomous regions	-1.8	-1.5	-1.5	-0.3	-1.1	-1.1	-1.1	...
Local government	0.3	0.5	0.5	0.2	0.1	...	-	-
Social Security	-0.9	-1.1	-1.1	0.3	-0.2	0.0	0.0	...
Public debt (% GDP)	84.4	92.1	92.1	94.9	96.3	...	-	-

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 Q4	2014 Q1	2014 Q2	2014 Q3	08/14	09/14	Balance 09/14 ¹
Financing of non-financial sectors ²									
Private sector	-4.3	-8.2	-7.9	-6.4	-5.7	-4.9	-5.0	-4.7	1,728.2
Non-financial firms	-4.7	-10.6	-9.7	-6.9	-6.0	-4.9	-4.9	-4.7	970.9
Households ³	-3.8	-5.0	-5.5	-5.6	-5.2	-5.0	-5.1	-4.6	757.3
General government ⁴	15.0	16.8	13.0	8.5	6.6	5.9	6.2	6.2	1,020.7
TOTAL	0.6	-1.1	-1.6	-1.5	-1.5	-1.2	-1.2	-0.9	2,748.9
Liabilities of financial institutions due to firms and households									
Total deposits	-4.5	2.1	2.2	0.2	-0.8	-1.2	-1.4	-1.4	1,169.2
On demand deposits	0.2	4.2	8.1	7.4	7.4	13.6	13.5	13.5	313.0
Savings deposits	-2.8	-0.1	1.4	3.8	5.9	6.9	7.0	7.1	214.4
Term deposits	-6.7	1.7	0.2	-3.6	-6.1	-9.4	-9.8	-10.0	620.9
Deposits in foreign currency	-4.0	16.8	-0.1	-1.1	0.1	0.3	0.5	0.5	20.9
Rest of liabilities ⁵	-13.2	-16.8	-12.7	-11.1	-8.3	-6.8	-9.5	-10.7	114.9
TOTAL	-5.7	-0.2	0.5	-1.1	-1.6	-1.7	-2.2	-2.3	1,284.2
NPL ratio (%) ⁶	10.4	13.6	13.6	13.4	13.1	13.0	13.2	13.0	-
Coverage ratio (%) ⁶	73.8	58.0	58.0	58.6	59.4	59.1	59.3	59.1	-

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.

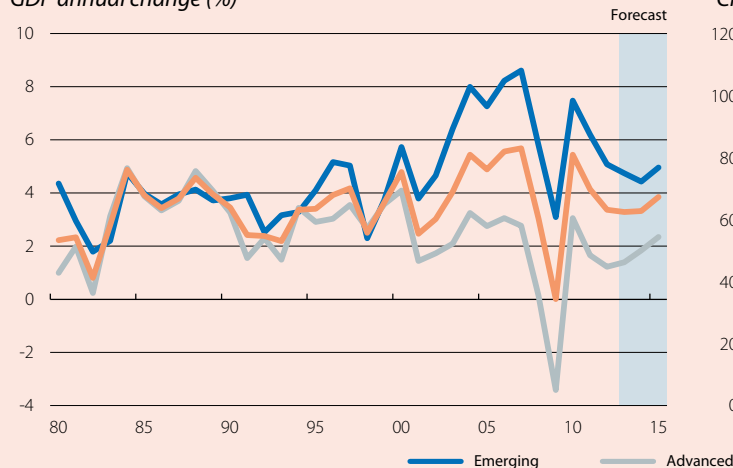
OUTLOOK 2015

Global recovery underway, with the permission of the US and the euro area

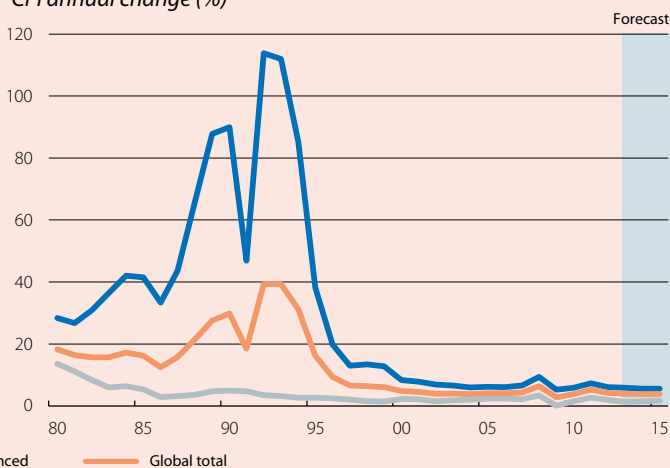
We predict 3.9% world growth for 2015. If you feel that this figure is rather high, then you are not mistaken: it is clearly above the annual average for the period 1980-2014 (3.5%) and also represents a jump up from the range observed over the last three years (3.2%-3.4%). In spite of the pessimistic tone prevailing in the forecasts of most international organisations in the last few months, they all predict that growth will speed up next year. There is therefore broad consensus regarding the direction the world economy is expected to take.

