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MONTHLY REPORT • ECONOMIC AND FINANCIAL MARKET OUTLOOK

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ECONOMIC & FINANCIAL ENVIRONMENT

FINANCIAL MARKETS

The decoupling of gas and oil prices

INTERNATIONAL ECONOMY

*Shanghai-Hong Kong Stock Connect:
connecting with the Chinese stock market*

EUROPEAN UNION

*The ECB finds itself in an alley with just
one exit: QE*

SPANISH ECONOMY

On the sustainability of the pension system

DOSSIER: REASON AND EMOTION IN DECISION-MAKING

*Price formation in financial markets:
between reason and emotion*

*Portfolio management: from theory
to practice*

*The transformation of household
confidence after a crisis*

The soul of companies



"la Caixa" Research

MONTHLY REPORT - ECONOMIC AND FINANCIAL MARKET OUTLOOK

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Black gold: the focus of attention in 2015

One of the main sources of uncertainty for the world economy throughout 2015 is going to be the trend in oil prices. There are essentially two questions to be answered here: firstly, in what price range will the market find its new equilibrium in the short term? And, secondly, to what extent will this equilibrium last? Or, in other words, is this just a temporary slump in oil prices and they will soon return to their long-term trend, perhaps at their level between 2011 and 2014?

In a few months, the price of crude has fallen by almost half. Although it is true that Europe's frail economy and the slowdown in China may have had some influence, an analysis of the market shows that the fall in prices is due more to supply than demand. The supply of crude oil from countries that are not members of the Organization of the Petroleum Exporting Countries (OPEC) has increased but this has not been accompanied by a reduction in production by the OPEC countries. This is a new situation. On other occasions, OPEC used to try to adjust its supply when other suppliers increased their production, even though this might not always have been achieved due to the difficulty in maintaining discipline among its members. Now, however, it has been OPEC's own leading country, Saudi Arabia, that has declared its intention to maintain its production levels even after the slump in prices. This change in stance has surprised investors, who have quickly adapted their strategies to the new environment and thereby speeded up the adjustment in the price of crude oil. What does Saudi Arabia hope to achieve? How long will it try to keep this strategy going?

One way of attempting to answer such questions is by examining the effect of low prices on different oil producers. The countries most severely affected are those whose public finances and balances of payment become unsustainable when the price falls below 60 dollars a barrel. Low prices also affect the financial viability of much of the new oil supply that has emerged recently, buoyed by prices exceeding 100 dollars a barrel. This supply includes shale oil in the United States but also drilling for crude oil at very deep offshore sites.

With its low price strategy, Saudi Arabia might be attempting to deter (high cost) marginal investment in the industry and thereby preserve OPEC's dominance. Moreover, and without considering geopolitical factors, this policy would also reaffirm the leading role of the Saudi kingdom within its own cartel. It is, undoubtedly, the producer with the greatest capacity to withstand prices at their current level given that it has very low production costs, the largest crude reserves on the planet and a large buffer of international reserves.

Should this interpretation of Saudi's strategy be roughly correct, the period of low prices, i.e. within the range of 60 to 70 dollars, would probably last for several quarters and, once its aims had been achieved and providing the world economy grew significantly, the price would return to higher, more sustainable levels in the medium term, at around 80 or 90 dollars a barrel.

In short, the fall in crude oil prices is unlikely to be permanent but neither is it a temporary phenomenon free from any macroeconomic effect on its own industry. The most probable outcome is that low prices will last long enough to have a positive effect on oil-consuming countries and significant effects on competition within the industry. However, given that oil is still a scarce resource, its price should logically go up again in the medium term and we may even see 100 dollars a barrel again. Consequently we should not give up our policies to save energy and use it more efficiently but, in the meantime, a period of more affordable prices is very welcome in economies that are net importers of oil, such as the euro area whose low growth is causing serious political tensions in many of its member states.

Jordi Gual
Chief Economist
31 December 2014

CHRONOLOGY

DECEMBER 2014

- 16** Russia's central bank raises the official interest rate by 6.5 pps to 17% to slow down the rouble's depreciation.
- 24** Shinzo Abe is re-elected as Japan's Prime Minister.
- 29** Early elections are called in Greece.

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.

AGENDA

JANUARY 2015

- 8** Index of economic sentiment euro area (December).
Household savings rate (Q3).
- 9** Industrial production index (November).
- 15** Financial accounts (Q3).
- 16** Loans, deposits and NPL ratio (November).
- 22** Labour force survey (Q4).
Governing Council European Central Bank.
- 27** Fed Open Market Committee.
- 30** CPI flash estimate (January).
Flash GDP (Q4).
Flash GDP of the United States (Q4).
- 31** Balance of payments (November).
Index of economic sentiment euro area (January).

FEBRUARY 2015

- 6** Industrial production index (December).
- 12** European Council.
- 13** Flash GDP of the euro area (Q4).
- 16** Flash GDP of Japan (Q4).
- 18** Loans, deposits and NPL ratio (December).
- 26** Quarterly national accounts (Q4).
Index of economic sentiment euro area (February).
- 27** CPI flash estimate (February).
Balance of payments (December).

2015 starts off with signs of recovery

The global recovery has advanced to some extent at the start of 2015 but downside risks have also increased. The latest data available point to 2014 ending with a relatively widespread trend of higher growth. This is a good foundation for 2015 to provide us with even more noticeable expansion, which would bring world growth for the year we have just started to 3.9% (3.2% in 2014). But some downside risks have emerged together with this underlying positive trend. Firstly, entrenched geopolitical risks are clearly creating uncertainty and ultimately financial volatility. For example, the complicated poker game between oil producers has ended up pushing crude oil prices down to levels that, should they continue, could start to destabilise some economies. Moreover, in the same geo-strategic area it has been confirmed that the entrenchment of conflictive fronts is finally eroding not only the parties involved but also a wider environment. Russia would be a case in point for both risks, with the country teetering on the verge of a potentially severe recession.

The United States and China now face the challenge of handling a more mature cycle. These countries share two important aspects at a global level: both are fundamental in terms of their contribution to world growth and both are now starting to tackle aspects typical of more mature phases of the cycle. In the US, the most recent data point to the economy entering a clearer phase of expansion. Given the absence of any appreciable inflationary tensions, the Federal Reserve has no need to hurry its monetary normalisation and is attempting to prepare economic agents for a different financial scenario via its forward guidance. Such an effort is crucial as each positive macroeconomic figure in the US has had a knock-on effect in the form of foreign exchange weakness in economies such as Mexico and Colombia, a reminder of just how closely the market is watching in this new monetary phase. Meanwhile China is attempting to actively manage its economy as it enters a phase of relatively low growth. Indicators suggest that the slowdown is gradual and it is reassuring to think that the country also has considerable room for manoeuvre in terms of its fiscal and monetary policy. Nonetheless, it is critical for this process to be gentle since, otherwise, the anxiety seen in the summer of 2014 regarding a hypothetical hard landing for China could be repeated.

The recovery is continuing in the euro area but slowly and with differences between countries. Any analysis of

the underlying trends in the current situation faced by the euro area must necessarily make a wealth of fine distinctions. On the one hand, it is clear that economic activity is increasing. Figures from the final part of the year confirm that the euro area is moving away from the stagnation seen in the summer. Moreover, the factors that are driving this recovery look like continuing: private consumption, the component of domestic demand with the greatest inertia, is picking up and the effects of the euro's depreciation and falling oil prices will have considerable impact in 2015. However, the rest of the panorama is less encouraging. In Europe, the political risks mentioned above are crystallizing in the political uncertainty in Greece. But it is not just the political front that causes concern: the economy is not entirely free from risk either, affected by a recovery that is too slow and unevenly spread among countries. Lastly, the threat that this current situation of low inflation might become a deflationary phase has not diminished. Given this situation, and given the modest success of its long-term liquidity auctions, the ECB is very likely to start a large-scale programme of public debt purchases during the first quarter. This new monetary expansion will be accompanied by the so-called Juncker plan which attempts to improve private investment in the EU via public guarantees. In short, extraordinary measures are being taken in Europe to allay equally extraordinary risks.

The other, more positive side of the coin for growth - Spain. In spite of this uncertain situation, our economy is enjoying favourable growth. The latest data confirm that domestic demand speeded up in the last part of 2014, fundamentally as a result of improved confidence regarding growth prospects. In the short term, this factor makes our cycle somewhat independent from the more contained cycle of the euro area. However, in terms of inflation, prices are still falling in Spain (-0.4% year-on-year in November). Although this disturbing figure is largely because of the drop in oil prices, even after discounting the volatile components of energy and fresh foods inflation still has not risen since last May. However, our forecasts point to core inflation abandoning this zone of zero growth as from the beginning of 2015 (general inflation will follow suit later on). In short, Spain seems to be prepared to tackle this stage of higher global uncertainty from the end of 2014 relatively well. But it would be even better if some of the world's riskier injuries could be healed quickly.

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	2.7	2.2	3.6	3.2	2.7
Euro area	-0.4	0.8	1.3	1.8	0.8	0.8	0.7	0.8	1.2	1.5
Germany	0.2	1.5	1.5	1.9	1.4	1.2	1.1	0.8	1.4	1.8
France	0.4	0.4	0.8	1.3	0.0	0.4	0.4	0.6	0.9	0.9
Italy	-1.9	-0.4	0.5	1.2	-0.4	-0.5	-0.4	-0.1	0.3	0.7
Spain	-1.2	1.3	1.9	2.2	1.3	1.6	1.8	1.9	2.0	1.9
Japan	1.6	0.3	1.2	1.1	-0.3	-1.2	0.3	-0.7	1.5	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	0.4	-2.5	-0.1	0.8	0.7	-0.6	-2.0	-3.1	-3.0
Turkey	4.1	2.6	3.3	4.6	2.2	1.7	2.0	2.5	3.1	3.4
Poland	1.6	3.3	3.4	3.9	3.4	3.3	2.8	3.0	3.3	3.5
South Africa	2.2	1.4	2.3	2.8	1.3	1.4	1.1	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	1.6	1.0	2.3	2.1	1.8	1.3	0.8	0.6	0.9
Euro area	1.4	0.4	0.7	1.5	0.6	0.4	0.2	0.0	0.5	0.9
Germany	1.6	0.8	1.1	1.6	0.9	0.8	0.5	0.4	0.8	1.4
France	1.0	0.6	0.7	1.3	0.8	0.5	0.3	0.1	0.4	0.9
Italy	1.3	0.2	0.6	1.1	0.4	-0.1	0.1	0.0	0.3	0.8
Spain	1.4	-0.2	0.3	1.6	0.2	-0.3	-0.5	-0.7	-0.1	0.6
Japan ³	0.4	2.7	1.8	2.3	3.6	3.3	2.3	1.9	0.6	1.7
United Kingdom	2.6	1.5	1.5	1.9	1.7	1.5	1.0	1.0	1.4	1.7
Emerging countries										
China	2.6	2.0	2.1	2.5	2.2	2.0	1.6	2.1	2.5	2.4
India ⁴	6.3	3.7	2.9	4.6	5.8	2.4	1.6	2.5	2.2	2.2
Indonesia	6.4	6.3	5.6	5.8	7.1	4.5	5.7	5.4	5.5	5.6
Brazil	6.2	6.3	6.0	5.6	6.4	6.6	6.6	6.2	6.0	6.0
Mexico	3.8	4.0	3.5	3.1	3.6	4.1	4.1	3.7	3.6	3.4
Chile	2.1	4.1	3.3	4.3	4.5	4.7	4.0	3.5	3.4	4.4
Russia	6.8	7.7	8.2	5.6	7.6	7.7	9.2	9.2	8.6	8.0
Turkey	7.5	8.9	7.1	6.3	9.4	9.2	9.1	7.4	7.1	7.0
Poland	1.2	0.3	1.4	2.3	0.5	-0.1	0.0	0.8	1.5	1.5
South Africa	5.8	6.1	4.9	5.5	6.5	5.9	6.1	4.3	4.8	4.9

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	2.1	1.6	2.3	2.7	2.9	2.7	2.2	1.8
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	5.0	4.5	3.2	3.1	3.9	5.1	4.7	5.0
Capital goods	5.6	11.9	8.6	5.8	12.7	9.5	9.8	9.9	8.2	8.5
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	1.8
Exports of goods and services	4.3	4.6	5.9	5.1	1.5	4.6	6.1	7.3	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	2.2	1.3	1.6	1.8	1.9	2.0	1.9
Other variables										
Employment	-3.2	0.9	1.7	1.8	0.8	1.4	2.0	2.1	1.7	1.6
Unemployment rate (% labour force)	26.1	24.5	22.9	21.6	24.5	23.7	23.9	24.1	22.7	22.2
Consumer price index	1.4	-0.1	0.3	1.6	0.2	-0.3	-0.5	-0.7	-0.1	0.6
Unit labour costs	-0.4	-0.5	0.1	1.0	-0.1	-0.4	-0.4	0.0	-0.5	0.3
Current account balance (cum., % GDP) ¹	0.8	-0.2	0.1	0.4	-0.2	-0.2	-0.2	-0.1	-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	0.5	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	0.23	0.72	1.65	0.23	0.23	0.24	0.32	0.56	0.88
12-month Libor	0.68	0.56	1.21	2.11	0.54	0.56	0.57	0.75	1.02	1.38
2-year government bonds	0.30	0.44	1.26	2.27	0.40	0.50	0.52	0.73	1.05	1.46
10-year government bonds	2.33	2.53	3.09	3.73	2.61	2.49	2.27	2.59	2.96	3.29
Euro										
ECB Refi	0.54	0.16	0.05	0.05	0.22	0.12	0.05	0.05	0.05	0.05
3-month Euribor	0.22	0.21	0.05	0.06	0.30	0.16	0.08	0.05	0.05	0.05
12-month Euribor	0.54	0.48	0.32	0.36	0.57	0.44	0.33	0.32	0.32	0.32
2-year government bonds (Germany)	0.13	0.05	-0.05	0.09	0.10	-0.01	-0.04	-0.05	-0.05	-0.05
10-year government bonds (Germany)	1.62	1.23	0.68	1.11	1.43	1.06	0.76	0.66	0.67	0.68
EXCHANGE RATES										
\$/euro	1.33	1.33	1.18	1.15	1.37	1.33	1.28	1.22	1.19	1.16
¥/euro	129.65	140.42	146.92	144.90	140.11	137.68	142.92	146.80	146.36	146.15
£/euro	0.85	0.81	0.78	0.78	0.82	0.80	0.79	0.78	0.78	0.78
OIL										
Brent (\$/barrel)	108.47	99.45	69.13	84.68	109.65	103.38	77.05	61.93	66.43	71.68
Brent (euros/barrel)	81.67	74.83	58.58	73.64	79.96	78.02	61.68	50.77	55.83	61.80

Note: 1. Four quarter cumulative.