Growth and inflation forecasts for 2015

GDP annual change (%)



CPI annual change (%)



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

The driving force behind this recovery lies in both developed and emerging countries. Specifically, the IMF expects growth in the main developed countries to rise from the 1.8% forecast for 2014 to 2.3% in 2015 and the increase predicted for the main emerging countries is also considerable: from 4.4% in 2014 to 5.0% in 2015. By country, the United States and China stand out, providing 44% of global growth while their economic share of the world's total is just 33%. At the opposite end of the scale are Japan and the euro area which, in spite of accounting for 24% of the world's economy, will only contribute a meagre 17% to its growth.

Moreover, this acceleration in growth is not expected to be accompanied by an upswing in inflationary pressures. In fact, for the coming year global inflation is expected to rise by just 0.1 pps, reaching 3.9%. The developed countries have kept inflation at a distance for some years now and, given that many of them still have low utilization of production capacity, it comes as no surprise that, in general growth is increasing while inflation remains at a moderate level. Inflation prospects are particularly interesting in the main emerging countries: even if growth remains at a relatively high level, inflation will only increase by 0.1 pp (from the 5.5% expected for 2014 to 5.6% in 2015, specifically).

Naturally the fall in oil prices predicted for the coming year should help this scenario to come about.¹ But the underlying factors that lead us to believe the main emerging countries will be able to maintain a good rate of growth without this leading to inflationary pressure date from further back. Of note among these factors is the improvement in institutions responsible for designing economic policy; in particular the greater independence of authorities responsible for monetary policy, as well as greater awareness of just how important it is to keep a balanced macroeconomic situation.

Nevertheless, like last year, the risks threatening this scenario of global recovery are considerable. The different sources of geopolitical tension constitute one of the main factors that must be closely monitored. Ukraine, the Middle East, Isis... the list of ongoing conflicts that have intensified throughout 2014 is quite long. Theoretically, sooner or later common sense should prevail and the different parties should sit down at the negotiating table, with these conflicts gradually diminishing as a risk factor.

1. For a detailed analysis of the dynamics of oil prices, see the article «Weakness, shale and Saudi Arabia's strategy behind the upheaval in oil» in this Dossier.

However, such disputes are often promoted by minority groups with goals that are not standard and frequently unclear, making them difficult to predict.

In addition to geopolitical conflicts, we expect other risk factors that have accompanied emerging countries over the last few years to diminish in 2015. Specifically, one of the big fears recently hovering over analysts' forecasts was a sharp deterioration in China's economy. Although this cannot be completely ruled out as a risk factor, it is now less likely to happen. The Chinese government is demonstrating that it has instruments it can use to gradually direct the shift in its economic model towards lower but more sustainable growth rates in the long term. The risk of a systemic crisis breaking out in the main emerging countries has also diminished. The acronym of the «fragile five» economies used frequently a year ago, when the market did not discriminate between emerging countries and treated them as a common risk factor, now seems a distant memory. In the last few quarters it has gradually become clearer which countries have a healthier economic situation and are carrying out reforms to maintain balanced long-term growth (such as India and Mexico) and which are in a more vulnerable position (such as Brazil, Russia and Turkey).

In fact, from a global perspective the risk factors associated with developed countries seem more relevant, especially in the US and the euro area. Let's look at this step by step. At last the conditions in the US seem right for growth to reach levels of around 3%: the deleveraging process is now in its advanced stages; the real estate sector has completed its adjustment and both sales and prices have posted positive growth rates for several quarters; the labour market is responding to this improved economic activity with a job creation rate that is more than acceptable and unemployment has now fallen below 6%; while investment, the big task that was still pending for the US economy, has been growing apace for several quarters now. The macroeconomic outlook therefore provides the Fed with reasons to start normalising monetary conditions next year.

However, although this scenario seems reasonable, not all doubts have been dispelled. One of the most appreciable risk factors for the US economy is closely linked to its estimated potential GDP. After the recession, intense debate has arisen regarding the potential GDP of developed countries, especially those, like the US, whose growth was boosted by factors that were believed to be structural in the pre-crisis years but which have turned out to be merely temporary. This issue affects a scenario that could be particularly harmful for the global economy: the appearance of signs of overheating in the US, for example with upward pressure on wages sooner than expected. This scenario, which could materialise if observed and potential GDP are closer than believed, would reveal a lower growth capacity than predicted and would force the Fed to raise interest rates earlier than expected at present (and surely also accelerate the process of draining off the liquidity injected over the last few years). This would be a highly delicate scenario that would force the Fed to strike a difficult balance between gradually applying constrictive policies to ensure an orderly normalisation and pressure in the opposite direction from the aforementioned dynamics of the economy. At a global level, and beyond the consequences for financial markets (analysed in detail in the article «2015: monetary policy continues to set the tone for the financial markets» in this Dossier), this scenario could be highly detrimental for some emerging countries as they would lose the large amount of financing they receive from the United States.