Forecasts

CURRENT SITUATION · Positive prospects but greater volatility, the scenario for 2015

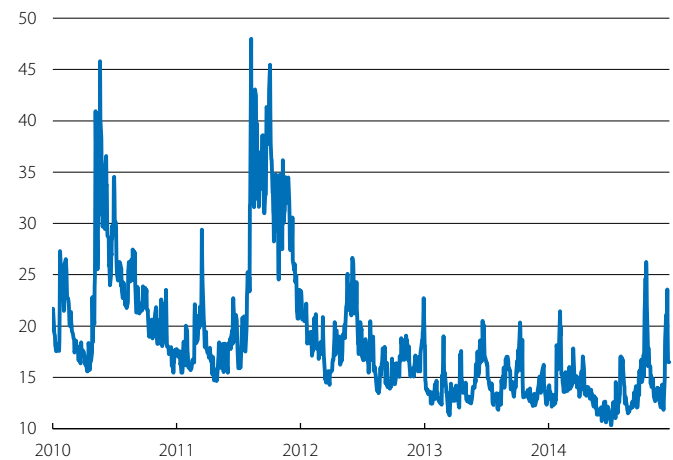
The year ended in a volatile mood after the relative peace and quiet of the first half of 2014 with international markets suffering the consequences of new setbacks in December. The fall in the price of crude oil, the rouble crisis and political instability in Greece all interrupted the calm reigning in November. The weak demand for funds by European banks in the ECB's second TLTRO and the unanchoring of inflation expectations have not helped the situation either, adding pressure to the monetary authority to start buying up the region's sovereign debt. These factors have led to further corrections in risk asset prices, particularly affecting emerging countries and the energy industry. However, the support of the safety net provided by global monetary accommodation, improved world growth and investors' search for yield look like laying the foundations for risk assets to perform well in 2015.

The Fed changes its rhetoric but not its intentions. At its last meeting of the year, the central bank upgraded its economic outlook for the next two years although it expects inflation to remain below 2% due to pressure from energy prices. It also introduced changes in its forward guidance by stating that, within the current context of improved economic activity in the US and a dynamic labour market, the institution will be «patient» about starting to normalise its monetary policy. Although it has abandoned the premise that it would keep interest rates low for «a considerable time», the underlying message is still highly accommodative. At the subsequent press conference, Chairman Janet Yellen noted that its monetary strategy will be affected by the trend in economic data and inflation but indicated that no hike in interest rates is likely to occur in the first two meetings of the year.

The ECB decides to launch a public debt purchase programme (QE) in 2015 Q1. At its last meeting of the year, the institution's Governing Council (GC) made no changes to official interest rates or to the parameters of its unconventional policy, albeit noting that the expansion of its balance sheet by a trillion euros is now classified as an «intention» when it had previously been seen as an «expectation». The ECB also acknowledged that economic activity and inflation are turning out to be weaker than expected. It therefore argued that it was still too early to evaluate the effectiveness of the measures already implemented (TLTROs, purchases of covered bonds and ABS), pointed out that large-scale public debt purchases are included among the possible measures and remarked that a unanimous Council would not be required to approve such measures. We therefore expect the institution to announce, early in 2015, that it is going to launch a quantitative easing programme totalling around 500 billion euros and lasting one year.

VIX index of global aversion in financial markets

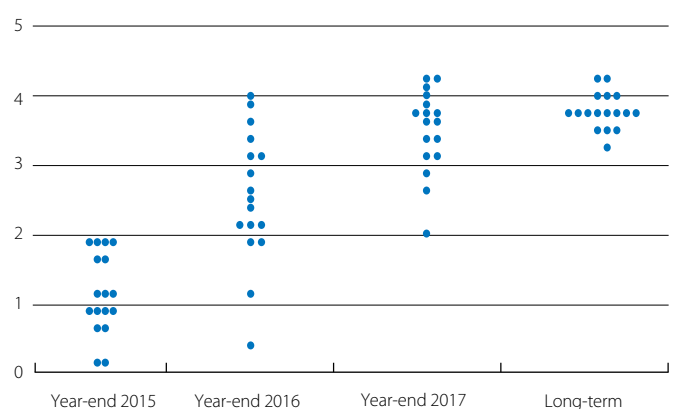
(Index)



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

Fed: appropriate level for the official interest rate *

(%)

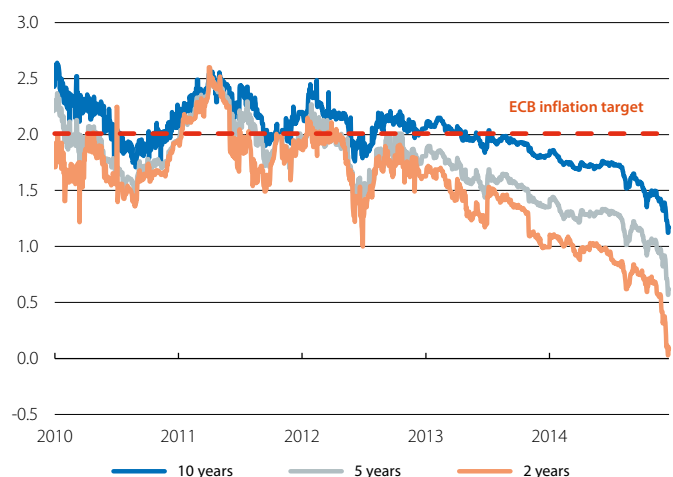


Note: * According to Committee members at 17 December.

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

Euro area: inflation expectations *

(%)



Note: * Calculated based on inflation-linked swaps.

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

Modest demand in the TLTRO. Europe's banks requested almost 130 billion euros in the ECB's second long-term refinancing operation, slightly below the 150 billion expected by the consensus of analysts. In the two TLTROs carried out, the ECB has placed 212.4 billion euros, representing 53% of the total amount available.

The crisis of confidence regarding Russia has become a currency crisis due to the country's weak economic foundations, the downward slide in oil prices and international sanctions. The Russian currency depreciated by 30% in a single session, something the country had not seen since its financial collapse in 1998. Finally, the emergency actions taken by Russia's central bank managed to limit pressure on the rouble and redirect the extreme levels of volatility. Specifically, the monetary authority increased the official interest rate to 17% from 10.5%, intervened in the foreign exchange market by selling foreign currency reserves and announced new measures to provide banks with liquidity. In the rest of the emerging countries, of note is the active stance taken by China's monetary authorities on the macroprudential front after lowering official interest rates last month. The restriction on the use of low-rated corporate bonds as collateral in refinancing operations for financial institutions is aimed at preserving the Asian giant's financial stability.

The outbreaks of volatility boost US Treasuries. Stability has dominated the US debt market with the yield on short-term debt notably approaching the level of Fed funds (i.e. the official interest rate). The absence, so far, of any inflationary pressures and the consequent continuation of accommodative monetary policy by the Fed have brought about this situation. Over the coming months the central bank's normalisation strategy could create greater volatility and lead to an upswing in yields in the short tranche of the Treasury curve.

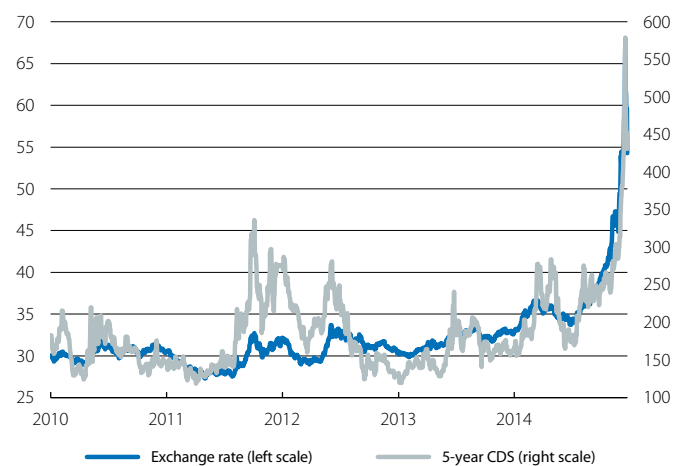
Upswings in volatility also boost German public debt, with the expectation of a sovereign debt QE by the ECB as an additional support. Larger flows towards safe assets (a flight to quality) due to sources of instability at a global level (falling oil prices and the Russian crisis) and at a European level (political disagreements in Greece) have pushed down yields on German bonds. Debt with maturity of between 1 and 4 years now has a negative yield and, in the case of the 10-year bund, this has fallen to a new minimum (0.6%). This trend has also been encouraged by more moderate expectations regarding economic growth and a reduction in the German Treasury's gross borrowing planned for 2015, the lowest level in 13 years.

Peripheral Europe, prepared for the launch of sovereign QE. The uncertainty regarding early elections in Greece and the Syriza party leading the polls have strongly pushed up yields on Greek sovereign debt. The likelihood of the Greek government being taken over by a party that is against the reforms demanded by the troika and against the bail-out programmes represents a considerable obstacle for Greek

Russia: trend in sovereign CDS * and the rouble

(Roubles per dollar)

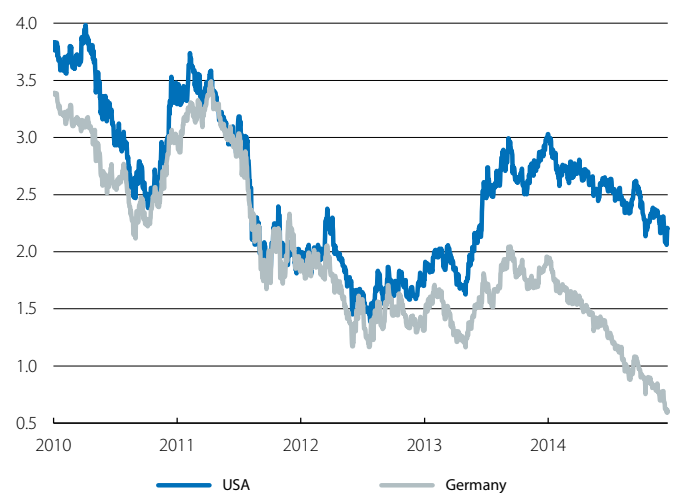
(bps)



Note: * Credit default swap on 5-year sovereign debt.
Source: "la Caixa" Research, based on Bloomberg data.

Yields on 10-year public debt

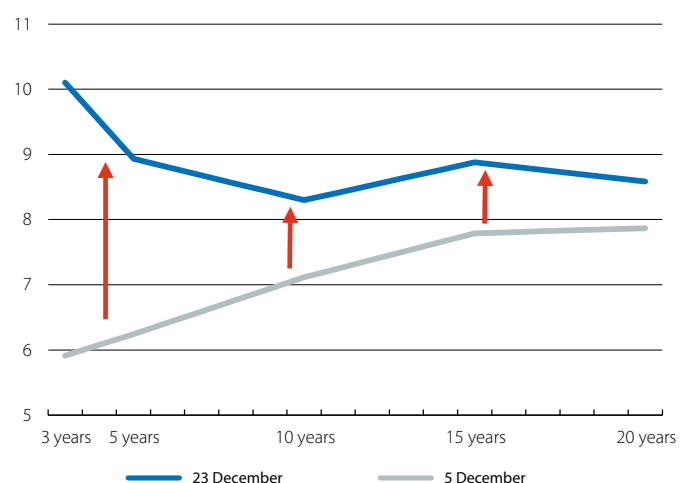
(%)



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

Greece: sovereign debt curve

(%)



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

sovereign debt to return to the favourable path it had taken over the last few months. Albeit less intensively, this uncertainty has also affected the slope of the Portuguese curve. The uncertain political panorama in Greece has not caused any notable upset in the remaining peripheral debt, however. Expectations that the ECB will extend its range of purchases to sovereign bonds have also overshadowed these problems. This acquisition of public debt will mainly benefit Spain, Italy and Portugal with a significant narrowing of their sovereign spreads.

In Spain, the Treasury completes its financing programme for 2014, attracting almost 235 billion euros in bonds and bills. Of note was the sharp fall in costs, the longer maturities for new issuances and the fact that financing for 2015 has been brought forward.

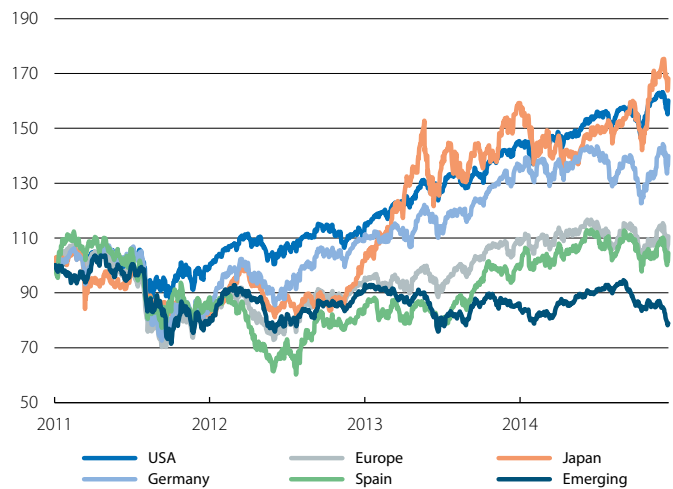
Energy is hindering recovery in the stock exchanges.

December was characterised by more volatile stock markets with the main stock market indices recording small percentage gains, albeit with very wide price ranges. Foreign exchange instability in some emerging markets, with Russia at the head, the economic consequences of cheaper crude for oil-producing countries and Greece's political instability have set the tone for the last few weeks. However, the Fed's «patient» stance regarding the normalisation of its monetary policy and the favourable statements made by ECB members on sovereign debt purchases supported the stock markets in developed countries towards the end of the month. The sector most severely hit was energy due to the risk posed for the industry's income statements by falling oil prices. Nevertheless, in spite of a more volatile environment because of interest rate normalisation in the US and various sources of geopolitical risk, the outlook for equity markets in 2015 is positive (see the Focus «Equities: a market with potential»), particularly in Europe and Spain.

The currencies of some «weak» emerging countries have been hit by falling Brent oil prices. On average, their currencies depreciated by 5% against the dollar in December in a context of severe turbulence in emerging foreign exchange markets. For its part the euro's exchange rate has continued to weaken, reaching 1.22 dollars, its lowest value in two years. The effect on Europe's currency of the disparity between the monetary policies employed in the US and the euro area will tend to increase as the ECB's sovereign QE programme looks like starting up. Regarding commodities, Brent oil has continued to fall, reaching around 60 dollars per barrel where it remained stable at the end of the year. In the short term excess supply, the downward revision of forecasts for crude oil demand in 2015 and the lack of agreement among OPEC countries to reduce their production will keep the price low.

Trends in the main international stock markets

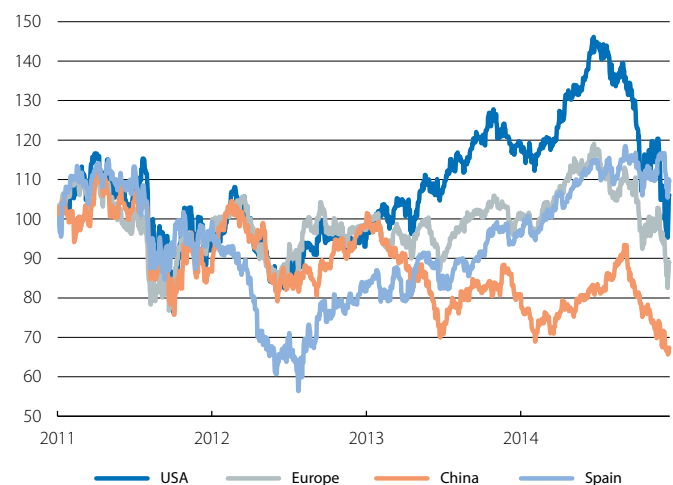
Index (January 2011 = 100)



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

Energy sector: stock market trend by country

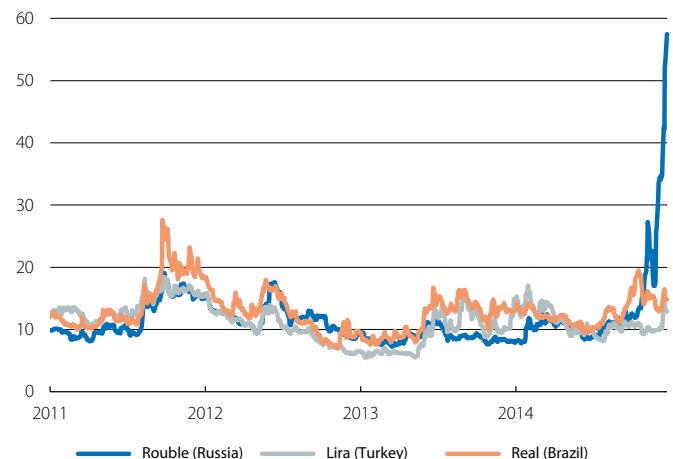
Index (January 2011 = 100)



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

Emerging currencies: implied exchange rate volatility against the dollar

(%)



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

FOCUS · Equities: a market with potential

2014 was a good year for equities at a global level: the MSCI index for World Local Currency with dividends provided gains of almost 10% and, although there were significant disparities between countries and sectors, they have not impaired the overall good performance of the stock market and this situation is likely to continue in 2015.

One initial aspect that must be taken into account is the macroeconomic environment. For 2015, the consensus of analysts and most international bodies agree that the international economy will speed up while global inflation is likely to remain at low levels. In other words, a return to what some, as in the children's tale, call the «Goldilocks economy»: not cold enough to arouse fears of a recession but not so hot as to cause concern regarding inflation. A mild macroeconomic climate has typically been favourable for stock markets but this has now become particularly important as it is crucial to ensuring that a certain decisive factor continues within the financial framework of the last few years: the abundance of liquidity. In spite of the divergent strategies employed by the main central banks, on the whole monetary conditions will remain extremely accommodative in 2015 (the ECB's and Bank of Japan's expansionary measures will take over from those of the Fed), ensuring very relaxed liquidity conditions at a global level. Apart from helping to finance companies and reducing financial costs, this factor also boosts stock markets via the search for yield: investors, unsatisfied with the low interest rates offered on monetary assets and public debt, increase the relative weight of equity in their portfolios. In fact, an increase in capital flows could already be seen from government bonds towards equity markets throughout 2014 and we expect this trend to continue in 2015.

A second notable aspect of the global environment is the fall in commodity prices, and specifically in energy prices. The positive effect of this is twofold. On the one hand it reduces companies' production costs, helping to increase their margins while, on the other, it stimulates household expenditure. Although it also leads to the threat of deflation, this impact should be offset by the accommodative monetary policies, improvement in real wages and revival in credit. Europe's periphery would see the greatest benefit from this effect as it has highest rate of energy imports as a share of GDP while the euro area will also be boosted by an additional third factor, the depreciation of the euro, which will help to improve the revenue received by European firms from exports.

These three key elements in the global environment (liquidity, commodity prices and exchange rates) should

all act as a spur to Europe's stock markets. In fact, the consensus of equity analysts expects the increase in earnings per share enjoyed by European companies to be more than considerable. The growth in earnings in the United States is expected to continue being positive but modest, given factors such as rising wage costs. Moreover, the Fed's normalisation strategy could push up dollar interest rates, which would increase the discount rate and therefore reduce share price multiples (P/E ratio, etc.) in the US stock markets. For their part, emerging companies are facing more difficulties in the coming quarters due to the slowdown in growth of their economies, the continued depreciation of their currencies and the fall in revenue from commodity exports. From a sector point of view, and in line with these arguments, all the evidence seems to suggest that those companies most closely linked to the trend in the price of crude oil should be the hardest hit, followed by those whose business is related to commodities. On the other hand, the increase in disposable income thanks to cheaper energy and improved financing conditions should boost share prices in cyclical and consumer sectors such as distribution, retail, transport, airlines and automobiles.

Nevertheless, the risks observed in 2014 that hover over this Goldilocks panorama have also continued. Specifically, geopolitical tensions, the Fed's normalisation strategy, deflationary forces in the euro area and the extent of the slowdown in the Chinese economy still head the list of threats that need to be closely monitored.

Trend in the global stock market

(MSCI global index) *



Note: * Calculated in the local currency (without taking the trend in the exchange rate into account).

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

FOCUS · The decoupling of gas and oil prices

At a time when all eyes are on oil due to the dramatic fall in its price since the middle of the summer, the price of gas (especially in the US) has remained stable. Historically prices for both these fuels used to move in a very similar way. However, in the last few years this relationship has broken down (once again, mainly in the US). While the price of crude has fallen by 50% in the last six months, the price of US gas has dropped by about 15%. What are the reasons for this divorce between prices?

The boom in unconventional energy (shale) led by United States, both in gas and oil, and its uneven impact on both markets is the main reason for prices decoupling. At present, US natural gas is still three times cheaper than oil on an energy equivalent basis (see the graph).¹ This is due to the fact that the gas market, far from being global like the oil market, is split into three large regions (United States, Europe and Asia) that are mutually isolated due to high transport costs, especially overseas. In the US case the gas shale revolution has led to a substantial increase in supply for the region and has therefore considerably lowered its price, but this has not been passed on to the rest of the world.

By way of example, between 2007 and 2013 US gas production increased by 26% with shale eventually accounting for 40% of all production (compared with less than 5% at the beginning of 2000). The fall in gas prices that occurred during this period in the US reached 45%. However, the sale of oil at a global level meant that the prices for this resource followed a very different path, even though US production also increased. Although crude oil production in the United States rose by 45% in the same period, the country only produces around 10% of the world's total. Nevertheless, we should make one very important proviso at this point. In spite of the relatively global nature of the oil market, the US shale revolution did have some effect on the price of oil extracted in the country (namely West Texas Intermediate): this fell significantly compared with the price for crude oil sold in Europe (Brent), a difference that had reached 20% by the end of 2011 and 2012. The reason for this was the bottleneck occurring in the oil storage hub located at Cushing (Oklahoma), resulting in a large stockpile of oil and pushing down prices. This situation has gradually been corrected as Cushing's transport infrastructure has been improved but it has lasted several years.

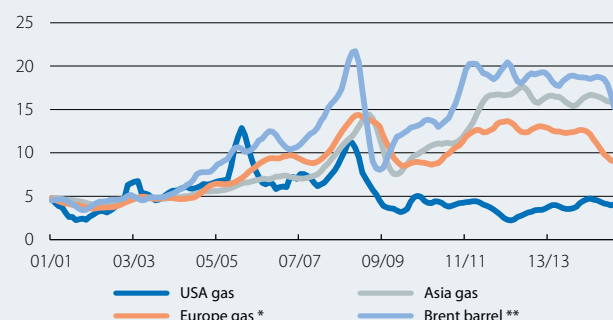
Similarly, and in spite of the aforementioned fragmentation in the world gas market, there has also been some decoupling in Europe between the price of these two fuels (gas and oil). Nonetheless, such decoupling has been to a lesser extent and the price of gas in Europe is still twice as much as that of the

United States while, in Asia, it is four times higher (see the graph). In the European case, in order to make gas investment and exploitation more attractive, in the early years (in the 1950s and 1960s) the decision was taken to set up long-term contracts indexed to the price of oil (a clear energy substitute). This practice has continued up to the present day; in 2011 around 70% of the contracts were still long-term and indexed. However, since then the spot market, in which the price is fixed more in line with local supply and demand factors, has gradually come to the fore. This development has been encouraged by three factors: falling transport costs (due to advances made in the field of liquefied natural gas), regulatory changes in the European Union to further liberalise the energy market and extensive fluctuations in oil prices.

In the long run, this greater price disparity in both dimensions (between gas and oil and between regions) is likely to diminish. At an international level the United States might become interested in exporting gas, an option that is currently subject to extensive legal restrictions. The significant price differences, especially compared with Asia, together with the aforementioned advances made in liquefied natural gas (reducing shipping costs) may make it profitable for American gas to be sold beyond the country's borders. Such a development would help bring prices closer together in the three markets. With regard to the difference between gas and oil prices, should the gap observed continue for any length of time, especially in the US market, this might encourage the more expensive fuel (in this case oil) to be replaced by the cheaper one (gas), which should also limit this disparity in the long term.²

Oil and natural gas prices

4-month average
(dollars per million British thermal units)



Notes: * The benchmark gas price for Europe is the average of Germany's imports, taking into account contracts indexed to the price of oil.
** The recent drop in oil prices is not so pronounced in the graph as these are average figures for the last four months.

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

1. The value of the same amount of energy for both fuels.

2. For example, with the price gap in 2013, the EIA estimates that, up to 2040, the use of natural gas in the transport sector could grow at an annual rate of 12%.

KEY INDICATORS

Interest rates (%)

	31-Dec	28-Nov	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	0.08	0	-20.9	-20.9
1-year Euribor	0.33	0.33	0	-22.6	-22.6
1-year government bonds (Germany)	-0.06	-0.07	1	-24.3	-24.3
2-year government bonds (Germany)	-0.10	-0.03	-7	-31.3	-31.3
10-year government bonds (Germany)	0.54	0.70	-16	-138.9	-138.9
10-year government bonds (Spain)	1.61	1.90	-29	-254.1	-254.1
10-year spread (bps)	107	120	-12	-115.2	-115.2
Dollar					
Fed funds	0.25	0.25	0	0.0	0.0
3-month Libor	0.26	0.23	3	1.4	1.4
12-month Libor	0.63	0.56	7	4.7	4.7
1-year government bonds	0.21	0.12	9	9.8	9.8
2-year government bonds	0.66	0.47	19	28.0	28.0
10-year government bonds	2.17	2.16	1	-85.8	-85.8

Spreads corporate bonds (bps)

	31-Dec	28-Nov	Monthly change (bps)	Year-to-date (bps)	Year-on-year change (bps)
Itraxx Corporate	63	58	5	-7.4	-7.4
Itraxx Financials Senior	67	59	8	-19.7	-19.7
Itraxx Subordinated Financials	149	137	12	20.1	20.1

Exchange rates

	31-Dec	28-Nov	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
\$/euro	1.210	1.245	-2.8	-12.0	-12.0
¥/euro	144.850	147.720	-1.9	0.1	0.1
£/euro	0.777	0.796	-2.4	-6.5	-6.5
¥/\$	119.780	118.630	1.0	13.7	13.7

Commodities

	31-Dec	28-Nov	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
CRB Index	437.8	454.6	-3.7	-4.1	-4.1
Brent (\$/barrel)	55.8	69.0	-19.2	-49.7	-49.7
Gold (\$/ounce)	1,184.9	1,167.4	1.5	-1.7	-1.7

Equity

	31-Dec	28-Nov	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
S&P 500	2,058.9	2,067.6	-0.4	11.4	11.4
Eurostoxx 50	3,146.4	3,250.9	-3.2	1.2	1.2
Ibex 35	10,279.5	10,770.7	-4.6	3.7	3.7
Nikkei 225	17,450.8	17,459.9	-0.1	7.1	7.1
MSCI Emerging	956.3	1,004.7	-4.8	-4.6	-4.6
Nasdaq	4,736.1	4,791.6	-1.2	13.4	13.4

CURRENT SITUATION · 2015 begins with sharp contrasts

The international economy will build up steam in 2015.

Specifically, we estimate growth of 3.9% in 2015, higher than the 3.2% seen in 2014 and within an overall context of inflation still being contained, at around 3.5%. The scenario for 2015 has begun with strong contrasts. Among the advanced economies, the good performance by the US, whose growth is still solid thanks to domestic consumption, investment and less fiscal adjustment, contrasts with the weakness of the Japanese economy, struggling to move away from its secular deflation. Among the large emerging countries, the gradual but controlled slowdown of the Chinese economy contrasts with the episode of the Russian crisis, introducing a high degree of volatility.

UNITED STATES

The US economy «continued to expand» according to the Fed's assessment in its Beige Book field study from December, replacing the more tepid classification of growth as «modest to moderate». The third estimate for GDP growth in Q3, once again revised upwards, confirms this expansionary scenario. This places year-on-year growth at 2.7% (at 2.3% and 2.4% in the first and second estimates, respectively), supported by strong consumption and non-residential investment. This slight improvement does not alter our growth forecasts for 2014 and 2015, however, which remain at 2.3% and 3.1%, respectively.

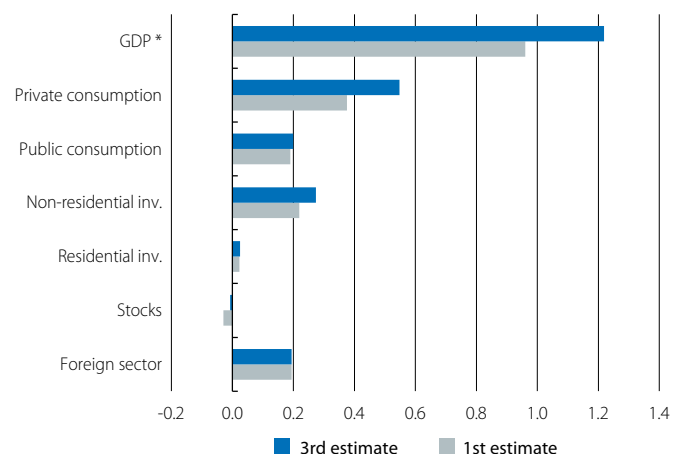
Q4 business indicators continue to show robust expansion.