Naturally, this scenario would also be harmful for the euro area as the United States is its main trading partner. The euro area continues to be a step or even several steps behind the US economy and, as we have seen in the last few months, its recovery is still very fragile. Although we do not believe the weakness observed recently is a precursor to a third recession, we do think that its growth capacity is very low and therefore vulnerable to any setback it may encounter along the way. In this respect, if the recovery ends up being slower than initially expected in the coming year (either due to the aforementioned external factors or due to internal factors), the support mechanisms already applied are likely to be intensified. In other words, even more accommodative monetary policy, extending the asset purchase programmes started up by the ECB over the last few months and, if necessary, launching new programmes that might include the direct purchase of sovereign and/or corporate bonds. It is also likely that such a decision would be accompanied by further relaxation of commitments to reduce fiscal deficits. Nevertheless, unlike the risk scenario for the United States, the global macroeconomic impact of a relapse in the euro area would probably be less significant. The effect of lower growth in the euro area would probably be felt by its closer neighbours, in particular the countries of Eastern Europe, but it should not affect other economic zones to any great extent.

In conclusion, when examined at a global level 2015 looks like it will provide some good figures, both for growth and inflation. However, this generally favourable situation contains some discordant notes including, unfortunately, the euro area. Moreover, the risks that have been threatening the main developed countries for several years now have not disappeared completely. We cannot let down our guard just yet.

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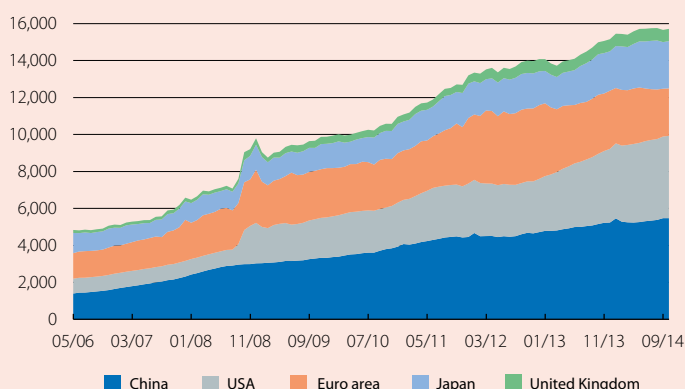
2015: monetary policy continues to set the tone for the financial markets

Monetary policy has played a vital role in financial market trends throughout the last few decades and this influence has become even greater, if possible, after the crisis that started in 2007. The extraordinarily accommodative monetary strategy implemented in unison by the main central banks helped to re-establish liquidity worldwide, which has ultimately provided a powerful boost for the recovery in the markets. It therefore comes as no surprise that a large part of attention is now focused on how these monetary authorities will act with a view to 2015. And some changes are expected.

In fact, as explained in the article «Global recovery is underway, with the permission of the US and the euro area» in this Dossier, for the first time in several years the monetary policies of the main central banks are going to be significantly different. Given the signs of improved economic activity in their respective countries, we can expect both the US Federal Reserve and the Bank of England to embark on their first official interest rate hike sometime in 2015, after ending their asset purchases in 2014. This shift in strategy contrasts with the greater monetary stimuli announced both by the European Central Bank and the Bank of Japan, given the weak outlook for their economies. The People's Bank of China, on the other hand, will continue its policy of «fine-tuning», at present leaning towards accommodation but far from the degree adopted by its Western peers. This new monetary scenario raises questions regarding the prevailing liquidity conditions in global financial markets in the future: will they be more restrictive or more lax; will they differ depending on the country and type of financial asset? The answers will largely depend on two factors: the volume of funds injected by the different central banks into system (which should be seen as «official liquidity») and investors' degree of risk aversion (crucial for the fluidity of private transactions).

Aggregate balance sheet of the main central banks

(Billion dollars)



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

encouraging more bonds to be issued. In a broader view, the divergence between monetary policies is likely to be reflected throughout the range of bonds. Expectations of a relatively imminent official interest rate hike in the US, together with the Fed putting a stop to its purchases of US government bonds, will push up Treasury yields. For instance, according to the forecasts of "la Caixa" Research, we expect the yields on two-year US bonds to rise by about 130 basis points next year. This figure clearly exceeds the 25-point rise predicted for German government bonds with the same maturity, as the ECB is keeping its official interest rates at their all-time low level and inflation expectations in Europe are still highly contained. Taking into account the fact that the sovereign debt of these two countries acts as a risk-free benchmark for other sovereign bonds in their respective currencies, this differential is likely to be passed on to corporate bonds, asset-backed securities, etc. (notwithstanding the corresponding risk premia, mentioned below). And the effects do not stop there. This change in spreads between assets on both sides of the Atlantic also has a very direct impact on the relative value of their currencies. The explanation is simple. The higher return offered by US assets will attract more capital towards dollar denominated assets, pushing up the currency's value against the euro. In line with this argument, the dollar has already become notably stronger over the last few months, going from 1.37 dollars per euro to almost 1.25. The medium-term outlook suggests the dollar will continue to appreciate although much more contained, coming close to 1.20 dollars per euro in the medium term.