The business sentiment index (ISM) for manufacturing stood at 58.7 points in November while the index for services rose to 59.3, both in the zone indicating robust expansion. Along the same lines the business sentiment index for small enterprises rose to 98.1 points in November (96.1 in October), supported by an improvement in future expectations. Undoubtedly such trends endorse the good performance we expect from corporate investment in 2015. Retail sales also stand out, growing by 5.1% year-on-year in November, above the consensus forecasts and October's figure (4.5%), as well as the industrial production index, advancing strongly by 15.2% year-on-year, the largest year-on-year rise since January 2011.

The labour market continues to improve within a context of growing economic activity. In November 321,000 jobs were created, substantially surpassing the figure of 200,000 which usually suggests a strong market. The unemployment rate remained flat at 5.8%, the lowest level for the last six years and close to the 5% unemployment rate observed at the end of 2007. The downside to this vigorous tone is the relatively lacklustre employment rate (the relationship between employment and the population aged over 16), standing

USA: GDP

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

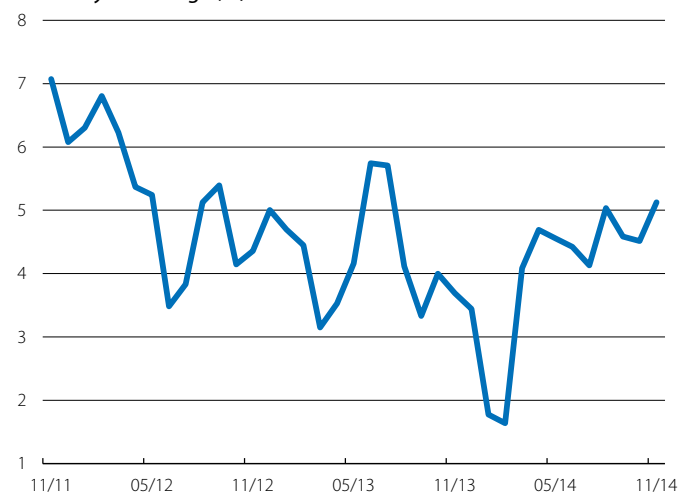


Note: * Quarter-on-quarter change.

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

USA: retail and consumer goods

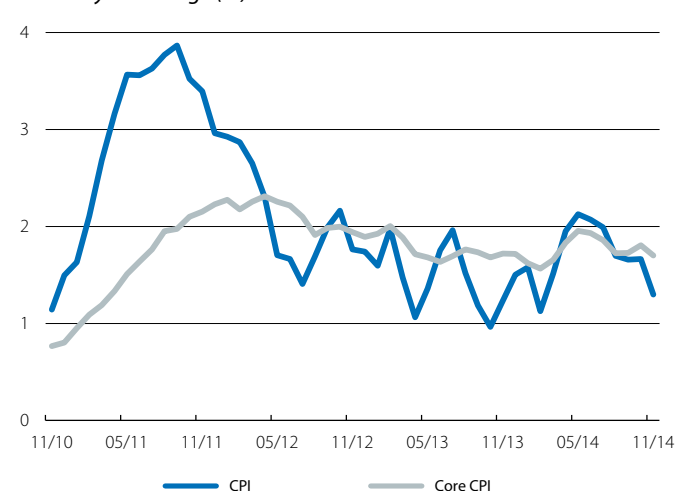
Year-on-year change (%)



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

USA: CPI

Year-on-year change (%)



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

at 59.2%, 4 pps below 2007's level, a significant proportion of which is due to the demotivating effect caused by the years of crisis.

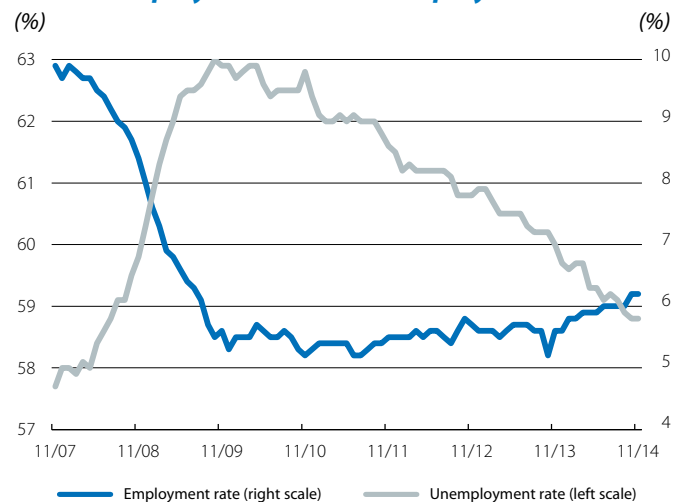
The slump in fuel prices has an impact on inflation in the United States. Specifically, in November this was 0.4 percentage points below the figure for the previous month (1.3%) due to the further drop in energy prices, which was not offset by the rise in the rest of the components. Core CPI (without foods or energy) increased by 0.1% month-on-month, bringing its year-on-year growth to 1.7%. Although we have maintained our growth forecasts, the change made to the forecasts for oil has forced us to revise downwards our forecast for inflation in 2015 (from 1.5% to 1.0%). Such moderation is also supported by the Federal Reserve's accommodative message given at the last meeting of the Federal Open Market Committee (FOMC). According to the statement issued, the Fed will be «patient» in its handling of any rises in the official interest rate.

JAPAN

The Prime Minister Shinzo Abe receives the population's endorsement for his expansionary policies on winning the early elections held in December in an environment marked by the recession and stagnant inflation: GDP growth was revised downwards both for Q1 and Q3; the Bank of Japan's benchmark CPI stood at 0.7% year-on-year in November (excluding the effect of the VAT hike last April), far from the 2% target set by the monetary authority; and Moody's reduced the credit rating for its public debt which already represents 250% of GDP. This downward revision of GDP has forced us to reduce our growth forecast for 2014 to some extent (from 0.4% to 0.3%). With a view to 2015, the delay until April 2017 of the second VAT hike, the announced increase in public expenditure (equivalent to 0.7% of GDP) for low-income households and small enterprises and the recent intensification in the BOJ's quantitative easing have led us to keep our forecast at 1.2%.

The depreciation of the yen is affecting domestic demand. Since the BOJ upped its rate of asset purchases last 31 October, the yen has depreciated by 10% against the dollar, and the Nikkei stock index, dominated by large exporters, has risen by 14%. However, the benefits of a cheap yen for exports are limited at the yen's current levels, which are very low from a historical perspective. Nevertheless, the increase in prices of imported products is starting to have a negative effect on households and firms. The Tankan business sentiment index for large manufacturing firms fell slightly in Q4 (12 points) and is now significantly below the level of 17 points at which it started the year. Given this situation, cheaper oil will be a boost for Japan's economy which, due to the nuclear moratorium imposed after the Fukushima accident, has seen its oil imports rise significantly (from 2.3% of GDP in 2010 to 3.6% in July of 2014).

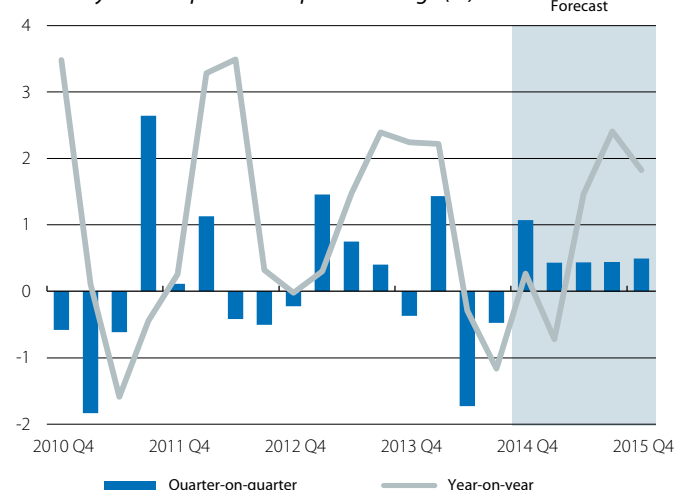
USA: unemployment rate and employment rate



Note: Unemployment rate (% of the labour force). Employment rate (employees/population aged over 16).
Source: "la Caixa" Research, based on data from the Bureau of Labor Statistics.

Japan: GDP

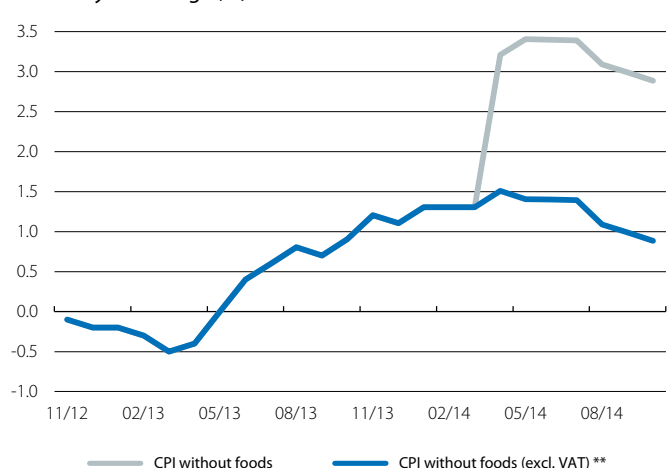
Year-on-year and quarter-on-quarter change (%)



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

Japan: CPI *

Year-on-year change (%)



Notes: * CPI without foods (but with energy), the BOJ's benchmark.

** Does not include the impact of the VAT hike in April 2014 from 5% to 8%.

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

EMERGING ECONOMIES

China continues its gradual, controlled slowdown. The PMI manufacturing index produced by the National Statistics Office fell to 50.3 points in November, its lowest level in eight months. Although this figure is still above the 50-point threshold (indicating expansion), it suggests that growth has slowed down considerably in the last few months. Judging by the rest of the indicators, this slowdown appears to be gradual. The PMI for services rose slightly to 53.9 points from its October figure of 53.8. Along the same lines, the country's retail sales figures came as a pleasant surprise, growing by 11.7% year-on-year compared with 11.5% in October. On the other hand a basic indicator such as the industrial production index grew by just 7.2% in November, lower than October's 7.7%. Nonetheless, a significant part of this slowdown is due to the forced stoppage of numerous factories in the north of the country during November's APEC summit (Asia-Pacific Economic Cooperation). Within this environment of a controlled slowdown, inflation is still tending to fall (1.4% in November), allowing the government to use further expansionary measures if required and we should remember that the Central Bank already surprised us in mid-November with a substantial cut in the official interest rate.

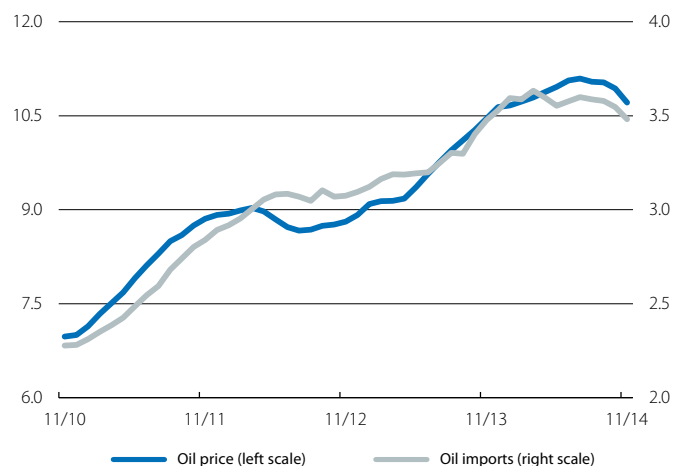
Russia will fall into recession in 2015 due to the combination of falling oil prices, international sanctions and geopolitical uncertainty related to Ukraine. Given this situation, its crisis of confidence has become a full-blown foreign exchange crisis. During the acute phase of this crisis in December the government admitted that Russia will enter a recession in 2015 and several events quickly followed: financial pressure intensified, the rouble fell against the euro, the interest rate on 10-year debt went from 10.6% to 16.2% and the central bank attempted to slow down the rouble's depreciation via reference rate hikes: from 9.5% to 17%.

Although Russia has some room for manoeuvre, there are downside risks. In particular the level of reserves is high, equivalent to 64.5% of the country's external debt and to 351% of its short-term external debt. This, together with low public debt (13.9% of GDP in 2013), provides some margin to avoid a potential default. Similarly the rouble's depreciation should cushion fiscal pressure and boost the current surplus, albeit at the risk of increasing costs, which may hinder growth. Given this uncertain context we have revised downwards our growth forecast for 2015 as a whole, from 0.8% to -2.5%. However, even with this revision the risks are still clearly downside with a recession that might become more intense should oil prices fall further and the loss of liquidity continue.

Japan: oil imports and prices

(Thousands of yen/barrels)

(% of GDP)

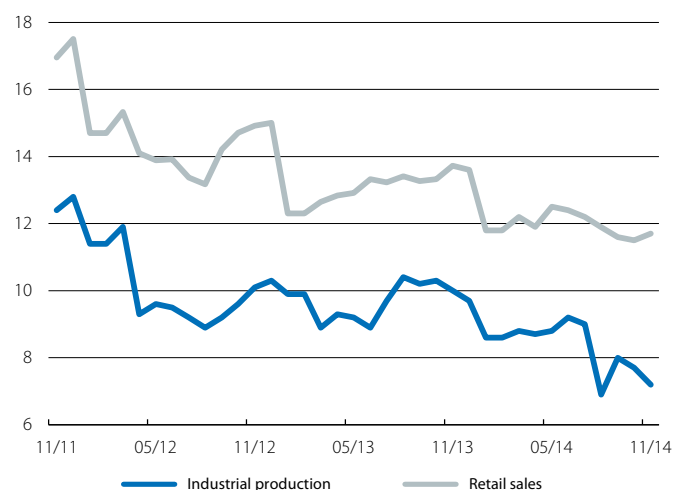


Note: In both variables, average from the last 12 months.