With regard to the first factor, the ambitious figures involved in the new quantitative easing programmes announced by the ECB and Bank of Japan allow us to predict a notable increase in 2015 in the aggregate balance sheet of the aforementioned five large central banks. In other words, this variable will return to its upward trend that had halted in 2014 after the dramatic rises seen between 2007 and 2013. In principle, this means that the global monetary system will still be accommodative, even once the Fed raises its interest rates. But in addition to the extent of this overall expansion, the change in composition of the assets through which it will be carried out suggests that the consequences will differ depending on the financial market in question. One clear example is the trend in Europe's covered bond market: the ECB's announcement that covered bonds will be included as eligible assets to increase its balance sheet has already pushed up their price (and reduced their yield), as well as

At present, the map of macroeconomic risks indicates that the trends described for interest and exchange rates are more likely to sharpen rather than diminish. On the one hand, the US is facing a threat of increasing inflationary pressure, which could force the Fed to withdraw its monetary stimuli faster than originally planned. On the other hand, the euro area runs the risk of continuing to weaken and suffer from deflationary pressures, so the ECB might redouble its accommodative efforts for a longer period than expected. In both circumstances the spreads between the assets denominated in the different currencies will widen, making the dollar even stronger and testing the Fed's resolve to allow greater deterioration in the external competitiveness of the US economy.

The outlook for risk assets will essentially depend on the interaction between the liquidity situation, risk aversion and the fundamental variables for each kind of asset (earnings in the case of shares, the solidity of corporate balance sheets in corporate bonds, the state of public finances in emerging sovereign debt, etc.). Such interaction, always complex, will be particularly so in 2015. In an increasingly interconnected financial world and with fewer restrictions on capital movements, the monetary policy decisions of the main central banks have consequences far beyond their own borders and potentially crucial ones. The willingness of investors to take on risk plays a vital role in how such consequences are passed on. With a view to 2015, several questions still hang over the future scenario that could damage investor confidence and lead them to search for a safe haven in those assets considered to be safer, in turn leading to episodes of tension in those financial markets associated more strongly with risk. One clear example of this was the episode of financial agitation in spring 2013. At that time, fear of the Fed withdrawing its quantitative easing sooner than expected led to significant outflows of capital from emerging countries, resulting in sharp losses in assets as well as a depreciation of their currencies. Although further episodes of increased volatility in 2015 cannot be ruled out (whose triggers could come from monetary normalisation policy, the economic cycle or geopolitical conflicts), we expect the repercussions on emerging markets to be much less than those experienced in the spring of 2013. There are fundamentally two reasons for this greater stability. The first is that investors have learned their lesson from the turbulences in 2013, now leveraging any risk adopted much more effectively. They should therefore react less violently in any future episodes of capital outflows. The second lies in the efforts made to correct imbalances, both internal and external, by a large number of developing countries (especially India), reducing the potential sources of risk to just a few (such as Russia, Brazil and Turkey).

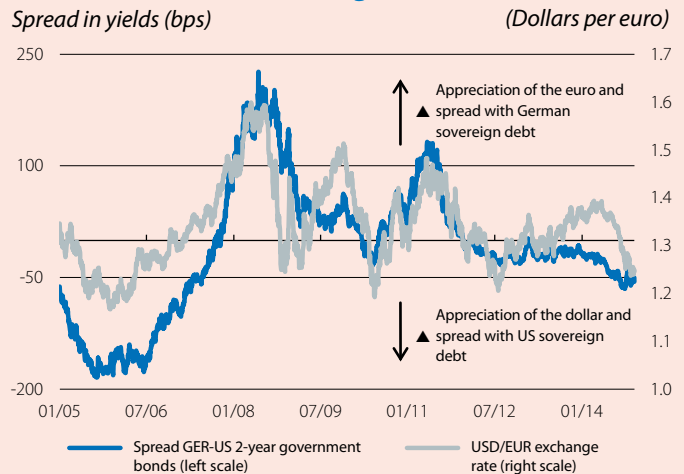
As has been observed in the recent episode of financial tension in October, the stock markets are also strongly affected by fluctuations in investor risk aversion. In this case further episodes of volatility cannot be ruled out as the uncertainties surrounding monetary strategy in 2015 are gradually resolved. However, the context of economic recovery should, in general, support further gains in equity. In the medium term, the European stock markets look most likely to enjoy gains as there might even be some pleasant surprises in corporate earnings over the coming quarters.

In conclusion, the important monetary decisions taken in 2015 will largely determine the trend in global financial markets. Given this situation, it is vital for central banks to adopt an orderly normalisation strategy, accompanied by effective forward guidance that dispels any possible doubts arising along the way. Only in this way will global financial stability be assured.

Joan Daniel Pina

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Yield on US and euro area sovereign debt and the euro-dollar exchange rate



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

Weakness, shale and Saudi Arabia's strategy behind the upheaval in oil

Oil is once again becoming a key factor for the short and medium-term economic outlook. After a period of relative stability (the Brent barrel has fluctuated around 110 dollars over the last three years), a sharp fall of more than 30% between June and November has taken most analysts by surprise. So have we embarked on a phase of «cheap» oil or will we see an equally sharp rise as this fall in the future? Although the answer to such a huge question goes beyond the purpose of this article, we might be able to provide some clues as to where prices will go in 2015 by merely describing some of the elements that lie behind this sudden decrease.

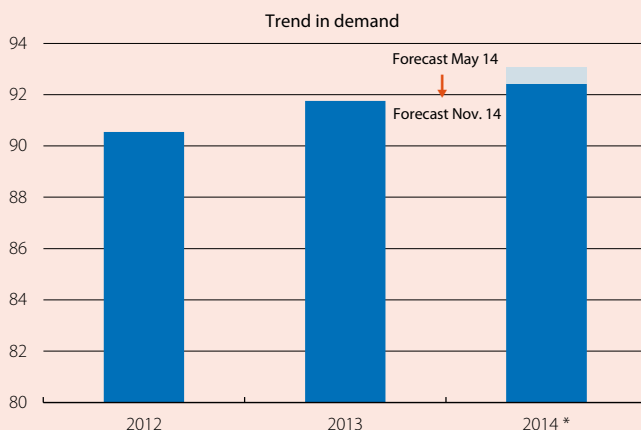
Without doubt, this downward correction has given oil importing countries some respite, especially many of the euro area economies whose growth is still weak. At the other end of the spectrum, oil exporters are suffering the consequences of unexpectedly lower prices. A reduction in their oil revenues could jeopardise the sustainability of their public accounts which are closely linked to this revenue, as well as put pressure on their external positions (deteriorating their current balances). In particular, the equilibrium price of their fiscal balances (the price at which the fiscal balance is zero) is significantly higher than 85 dollars per barrel in most cases although, naturally, not all of them have the same resources to withstand a period of low prices. For example, the fiscal equilibrium price for Saudi Arabia is above 90 dollars, but its ample international reserves and access to low cost financing provide it with a privileged position compared with other exporters such as Iran, Venezuela and Nigeria, to cite just three countries that also form part of the oil cartel, OPEC.

The convergence of different kinds of factors, related to both supply and demand, has helped oil prices to plummet. Concerning demand, of note is the error in predicting an increase in demand in 2014. The International Energy Agency (IEA) expected higher growth in the demand for oil than finally occurred, as can be seen in the continual downward revisions of its estimates, the last one in October (see the graph). Weaker global prospects, especially in the euro area, and a larger slowdown in growth rates in Asia, principally China, are two factors that have undoubtedly encouraged these continual reductions in the forecasts.

There is also the effect of the closure of a large number of long speculative positions held since the start of the summer within an overall risk-off situation regarding energy commodities in general and crude oil in particular. As well as the effect of the dollar's appreciation which, in the short-term, allows exporting countries to maintain their revenue even though the price per barrel is falling.

Imbalance between supply and demand

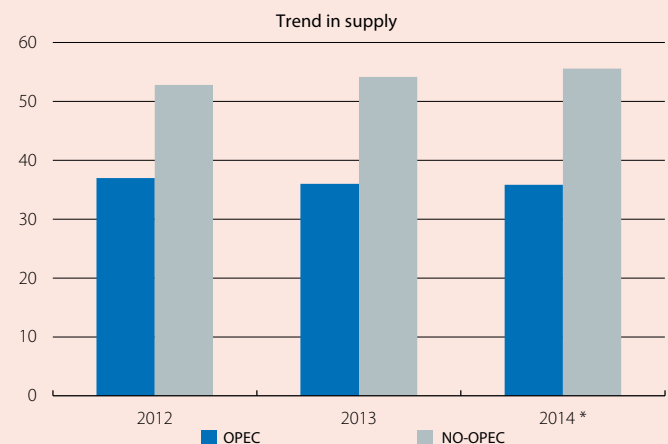
(Millions of barrels a day)



Note: * The 2014 data are a forecast.

Source: "la Caixa" Research, based on data from the IEA and EIA.

(Millions of barrels a day)



On the supply side, Libya's vigorous and unexpected return to the international oil scene after the disruptions in production caused by its armed conflict, together with an increase in production in Iran, Nigeria and Iraq, have all played an important part. However, two countries have contributed considerably to this huge correction: the US and Saudi Arabia. The shale oil (and gas) revolution has once again placed the US in the centre of the world's energy map. In spite of the relatively wide distribution of international shale reserves, today's production and exploitation are concentrated mostly in the US and Canada. In particular, US shale oil production accounts for around 35% of its total crude production (compared with 5% in 2005) according to the US Energy Information Administration (EIA). Shale gas is in the same proportion, also representing 40% of all the gas produced in the country. According to the IEA, the United States would become the world's leading oil producer before 2020, ahead of Saudi Arabia and would even take the place of Russia in terms of gas production, becoming almost self-sufficient in energy terms by around 2035.