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

China: industrial production and retail sales

Year-on-year change (%)

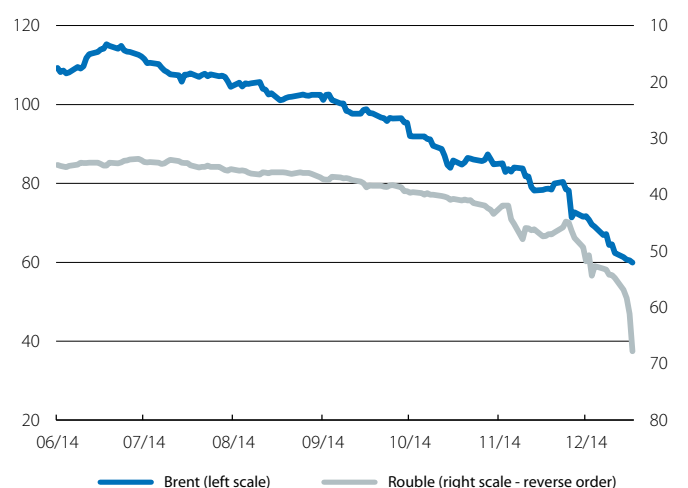


Source: "la Caixa" Research, based on data from the National Bureau of Statistics of China.

Russia: oil prices and the value of the rouble

(Dollars/barrel)

(Roubles/dollar)



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

FOCUS · Mexico: the first positive results from its structural reforms

Mexico approved six structural reforms between November 2012 and December 2013: affecting labour, education, telecommunications, finance, energy and the fiscal area. Each one of these is substantial in its own right but, taken as a whole, they represent the biggest reform carried out by the country in decades. The fundamental reason for this ambitious agenda of reforms is the need to improve the growth potential of Mexico's economy, which the IMF places between 2.8% and 3.0%, at the tail end of Latin American countries. According to available estimates, should this package of reforms be applied properly it will help to boost the country's growth potential by up to 3.5%-4.0%.¹

So are these reforms on the way to bringing about the important results they promise? There was a time when some thought the reforms might be put on the back boiler, slowing down the process to pass the necessary laws or failing to apply them. For the time being, however, none of these risks has materialised. The laws had already been passed by the end of 2014 and as far as the next step is concerned, namely their implementation, this also seems to be progressing satisfactorily. To give some significant examples, in education the first exercise has been carried out to evaluate teachers prior to their recruitment (breaking with the tradition of teaching graduates being given a job automatically); in the area of telecommunications, licences for two openly available national channels are in the process of being put to tender; lastly, in the financial sector, a new mechanism has already been implemented to dissolve Banco Bicentenario. Although a small bank (it accounts for just 0.015% of all assets in Mexico's banking system), what is relevant is the application of this new resolution mechanism.

But it is the energy reform that has aroused most expectation due to its potentially huge impact, a process which is also making good headway. It should be noted that the main aim of the energy reform is to increase oil production by exploiting reserves that are difficult to access, requiring the incorporation of technology and investment from the private sector (the previous constitutional framework limited private involvement). In this respect, PEMEX has already announced ten projects it will carry out in collaboration with the private sector during the period 2015-2020. This state-owned oil company will also adapt its current contracts to the new framework to generate new investment. Lastly, the private sector has also announced its willingness to take advantage of the new forms of participation offered by the reform. Thanks to this investment, encouraged by the reform, in 2020 investment in the oil industry could be 65% higher in real terms than the figure recorded in 2014:

1. On the content and economic impact of the reforms, see «A reformist drive is shaking up Mexico», *Monthly Report*, January 2014, "la Caixa" Research and «Mexico: 2014 Article IV Consultation-Staff Report», IMF, November 2014. These analyses conclude that the fiscal and energy reforms will have the greatest impact on the country's potential GDP growth.

compared with 27.4 billion dollars in 2014, investment could reach 45.2 billion dollars (in real terms) in 2020. Without the reform, this increase would have only been 27% (from the aforementioned 27.4 billion dollars in 2014 to 35 billion dollars).²

It should also be noted that the reforms will be implemented within a context of a temporary upswing in growth (growth will exceed 3.5% in the period 2015-2016) thanks to the expansion of the United States and to contained macroeconomic imbalances. In spite of this positive situation, however, we must not forget that, as mentioned above, any improvement in long-term prospects depends on the success of the agenda of reforms. Particularly if we take into account the fact that the challenges facing the country are not solely in the economic area. As Mexico's President, Peña Nieto, announced recently, the next effort must focus on improving aspects of governance and safety in the country, especially at a local level.

Mexico: main macroeconomic indicators

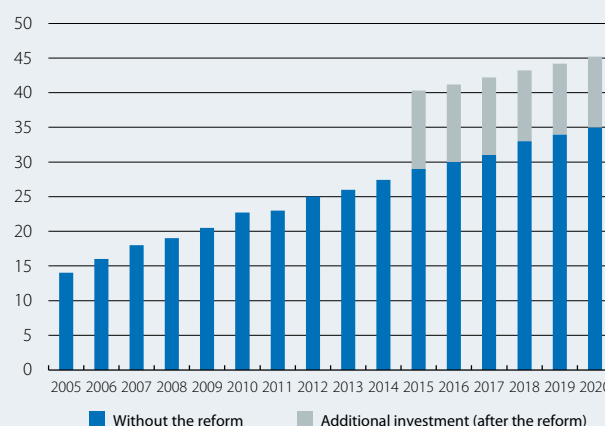
	2007-2011	2012	2013	2014 (f)	2015 (f)	2016 (f)
Real GDP growth (%)	1.8	4.0	1.4	2.3	3.6	3.8
CPI (%) (y)	4.3	4.1	3.7	4.1	3.2	3.3
Current account balance (% GDP)	-1.1	-1.3	-2.1	-1.9	-2.0	-2.2
Fiscal balance (% GDP)	-3.0	-3.7	-3.8	-4.2	-4.0	-3.5
Public debt (% GDP)	41.9	43.2	46.4	48.0	49.0	49.2

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

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

Mexico: investment in the oil industry

(Billion dollars in 2014)



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

2. See «The Emerging Markets Quarterly», September 2014, Barclays Research.

FOCUS · Shanghai-Hong Kong Stock Connect: connecting with the Chinese stock market

November saw the launch of the Shanghai-Hong Kong (SH-HK) Stock Connect, a programme that allows foreign investors access to the Shanghai stock market (A shares) via the Hong Kong stock market, an access that had been severely restricted for international investors until now.¹ The programme also allows investors from mainland China to easily trade on the Hong Kong stock market via the Shanghai market. This reform has taken place within the overall liberalisation and modernisation of China's finance and capital markets which, in turn, forms part of a broader mission towards a «more market-oriented» economy. This scheme has aroused huge expectations as it could become one of the biggest steps taken by the Asian giant in opening up its capital account.

This mechanism for mutual access connects two of the world's most important stock markets (namely Hong Kong and Shanghai): their union would produce the third largest market in stock capitalisation terms, smaller than just the NYSE and NASDAQ. As in all actions carried out by China to open up its economy, at present substantial controls remain in place, both regarding the products traded and their quantity, but this is still the most important step taken to date in the liberalisation of the Chinese equity market.² Previously foreign investors could only invest in the bond and stock markets of mainland China via the Qualified Foreign Institutional Investor (QFII) programme and the Renminbi Qualified Foreign Institutional Investor (R-QFII) programme, started up in January 2003 and December 2011 respectively, which not only have very strict quotas on the amounts that can be invested (representing less than 3% of China's stock market) but also require investor approval by the Chinese authorities. However, through the SH-HK Stock Connect all kinds of foreign investors (institutions and individuals) can invest in Shanghai and, in spite of the quotas set, their daily trading could reach 20% of the business volume of Shanghai's stock market (the seventh largest in stock capitalisation terms). This percentage might even increase as the programme finds its feet and quotas are enlarged. In all actions taken to open up its economy, China has acted first by setting up small, controlled pilot trials that have gradually been extended.

1. Numerous Chinese companies are listed on the Hong Kong stock exchange via H shares, and on the Shanghai stock exchange via A shares. As a result of the limitations in place until now for foreign investors wishing to trade on the Shanghai stock exchange, in practice A shares were restricted to domestic investors (from mainland China).

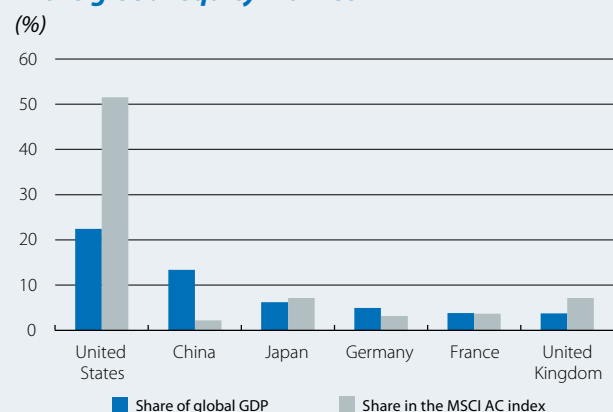
2. There is a daily limit of RMB 13 billion (2.1 billion dollars) for northbound purchases (from Hong Kong to Shanghai), and RMB 10.5 billion (1.7 billion dollars) southbound. Similarly, the securities that are eligible to be traded in mainland China total 568 (90% of the Shanghai stock market capitalisation), and 266 in Hong Kong (82% of the Hong Kong stock market capitalisation).

Without doubt this greater access to the Chinese stock market will increase the country's share in the portfolios of international investors in the world equity market. At present it is clearly under-represented: its share of the MSCI AC World stock market index is just 2.2%, far below the importance of China's GDP in the world's total, which is just over 13% (see the graph).³ This will help international investors to diversify their portfolios as well as possibly increase their returns thanks to the Asian giant's growth potential.

From the point of view of Chinese households, the start-up of the SH-HK Stock Connect provides a very important alternative route to channel their savings. The limited development and depth of the Chinese finance and capital markets has made it more difficult for them to diversify. A very large proportion of household savings has been invested in real estate (72%) while cash also accounts for a notable 20% of their total assets. This new scheme will also increase the number of Chinese firms that can take advantage of the inflow of global funds, previously highly restricted by the QFII and R-QFII programmes.

Lastly, in strategic terms China's more open capital account via the SH-HK Stock Connect should considerably increase the use of the renminbi (or yuan) at an international level. This internationalisation of the country's currency is an objective pursued intensively by the Chinese government over the last few years. In short, as China's economy becomes more liberalised, the omnipresent greenback may have to gradually make way for a new rival, the red note.

Economic relevance and relevance in the global equity market



Note: See note 3 for the text.

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

3. The MSCI AC index attempts to reproduce the yield from the global market (advanced + emerging) available for global investors. In addition to stock market capitalisation, to determine the share of each market within the index it also takes liquidity measures into account.

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	12/14
Activity									
Real GDP	2.3	2.2	3.1	1.9	2.6	2.7	–	...	–
Retail sales (excluding cars and petrol)	4.2	3.5	3.5	2.3	4.1	4.4	4.6	5.2	...
Consumer confidence (value)	67.1	73.2	74.0	80.5	83.4	90.9	94.1	91.0	92.6
Industrial production	3.8	2.9	3.3	3.3	4.2	4.6	4.5	5.2	...
Manufacturing activity index (ISM) (value)	51.8	53.9	56.7	52.7	55.2	57.6	59.0	58.7	...
Housing starts (thousands)	783.8	929.7	1,025	925	985	1,030	1,045	1,028	...
Case-Shiller home price index (value)	141.3	158.2	165	170	171	170	171	...	...
Unemployment rate (% lab. force)	8.1	7.4	7.0	6.7	6.2	6.1	5.8	5.8	...
Employment-population ratio (% pop. > 16 years)	58.6	58.6	58.5	58.8	58.9	59.0	59.2	59.2	...
Trade balance ¹ (% GDP)	–3.3	–2.8	–2.8	–2.8	–2.9	–2.9	–3.8	...	...
Prices									
Consumer prices	2.1	1.5	1.2	1.4	2.1	1.8	1.7	1.3	...
Core consumer prices	2.1	1.8	1.7	1.6	1.9	1.8	1.8	1.7	...

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	11/14
Activity								
Real GDP	1.7	1.6	2.2	2.2	–0.3	–1.2	–	...
Consumer confidence (value)	40.0	43.6	41.7	38.8	39.1	40.9	38.9	37.7
Industrial production	0.2	–0.6	5.8	8.3	2.6	–1.1	–0.8	–1.7
Business activity index (Tankan) (value)	–5.0	6.0	16.0	17.0	12.0	13.0	–	12.0
Unemployment rate (% lab. force)	4.3	4.0	3.9	3.6	3.6	3.6	3.5	3.5
Trade balance ¹ (% GDP)	–1.4	–2.4	–2.4	–2.8	–2.9	–2.9	–2.8	–2.7
Prices								
Consumer prices	0.0	0.4	1.4	1.5	3.6	3.3	2.9	2.4
Core consumer prices	–0.6	–0.2	0.5	0.6	2.3	2.3	2.1	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	11/14
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	11.7
Industrial production	10.0	9.9	10.0	8.7	8.9	8.0	7.7	7.2
PMI manufacturing (value)	50.8	50.8	51.3	50.3	50.7	51.3	50.8	50.3
Foreign sector								
Trade balance ¹ (value)	230	258	258	233	253	321	335	356
Exports	8.0	7.8	7.4	–3.4	5.0	13.0	11.6	4.7
Imports	4.3	7.3	7.1	1.7	1.4	1.1	4.6	–6.7
Prices								
Consumer prices	2.7	2.6	2.9	2.3	2.2	2.0	1.6	1.4
Official interest rate ² (value)	6.00	6.00	6.00	6.00	6.00	6.00	6.00	5.60
Renminbi per dollar (value)	6.3	6.1	6.1	6.1	6.2	6.2	6.1	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 · The year ends with an improved tone

Moderate growth in the euro area. In Q3 the euro area's GDP grew by 0.2% quarter-on-quarter, the same figure as in the previous quarter. Of particular note is the rise in private consumption (+0.5%) and exports (+0.8%). However, investment posted negative growth and net exports made an overall negative contribution due to the large increase in imports (+1.2%). We predict the same growth (0.2%) in the last quarter which will bring GDP growth for the whole year to 0.8%. This trend of positive growth will consolidate over the coming year, supported both by domestic demand, in particular private consumption thanks to the increase in disposable income and low commodity prices, as well as by exports.