However, in spite of this increase in supply, Saudi Arabia has not reduced its production by a single barrel. Over the last few years, it has used its privileged position to keep, as far as possible, world supply in line with demand at the time, helping it to maintain a relatively stable price. However, during the summer and the first few months of autumn, when the aforementioned changes in supply and demand materialised, OPEC's largest producer (accounting for one third of the cartel's total oil) did not reduce its production. This strategy has generated numerous economic and geopolitical theories. Low prices for a prolonged period of time would seriously punish Iran, Saudi Arabia's rival in a religious and political battle between Shiites (Iran) and Sunnis (Saudi Arabia) which they have been fighting for more than thirty years. Similarly, due to the specific characteristics of the shale industry, it is believed that a price substantially below 100 dollars, such as the present, could slow up shale investment in the US, which would help Saudi Arabia to keep hold of its market share. Whatever the reason, it seems clear that Saudi Arabia has embarked on a low price war, making the path that might be taken by the price of crude oil over the coming months even more uncertain.

Although it is not very likely, a slowdown in the shale fuel boom in the US would have significant economic consequences both at a local level (within the US economy itself) and globally. In the US, shale exploitation (both for oil and gas) has come as a considerable boost for the American extraction industry at a time when many industrial sectors were in crisis. According to data from the US Bureau of Economic Analysis, between 2007 and 2013 the production and number of workers in the energy sector grew by 36% in both cases. These data contrast with the trend in production and employment for the US economy as a whole over the same period, namely 14% and -2%, respectively. Although the modest relative weight of this sector in US production overall means that any direct effects are moderate, analysts are focusing their attention on the possible indirect effects in operation through the country's energy production and consumption structure. Specifically, in a report published recently, the Federal Reserve points out that energy-intensive industries have benefitted, and will continue to benefit, considerably from the drop in US gas prices and that, taking into account the fact that companies adjust their production gradually, the effects of the boom have yet to be seen in their entirety. That's why, for the moment, the estimated rise in manufacturing activity and employment is still at a moderate 2-3%.^{1,2} The shale revolution should also result in an improvement in the country's external balance in the medium term. As of today, close to 50% of its current deficit comes precisely from meeting its energy needs.

At a global level, shale has led to considerable price stability within the higher ranges. The balance between supply and demand has always been fragile, especially due to supply's relative inelasticity to growing demand. Given this situation, shale oil has provided a new source of supply for crude oil at prices from 80 to 100 dollars. In economic terms we could say that the supply curve has flattened out in the higher price zone. This has allowed demand to rise without pushing up prices, unlike what has happened in the past. The 140 dollars per barrel paid in mid-2008 are now a distant memory.

Cheap oil for a relatively long period of time, leading to less investment in non-conventional exploitation in the US, could thwart the improvements in production of numerous industrial sectors in the country, as well as increase fluctuations in prices internationally. Although lower oil prices should be an advantage for a net importer (such as the United States), halting the shale oil revolution could lead to a significant slowdown in the US shale gas revolution, which is very important for the country's industrial sector. Advances in fracking techniques, used to release both shale oil and gas, have clearly benefitted from the large number of exploitations not only of gas but also oil. Similarly, numerous underground shale deposits contain significant amounts of oil and gas so that a drop in oil prices could thwart investment in this kind of exploitation and therefore part of the future production of gas. Lastly, also of note are the advantages in lower energy dependence given the high volatility of oil prices due to ever-present and unpredictable geopolitical tensions.

Nonetheless, two elements are acting in favour of the shale revolution continuing. First, the rapid increase in productivity of fracking techniques makes it unlikely that a relatively cheap price such as the present might push shale out of the game. Second, the difficulties imposed by Saudi Arabia's low-price strategy on several members of OPEC mean that, sooner or later, the oil cartel will agree to reduce supply and the price per barrel will therefore recover part of the ground lost over the last few months. In this respect, it is no wonder that the decision taken last 27 November to keep OPEC's overall production ceiling the same came as a surprise.

In short, after an unusually long period of stable oil prices, the convergence of several factors has created uncertainty regarding the outlook for the short and medium term. The bulk of the evidence available suggests that, at least in the short term, oil will remain at a lower price than we have seen over the last few years. However, we are well aware of how oil prices work: as soon as you analyse why they have fallen or risen, they go up or down again. The only sure thing is that we will have to keep a close eye on them.

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1. See Melick, William R. (2014). «The Energy Boom and Manufacturing in the United States.» FRB International Finance Discussion Paper.

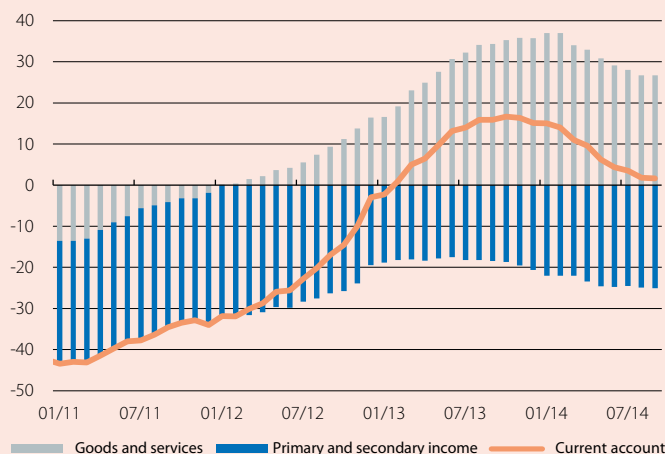
2. The limited integration of US gas in the international market means that its price is determined by local supply and demand and the shale gas boom has therefore been a key factor in the price falling.

Correcting the external deficit: high and low points

One of the greatest achievements of the Spanish economy during the crisis has been the correction of one of its main macroeconomic imbalances: the external deficit. Whereas, in 2008, the current account deficit accounted for 10% of GDP, in 2013 it posted a modest surplus of 1.4% of GDP, the first in 25 years.¹ However, the current account has deteriorated again during 2014. Between January and September the current account balance accumulated a deficit of 4.2 billion, contrasting with a surplus of 9.3 billion over the same period in 2013. This situation has set alarm bells ringing: it seems as if the Spanish economy cannot (or doesn't know how to) grow without accumulating an external deficit. Nevertheless a more detailed analysis helps us to temper this conclusion, of the utmost importance given the Spanish economy's large external debt.

Current account balance

Cumulative over 12 months (billion euros)



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

2014's deterioration in the current balance can essentially be explained by two factors. On the one hand, nominal imports of goods and services, which fell by 2.7% in 2013, grew by 5.1% during the first nine months of 2014 compared with the same period a year ago. This increase is due to the fact that the components of domestic demand that have grown the most during the recovery starting in 2013 Q3 have been the private consumption of durables, such as domestic appliances and automobiles, and investment in equipment, both with a strong import content.² On the other hand, nominal exports of goods and services performed badly, going from 3.5% growth in 2013 to 2.2% for the year to date up to September compared with the same period a year ago.

Although these trends are likely to change direction in the coming quarters as domestic demand shifts towards goods and services with less import content and European demand improves, the deterioration in 2014's balance of trade has highlighted the vulnerability of the adjustment taking place.

This has revived debate regarding the importance of

determining the relative weight of cyclical and structural factors in the current account deficit correction. A cyclical adjustment, which reflects weak domestic demand and a high output gap, means that the current balance will record a deficit again as soon as production picks up and GDP comes close to its potential figure. If, on the other hand, the adjustment is mostly structural in nature, i.e. a result of improving productivity and redirecting production resources towards the export sector, then it could grow without a deterioration of the external balance.

In practice, calculating the cycle-adjusted current balance will crucially depend on the estimate for potential GDP and the output gap. But there is one drawback: potential GDP is a theoretical construct and, as such, cannot be observed. Consequently the conclusions reached can be very different depending on the trend in potential GDP employed. For example, the EC estimates that most of the deficit correction between 2009 and 2013 would be structural.³ Specifically, it attributes 9.8 of the 11.1 points of correction to this; i.e. 88% of the adjustment. According to these estimates, the cycle-adjusted current account deficit stood at -0.2% of GDP in 2013 (the surplus recorded was 1.4%). This result comes from assuming a significant reduction in potential GDP, so the output gap would almost be closed. The IMF, however, assumes a smaller drop in potential GDP and, consequently, is less optimistic regarding the extent of structural correction. Specifically it estimates that around 30% of the adjustment can be put down to cyclical factors.⁴

Given the difficulty in discerning, with any reliability, what proportion of the adjustment has been structural due to the high degree of uncertainty surrounding such estimates, the Spanish economy should focus on bolstering a current surplus with a sufficiently wide margin to make sure it can reduce its external debt position. The latest data available, referring to 2014 Q2, show that the country's net international investment position (NIIP) rose to -999 billion euros; i.e. a debt position equivalent to 95% of GDP.⁵ This figure is far above the threshold of 35% set by the EC in its evaluation of the macroeconomic imbalances of EU countries, highlighting the importance of bringing this down to a more sustainable level.

1. The data used in this article correspond to the methodology employed in the new balance of payments manual (BPM6), except for the data from 2008, which correspond to the previous methodology.

2. Import content refers to the proportion of the value of production corresponding to the consumption of imported intermediate goods. This means that, when private consumption or investment increases, imports also increase.