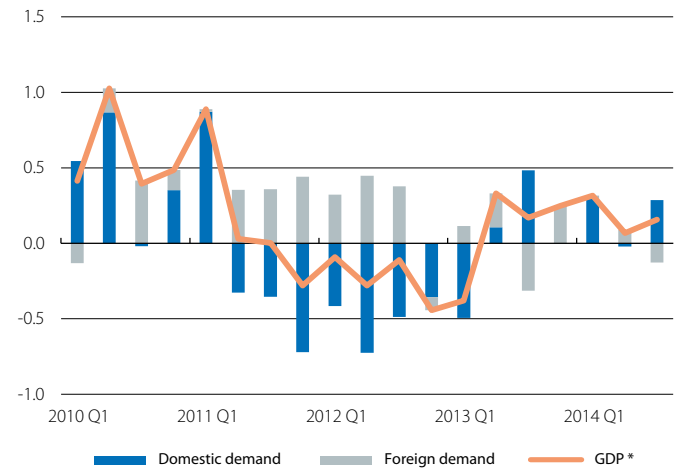
Revision of growth forecasts for 2015. The European Central Bank expects the euro area to grow by 0.8% in 2014 and by 1.0% in 2015, several tenths of a percentage point less than in its forecasts in September. To explain this downward revision, the ECB pointed to the fragility of the recovery with weaker economic activity than expected, the risk of deflation, the delay in implementing structural reforms in some countries and persistent geopolitical risks. However, its forecasts do not include the effects of a possible change in policy in 2015, including monetary. As argued in the Focus «The ECB finds itself in an alley with just one exit: QE», the bulk of the evidence available suggests that the ECB will embark on a programme of quantitative easing in 2015 Q1. This programme will push down interest rates, helping to consolidate the revival in credit, but will particularly lead to a devaluation of the euro, which will favour the export sector. The forecasts of "la Caixa" Research take into account the effects of the different policies that will be employed in 2015, including a quantitative easing programme during 2015 that will last approximately one year. The euro area is expected to grow by 1.3% in 2015, increasing to 1.8% in 2016 as quantitative easing takes effect.

Activity in the euro area recovers slightly in Q4. Business indicators have ended the year showing some improvement, albeit still at moderate levels. In France the PMI index rose slightly but is still in the recessionary zone while in Germany both the IFO (business climate index) and ZEW indices (which measures the expectations of investors and analysts) rose significantly. This positive trend can also be seen in the figures for industrial production, up by 0.1% month-on-month in October (0.7% year-on-year) with increases in all sectors (except energy and capital goods).

Demand indicators pick up slightly. In October retail sales grew by 0.4% month-on-month, consolidating the positive trend for the year so far and a 1.4% improvement on October's figure in 2013. This improvement is also reflected in the indicator for consumer confidence which rose in December

Euro area: GDP

Contribution to growth (pps)



Note: * Quarter-on-quarter change.

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

Euro area: GDP growth forecasts

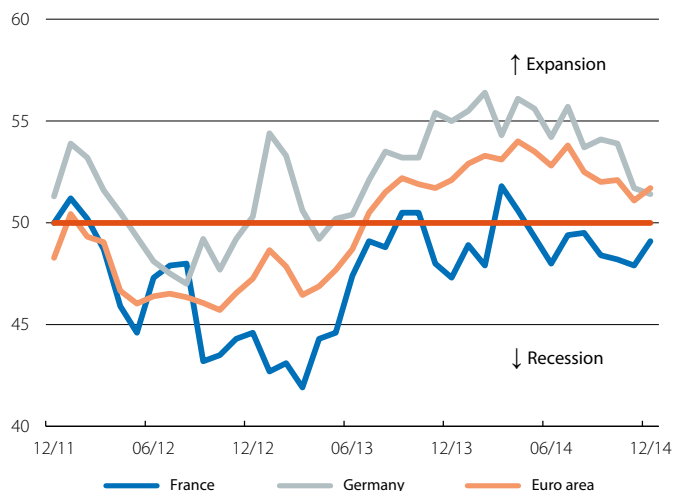
Year-on-year change (%)

	Forecast December 2014			Change compared with the last forecast		
	2014	2015	2016	2014	2015	2016
ECB	0.8	1.0	1.5	▼ 0.1	▼ 0.6	▼ 0.4
"la Caixa" Research	0.8	1.3	1.8	=	=	▲ 0.2
Consensus	0.8	1.1	-	=	=	-

Source: "la Caixa" Research, based on data from the ECB and Consensus Economics.

Composite PMI

(Index)



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

to its highest figure for the quarter. These positive data should consolidate over the coming months as the improved macroeconomic environment strengthens.

The labour market continues its tentative recovery.

Employment grew by 0.2% quarter-on-quarter in Q3 (0.3% in Q2). The highest increases in employment were recorded in the peripheral countries, namely Spain (0.3%), Italy (0.4%) and Portugal (1.4%) although these countries all start from a lower level. Germany, with a better starting point, posted more moderate growth, specifically 0.2%. Regarding the unemployment rate, this remained stable at 11.5% in October, 0.4 pps below the figure one year ago. However, the differences between the core and periphery are still very pronounced, the two countries with the lowest unemployment being Germany (4.9%) and Austria (5.1%) and the two with the highest being Greece (25.9%) and Spain (24.0%). With regard to wage costs, these rose by 1.4% year-on-year in the euro area in 2014 Q3. Germany's wage rise, 2.0% year-on-year, was higher than the average, in accordance with its healthy labour market. However, wage adjustment is still intense in Italy and Spain with a percentage change of 0.3% and 0.7% year-on-year respectively, so that these two countries should be able to continue improving their competitiveness.

Inflation is still very weak. In November inflation fell by 0.1 pps to 0.3% due to the fall in energy prices which push down the CPI both directly and indirectly, reducing the price of manufactured goods and transport services. By country, Germany saw the largest falls, placing its inflation in November at 0.5% (a figure not seen since February 2010) while France and Italy recorded inflation of 0.4% and 0.2%, respectively. In the short term we expect falling oil prices to continue pushing down inflation, even reaching negative figures in the coming months. However, inflation is expected to rise to 0.7% in 2015 and reach 1.5% in 2016. Core inflation will remain at positive levels similar to its present situation over the coming months and will start to pick up as from the second half of 2015.

The foreign sector is still recovering. Continuing with its trend of the last few months, the euro area's current account balance saw a surplus of 251 billion euros in October (cumulative over 12 months), equivalent to 2.5% of GDP. This positive trade balance was due particularly to improved exports and lower import prices, especially for energy products. The services balance also contributed to this advance, albeit to a lesser extent. This upward trend should continue and even accelerate over the next few months thanks to the ECB's accommodative policies, which will lead to a greater depreciation of the euro, and the constant improvement in the energy balance with the current slump in oil prices. The foreign sector therefore looks like being one of the euro area's main engines of growth for the coming quarters.

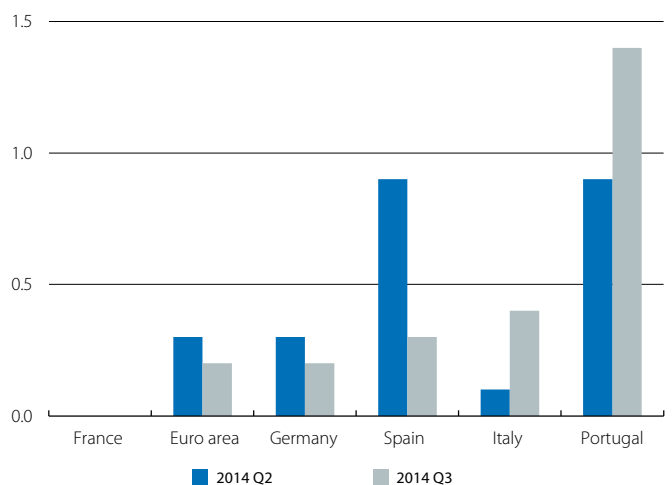
Euro area: consumption indicators



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

Employment

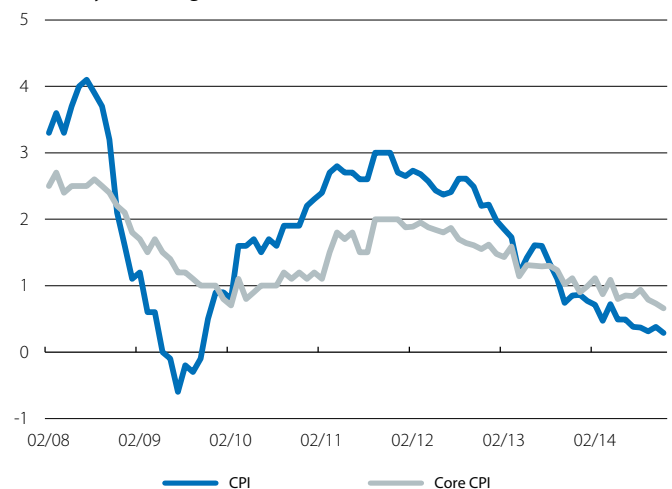
Quarter-on-quarter change, seasonally adjusted (%)



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

Euro area: inflation

Year-on-year change (%)



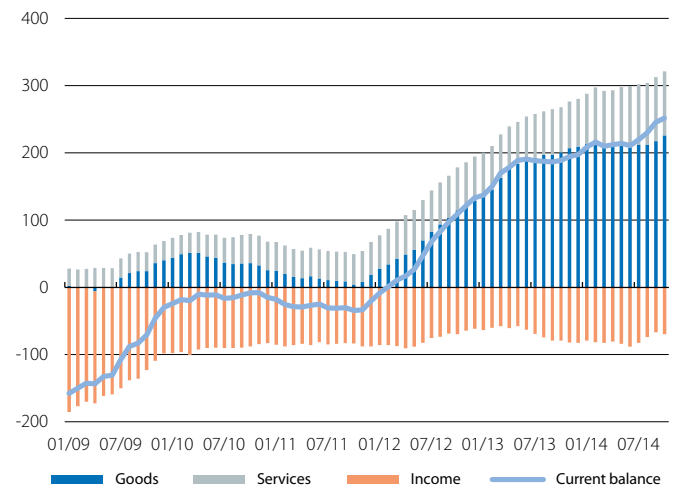
Source: "la Caixa" Research, based on Eurostat data.

Russia causes concern but alarm bells have yet to ring in the euro area. Geopolitical uncertainty (Ukraine), the West's sanctions and falling oil prices have had a very negative effect on the Russian economy, causing significant depreciation in its currency and widespread losses in its stock market. The depreciation of the rouble, which fell by more than 18% against the euro on 15 and 16 December, led Russia's central bank to take action, raising interest rates from 9.5% to 17% in a last-ditch attempt to bolster the currency. In 2015, the crisis caused by the combination of the three aforementioned factors will reduce the country's GDP more than expected. The risk of contagion to the euro area is limited, however. Russia accounts for 2.7% of the world's GDP and, in terms of trade, the countries in Eastern Europe will be the most affected. The main countries in the west of the euro area are less directly exposed: the exports to Russia from these economies account for less than 3% of their total exports. Regarding banking, the exposure of Europe's banks to Russian banking is limited except in the case of Austria. Nevertheless, the indirect effects of the Russian crisis could be substantial and it must therefore be closely monitored.

Political uncertainty in Greece. The failure of the presidential election has pushed Greece towards general elections on 25 January 2015. The Greek parliament could not achieve a large enough majority to elect a new President for the Republic in December and was forced to dissolve the chamber and call early general elections. The latest polls suggest Syriza will win which, should this come about, would greatly hinder negotiations with the troika to bring the bail-out to a satisfactory end in February. This could therefore become a new source of instability for the euro area. However, due to the large reduction in Greek debt on the balance sheets of the private investors, the risk of contagion is more contained than in the episodes of tension in 2011 and 2012.

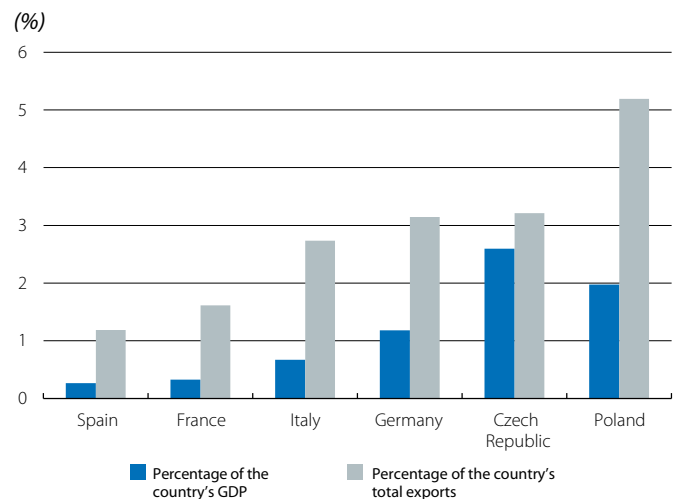
Euro area: current balance

Billion euros (cumulative over 12 months)



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

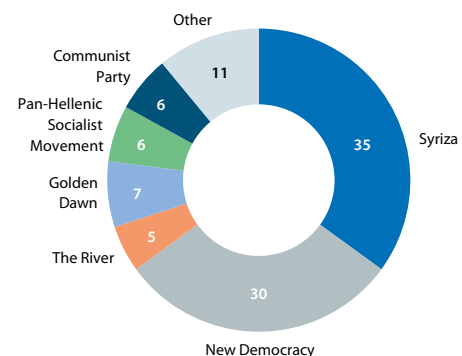
Exports of goods from the euro area to Russia



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

Greece: voting intentions *

(%)



Note: * 13/12/2014.

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

FOCUS · The Juncker plan: public guarantees to boost private investment in Europe

The need to increase investment in Europe has been pointed out by several international bodies and was analysed for the case of infrastructure in the Focus of MR11 «Investment in infrastructures: an appetising proposition but often with unexpected consequences». However, Europe's public sector has little margin to provide a widespread, significant boost in all countries given the delicate state of public accounts. Neither does the private sector, on its own, have much room to manoeuvre to finance investment projects as it is still immersed in deleveraging and battling with weak demand. The aim of the Juncker plan is to unite the forces of both sectors, encouraging private investment in an environment of abundant liquidity which is nonetheless not being used to finance new projects. Will it succeed?

The plan sets up a new entity, the European Fund for Strategic Investments (EFSI), initially provided with capital totalling 21 billion euros from the European Commission (16 billion) and the European Investment Bank (5 billion). The Commission will also allow countries to contribute to the EFSI's capital without this increasing their general government deficit. Based on this initial capital, the plan is to issue around 60 billion euros of debt which will be used as a guarantee to attract a further 245 billion euros of private funding, thereby reaching a total of 315 billion euros in investments over three years, equivalent to 0.8% of Europe's annual GDP (see the graph).

The European Investment Bank will be in charge of setting up the EFSI, which will start operating in 2015. The kind of investments to be financed are long-term projects for strategic infrastructures (such as transnational energy connections, broadband, etc.), transport, education and R&D. Part of these investments might be made via project finance; i.e. private financing that is specifically created to carry out a certain investment project. At present, Europe's project finance market is relatively undeveloped compared with other regions (see the graph), partly due to differing legislation in each country, and the Juncker plan may help to improve this situation.