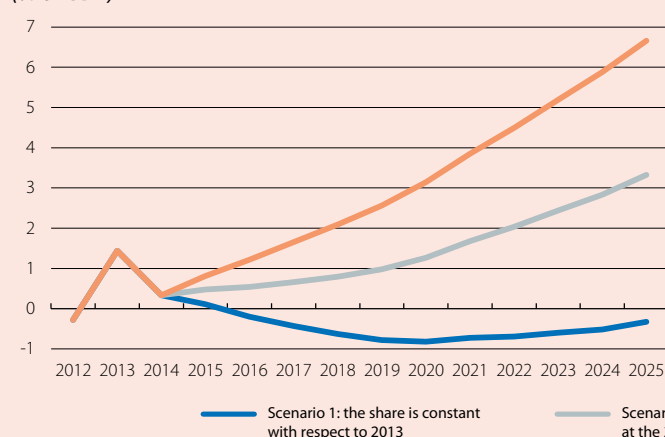
3. «The cyclical component of current-account balances», European Economic Forecast Winter 2014.

4. «Rebalancing in the euro area and cyclical current account adjustments», IMF WP 14/130, July 2014.

5. The NIIP is the difference between a country's investments abroad (assets) and investments from other countries (liabilities). If the balance is negative, it equals the net external debt.

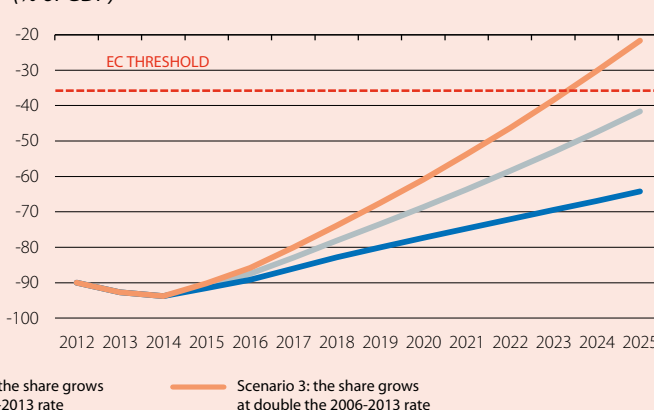
Trend in the current account balance

(% of GDP)



Trend in the net international investment position

(% of GDP)



Note: The share refers to the share of Spanish exports (Spanish exports to a country out of all of that country's imports).

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

We will outline different scenarios to provide a more accurate analysis of the impact of the current account balance on the trend in the NIIP. In a first scenario, we assume that export shares (Spain's exports to a country out of the total imports carried out by the country in question) remain constant at the 2013 level and, therefore, exports only increase as foreign demand grows (we assume that each country's imports grow at a rate equal to their growth in GDP). In a second scenario, we apply the hypothesis that export shares increase every year at the same rate as the annualised increase in the period 2006-2013. Lastly, in the most optimistic scenario, we assume that export shares accelerate and grow twice as fast every year as in scenario 2.

The growth projections for domestic demand of "la Caixa" Research are used for all these scenarios. Specifically, imports are estimated based on the import content of the components of domestic demand and of exports. For each of the scenarios, the trend in exports and imports of goods and services is projected under the different assumptions described above and the balance of trade is calculated.⁶

In the first scenario, the most conservative, the average annual rise in nominal exports between 2015 and 2025 would be 2.6%, the same as for imports. This means that the current balance will remain slightly negative until 2025. In this case, the NIIP is only reduced thanks to the denominator effect; i.e. thanks to growth in nominal GDP. Consequently, the adjustment in the international debt position would be very gradual and it would not fall below 35% until 2035, in 20 years' time!

This scenario highlights the fact that it is not enough for Spain to maintain its competitive position achieved so far. Further gains need to be made in competitiveness. The second scenario aims to reflect this situation, where we assume that export shares grow at the same rate as in the period 2006-2013. In this scenario, nominal exports would increase by 4.3% per year on average and imports by 3.2%. Consequently, the current account surplus would increase gradually, reaching 3.3% of GDP in 2025 and this would lead to a substantial correction in the NIIP, passing the 35% threshold in 2027.

To illustrate what would happen in a more optimistic scenario, where far-reaching structural reforms are introduced to accelerate gains in competitiveness, we assume that the rate of growth for export shares is double the previous scenario. In this case nominal exports would grow at an average annual rate of 5.6% and imports by 3.7%. The current account balance would increase considerably, reaching 6.7% of GDP in 2025. The NIIP would fall below 35% in 2024.

In short, the correction of the current balance over the last few years has been the first step in stabilising the external position of the Spanish economy but further improvements need to be made to guarantee the sustainability of external debt in the long run. To achieve this, it is vital to continue implementing all those measures that help make gains in competitiveness. Only in this way will the Spanish economy's growth be sustainable and balanced.

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6. To calculate the current account balance, the "la Caixa" Research forecasts were used for the primary and secondary income accounts (the same ones in all three scenarios) and added to the balance of trade. The net borrowing/lending of the economy was calculated by adding together the current account and the capital account. For simplicity's sake, the latter is assumed to be equal to 0.6% of GDP in each period (in line with the historical average). Lastly, the NIIP of a period is equal to the NIIP of the previous period plus net borrowing/lending, assuming there is no valuation effect for the NIIP. Valuation effects correspond to changes in the value of stock of external assets held by residents and in the value of stock of external liabilities held by non-residents.



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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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