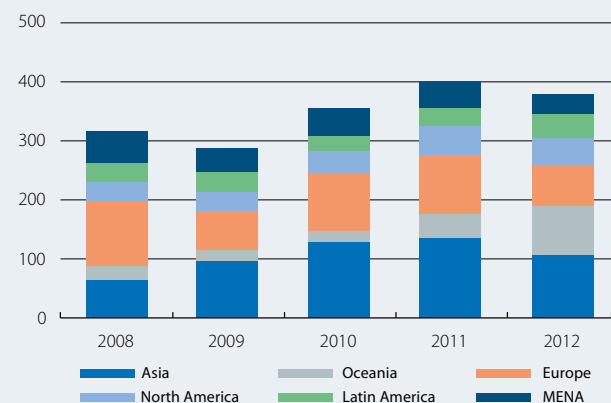
The EFSI will also inject capital and issue guarantees to help programmes to securitise loans to SMEs and mid-cap companies. In addition, the EFSI's resources could also be used to invest in European Long-Term Investment Funds, the European collective investment framework for infrastructures, as well as in firms that require long-term capital.

The EIB's technical assistance in terms of structuring, implementing and monitoring projects ensures some efficiency and transparency although details have yet to be announced regarding how the projects will be selected and the degree of guarantee provided by the EFSI, key aspects for the programme's success. It may be more difficult to attract private investors due to the limited capacity of public capital to absorb losses, a priori restricted by the ambitious level of leveraging planned by the EFSI. It should be noted, however, that although the guarantees issued by the EFSI will be limited, they can improve the risk profile of projects and therefore the interest rate required to finance them.

Consequently, although the macroeconomic impact of the Juncker plan is uncertain, it is potentially considerable. On the one hand, the EFSI might end up financing projects that would have been carried out anyway and, if this is the dominant trend, the programme will have little impact. Other earlier investment plans, such as Barroso's 120 billion euro plan in 2012 («compact for growth»), did not have much effect. But if, on the other hand, the guarantees provided by the EFSI are designed well, it could significantly speed up the implementation of projects that are currently shelved. The plan should also help to standardise legislation at a European level and reduce the obstacles represented by different sector regulations, boosting investment in Europe in general and project finance in particular.

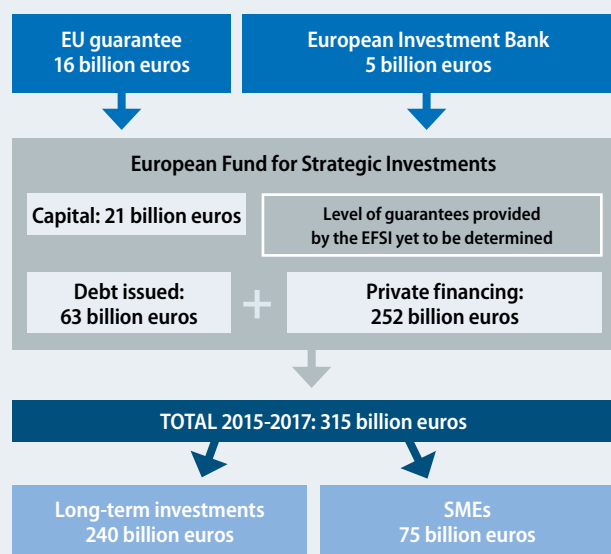
Volume of project finance by region

(Billion euros)



Source: "la Caixa" Research, based on data from the EIB (2013).

Structure of the European Fund for Strategic Investments (EFSI)



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

FOCUS · The ECB finds itself in an alley with just one exit: QE

In September 2014, Mario Draghi gave a surprise announcement that the ECB's balance sheet would be expanded by one trillion euros through the purchase of asset-backed securities and covered bonds and also by granting long-term credit at a very low interest rate with the condition that loans be given to the non-financial sector (known as targeted long-term refinancing operations or TLTROs), a commitment confirmed at its December meeting when the expansion of the balance sheet was classed as «intention» rather than «expectation». The impact of such announcements was immediate, with a significant drop in yields both on public and corporate debt as well as in interbank interest rates.

With the three programmes underway for a few months now, we can begin to analyse just how effective they have been. Unfortunately the conclusion is not very encouraging: the bulk of the evidence available suggests that the ECB will find it very difficult to increase its balance sheet to the level indicated via the measures announced to date. In the first two TLTROs held, the total amount demanded was 212 billion euros, far below the maximum available, namely 400 billion, and also below what analysts expected overall. Similarly, although the rate of covered bond purchases is higher than in previous programmes of a similar nature (see the corresponding graph), the scope of this last programme seems limited. Moreover, 210 billion euros are still pending repayment, corresponding to the TLTROs held in December 2011 and February 2012, which will drain liquidity.

Apart from growing doubts regarding the effectiveness of the measures being carried out, the uncertain macroeconomic situation of the euro area is also pressurising the ECB. Specifically, beyond the speed at which the euro area is recovering, which was already expected to be very slow, of particular note is the change occurring in inflation expectations. A change that is unlikely to reverse over the coming months, with inflation probably entering negative terrain. Although to a large extent this drop is due to falling oil prices and not to any further decline in domestic demand, fears of deflation will once again plague the euro area.

Given this scenario, and given the repeated statements of several members of the ECB's Governing Council, such as Coeure and Praet, opening the door more or less explicitly to the announcement of a sovereign debt purchase programme, the ECB seems almost bound to make a move in this direction at its coming meetings. If it finally implements a quantitative easing (QE) programme, it will more than likely opt for a sovereign debt purchase programme of around 500 billion euros which might last about one year. This new measure, together with the operations already underway, would

be enough to increase the size of the ECB's balance sheet as announced. In addition, the ECB has also opened the door to buying up corporate bonds.

Naturally, a programme of such characteristics would push interest rates to a slightly lower level than at present, helping to consolidate the recovery in credit, but the impact would surely be greatest on the exchange rate, with the euro possibly going below 1.20 dollars. However, at this stage in the game the biggest shock for growth prospects is not the announcement that QE will start, which the market has largely already supposed, but the possibility of the ECB not announcing it after all.

Given the inability of any other EU institution to revive growth, the ECB has become almost the only credible reference. If it disappoints the expectations aroused, the negative effect on household and investor confidence could be another blow to the still fragile recovery. It therefore appears that the ECB has entered an alley with just one exit: QE.

Germany: inflation expectations

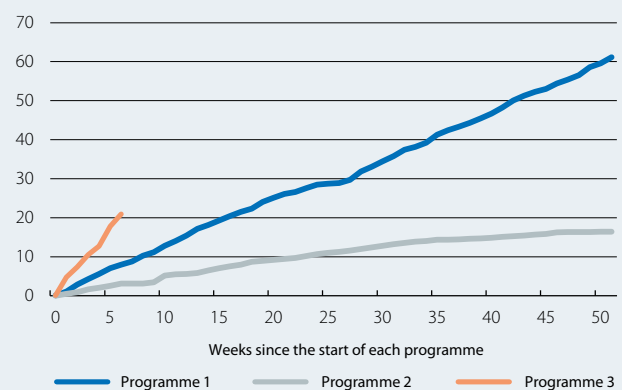
Implied in 10-year inflation-linked bonds (%)



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

Euro area: covered bond purchases under the ECB's programmes

Cumulative volume (billion euros)



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

KEY INDICATORS

Activity and employment indicators

Values, unless otherwise specified

	2012	2013	2013 Q4	2014 Q1	2014 Q2	2014 Q3	10/14	11/14	12/14
Retail sales (year-on-year change)	-1.6	-0.9	0.3	1.0	1.4	1.0	1.4	...	...
Industrial production (year-on-year change)	-2.4	-0.7	1.5	1.3	0.9	0.4	0.7	...	...
Consumer confidence	-22.1	-18.7	-14.4	-11.2	-7.7	-9.9	-11.1	-11.6	-10.9
Economic sentiment	90.8	93.8	99.1	101.6	102.2	100.9	100.7	100.8	...
Manufacturing PMI	46.2	49.6	51.9	53.4	52.5	50.9	50.6	50.4	...
Services PMI	47.6	49.3	51.3	52.1	53.0	53.2	52.3	51.3	...
Labour market									
Employment (people) (year-on-year change)	-0.5	-0.8	-0.4	0.0	0.4	0.6	-	...	-
Unemployment rate: euro area (% labour force)	11.3	12.0	11.9	11.8	11.6	11.5	11.5	...	...
Germany (% labour force)	5.4	5.2	5.1	5.1	5.0	5.0	4.9	...	...
France (% labour force)	9.8	10.3	10.2	10.1	10.2	10.5	10.5	...	...
Italy (% labour force)	10.7	12.2	12.5	12.6	12.6	12.8	13.2	...	...
Spain (% labour force)	24.8	26.1	25.8	25.2	24.7	24.2	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	10/14	11/14
Current balance: euro area	1.6	2.2	2.2	2.3	2.3	2.5	2.6	...
Germany	7.1	6.7	6.7	6.8	6.8	7.2	7.5	...
France ¹	-1.5	-1.4	-1.4	-1.5	-1.7	-1.4	-1.3	...
Italy	-0.5	1.0	1.0	1.3	1.3	1.6	1.7	...
Spain	-0.3	1.4	1.4	1.1	0.4	0.2	-0.1	...
Nominal effective exchange rate² (value)	97.8	101.6	103.1	103.8	103.8	101.6	99.5	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	10/14	11/14
Private sector financing								
Credit to non-financial firms ¹	-0.3	-2.3	-2.9	-3.1	-2.5	-2.0	-1.6	-1.3
Credit to households ^{1,2}	1.2	0.3	0.3	0.3	0.5	0.5	0.6	0.7
Interest rate on loans to non-financial firms ³ (%)	2.4	2.2	2.3	2.2	2.1	1.9	1.8	...
Interest rate on loans to households for house purchases ⁴ (%)	3.1	2.8	2.8	2.8	2.7	2.6	2.4	...
Deposits								
On demand deposits	4.1	7.9	6.6	5.9	5.2	5.9	6.3	7.1
Other short-term deposits	2.0	0.0	-1.5	-2.5	-2.0	-1.7	-2.1	-1.8
Marketable instruments	0.5	-14.8	-16.8	-12.7	-11.6	-6.0	-1.0	0.3
Interest rate on deposits up to 1 year from households (%)	2.8	2.0	1.6	1.6	1.4	1.3	1.1	...

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 · A good end to the year for the Spanish economy

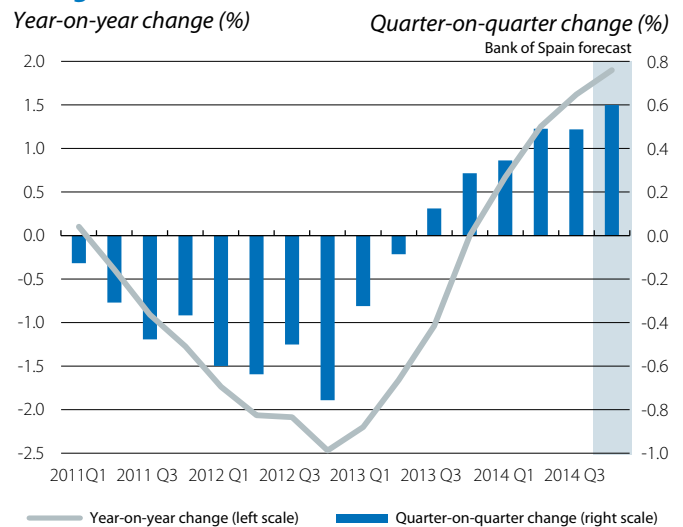
Spain's economy continues to grow at a good rate. According to the Bank of Spain, GDP grew by 0.6% quarter-on-quarter in Q4. Should this figure be confirmed, 2014 will end with 1.4% growth in GDP. Regarding the new year, the most recent forecasts of the consensus of analysts, from December, point to 1.9% growth for 2015. This figure represents a substantial improvement on January's forecast a year ago, which placed growth at 1.2% for 2015. The improvement in the outlook throughout 2014 is thanks to more confidence in the Spanish economy's growth capacity, which has also been reinforced by two additional factors: the slump in oil prices, deeper and longer lasting than initially expected, and the greater depreciation of the euro because of the actions carried out by the ECB throughout the year.

These good prospects for the Spanish economy contrast with the worsening of the euro area. In the second half of the year, the consensus of analysts revised downwards its growth forecasts for the euro area in 2015, going from 1.6% in July to 1.1% in December. Given the weak, uneven recovery in the euro area and the decrease in inflation expectations, we expect the ECB to implement additional quantitative easing measures in 2015 Q1 (see the Focus «The ECB finds itself in an alley with just one exit: QE»). More accommodative monetary policy has led us to reduce and flatten out the interest rate curves, which will boost financing conditions for the public sector. Specifically, we have revised downwards our yield on Spanish 10-year bonds by an average of 20 bps for 2015, down to 1.6%. Nonetheless, given that the increase in monetary supply will take some time to have an effect on the real economy, we have maintained our annual GDP growth forecast for 2015 at 1.9%, albeit revising it upwards to 2.2% for 2016 (previously 2.0%) as we expect exports to grow slightly more than originally predicted thanks to the euro's depreciation. On the other hand, we have maintained our forecast for the current balance as an increase in imports (due to the recovery in oil prices expected for 2016) will offset this effect.

Supply indicators look promising. The PMI manufacturing index rose strongly in November, reaching its highest level since March 2007. Industrial production also increased, by 1.2% year-on-year in October. The PMI for services, however, corrected part of the advance made over the last few months and stood at the 52.7 points, albeit still comfortably in the expansionary zone. Billing figures for firms and industrial orders also point to a sustained recovery, posting positive growth in October (2.0% and 3.7% year-on-year, respectively). One of the main industries for the Spanish economy, namely automobiles, continues to look strong (registrations rose by 17% year-on-year in November and turnover by 9.1% in October).

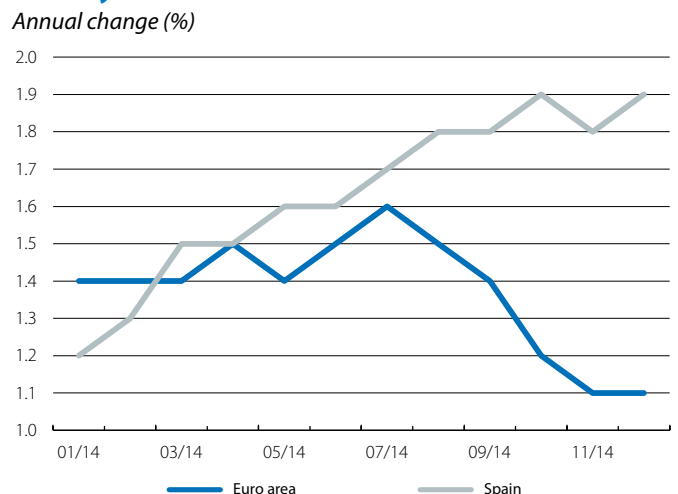
A positive balance for employment. The number of registered workers affiliated to Social Security grew more than expected in

GDP growth



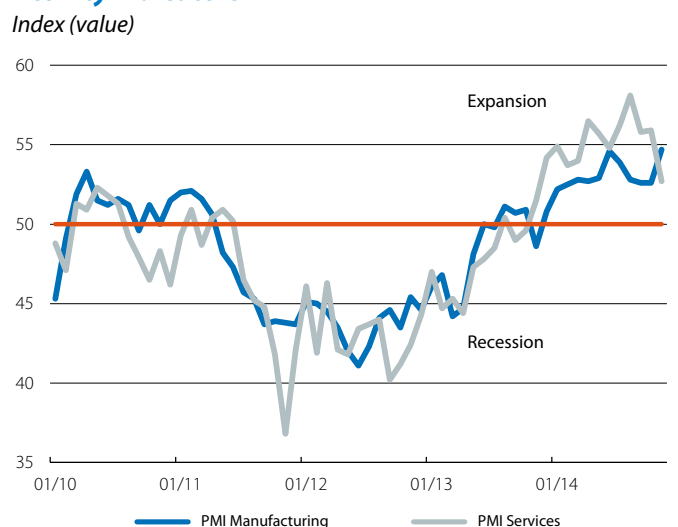
Source: "la Caixa" Research, based on data from the INE and the Bank of Spain.

Trend in GDP growth forecasts of the consensus of analysts for 2015



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

Activity indicators



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

November (95,040 seasonally adjusted). This notable increase was down to the services sector which has been creating jobs for several months, as well as to the fact that the improvement in industry and construction is gradually consolidating. Judging by employment expectations in the European Commission's opinion polls, the labour market should continue to recover apace over the coming months. On average, expectations are better than in Q3 and with highly significant growth in the construction sector, yet another example that the real estate market is stabilising. One particularly important aspect is the increase in new building permits, up by 2% year-on-year in September and the first positive rate since July 2007. This should improve the trend for the number of homes started in the last quarter of the year. There are also signs of real estate demand recovering with house purchases up by 16.0% year-on-year in October (13.7% in September).

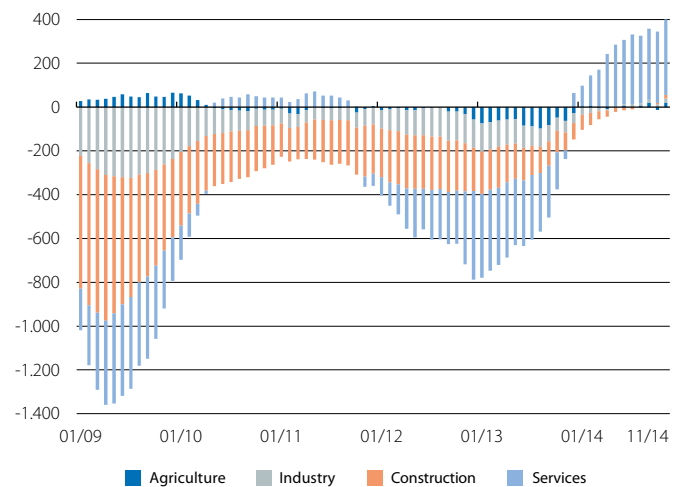
Moderate wages continue. In 2014 Q3, wage costs grew by 0.1% quarter-on-quarter according to the harmonised index of labour costs (0.4% in Q2 and -0.1% in Q1). These survey data therefore corroborate that wages are still adjusting, as shown by last month's figures from the National Accounts system. The moderate rise established in wage agreements in November, namely 0.6% year-on-year, suggests that wages will remain contained over the coming quarters. Moreover, given that inflation will be considerably lower in 2015 than previously expected, there will be no pressure from this source to increase wages. Because of this, we have revised downwards our growth forecasts for compensation per employee in 2015, so that unit labour costs can continue their adjustment but without incurring any loss in purchasing power. Consumption will also be strengthened by the improvement in household disposable income thanks to growing employment and the income tax reduction introduced in the tax reform.

Oil offers no respite to the CPI. In November, inflation fell to -0.4%, particularly as a result of falling prices in energy products, both oil and electricity, and also in fresh foods. On the other hand core inflation has remained at a standstill since May, between 0.0% and -0.1%. Over the coming months we expect general inflation to remain in negative terrain as oil prices are falling further and longer than initially predicted. In fact, December's growth in the CPI places inflation at -1.1%, a negative rate that has not been seen since 2009, also because of falling oil prices. However, while the 2009 drop in oil prices was mostly due to demand factors because of the world recession, this time around it is largely a result of supply factors. In any case, the slump in oil prices (-48.6% year-on-year at the end of year) has meant that inflation in 2015 has undergone a sharp downward revision, from 0.9% to 0.3%.

Signs of improvement in the foreign sector after a weak first quarter. Exports of goods grew significantly by 4.1% year-on-year in October. If we take the average from the last three months, this increase is higher than the one for the first half of the year, although it has eased slightly. Exports therefore continue to grow, although they cannot offset the

Employment

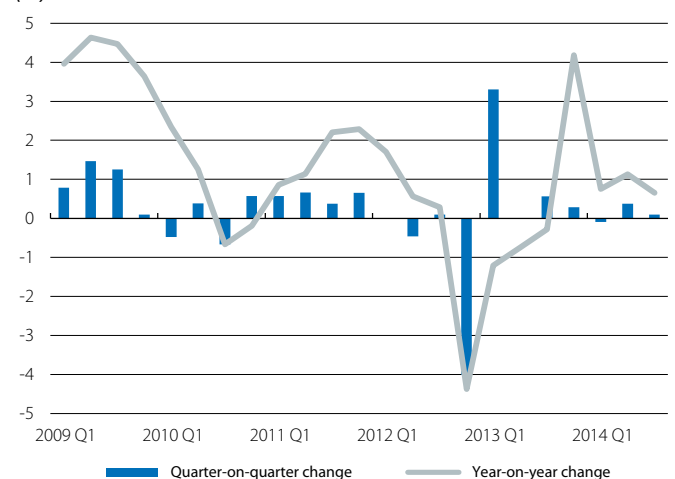
Year-on-year change (thousands)



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

Hourly wage cost

(%)

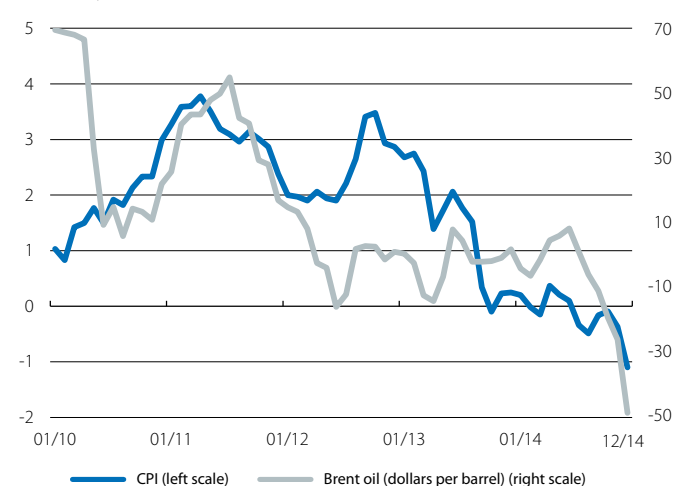


Note: Data seasonally adjusted.

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

CPI and oil prices

Year-on-year change (%)



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

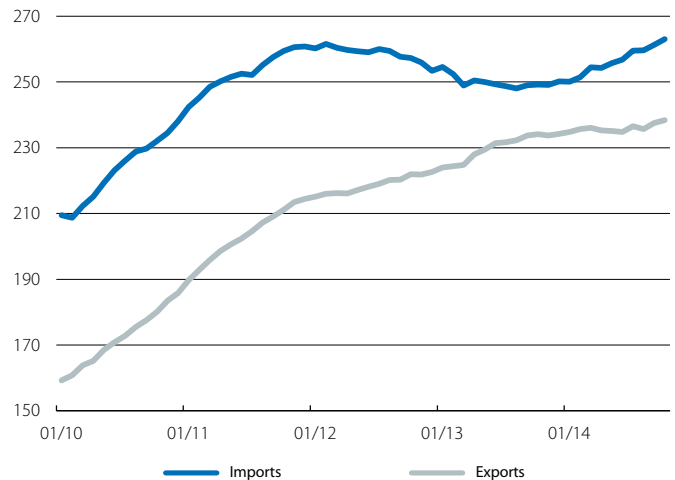
strength of imports at present, boosted by the recovery in consumption and strong investment in capital goods. With regard to the export of services, November's increase in the number of foreign visitors, namely 2.9% year-on-year, should help to offset part of the deficit in the balance of goods and income balance. The good tone observed in tourism's outbound markets, except for Russia which fell by 32.6% but only represents a small share of the total (1.3%), means that this favourable outlook for the sector should continue.

The AIReF warns of the risk of autonomous communities not meeting their deficit targets in 2014. The estimated deviation, more than 0.3 pps of difference from the 1% target, is mainly due to the large share of interest payments in financial costs, as well as expenditure being over budget and deviations in revenue. Given that a significant deviation has now been predicted for 2014, the AIReF insists that preventative measures be taken in seven communities to ensure they meet their deficit target in 2015, namely 0.7% of GDP. Specifically, according to this institution, deviation is very likely and extensive (a deficit above 2.0% of GDP) in Extremadura, Catalonia, Valencia and Murcia; and very likely but smaller (a deficit above 1.3% of GDP) in Castile-La Mancha, Andalusia and the Balearic Islands. The AIReF's report adds fuel to the debate on the financing system for autonomous communities and the need to reform it. Given this situation, on 26 December the Spanish government approved a Royal Decree to improve financing for the autonomous communities and local government corporations in the short term. Specifically, new financing funds were set up at zero interest for 2015. This zero interest rate will continue for two more years for those communities that meet their deficit target or for those that do not meet their target but present an adjustment plan to achieve this. On the other hand, public sector debt increased once again and reached 96.8% of GDP in 2014 Q3 (96.4% in Q2). The economic recovery and fiscal adjustment planned will help public sector debt to stabilise in 2016 around 101% of GDP, while it is expected to fall very gradually as from 2017.

A favourable trend for the banking sector. Although the outstanding balance of credit is still at a historically low level and the NPL rate is still high, the most recent figures show clear improvement in both areas, although not widespread in all segments. In October, credit for consumption and to acquire residential properties increased significantly and, should this continue, it will support the recovery in consumption and the real estate sector. With regard to corporate financing, new loans to SMEs increased again, up by 14.3% annually (cumulative from January to October), while new loans to large firms posted a drop, with figures that are still far from the levels reached in 2013. However, part of this fall is due to the replacement of bank loans with other sources of financing, such as capital markets. On the other hand, the non-performing loan (NPL) ratio fell once again in October, down to 12.9%. Nonetheless, the breakdown for Q3 shows a disparate trend by segment, with decreases in the NPL rate, for example, in loans to households to buy housing but increases in the NPL rate for loans to households for consumption.

Balance of goods

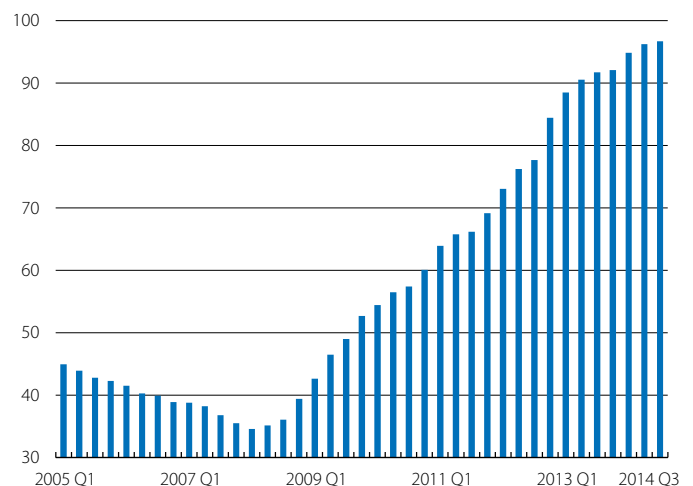
Cumulative over 12 months (billion euros)



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

Gross public debt

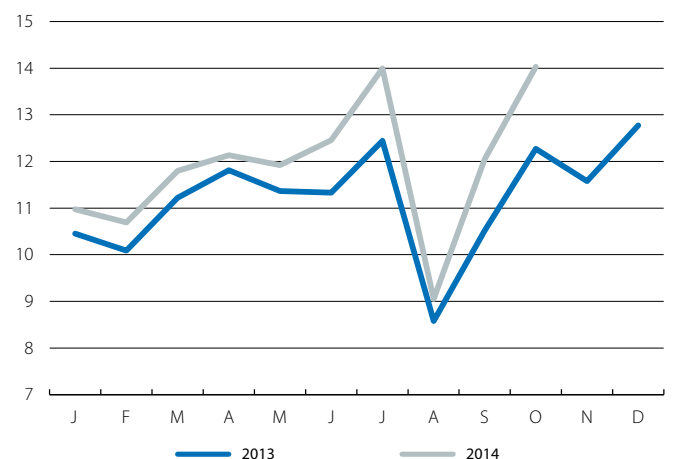
(% of GDP)



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

New loans granted to SMEs *

(Billion euros)



Note: * Loans under one million euros.

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

FOCUS · Financial defragmentation in the euro area: still some way to go

The financing terms in different countries of the euro area are gradually converging. One example of this is the narrowing spread of interest rates on new loans of under one million euros, the most widely used by SMEs, between core and periphery countries. According to the most recent data from October, the interest rate was, on average, 4.6% in the periphery (4.2% in Spain) and 2.7% in the core, a spread of 2.0 pps (see the first graph). At the peak of the euro area's sovereign debt crisis, this spread reached just over 2.7 pps. The announcement of the OMT programme¹ in summer 2012 by the ECB, together with its commitment to do whatever it takes to ensure the euro would survive, marked a turning point and stopped the fragmentation from getting any worse. Since then, notable progress has been made in the reintegration process. Improvements can be seen in many segments: yields on sovereign debt for peripheral countries are now at an all-time low, interest rates on corporate and bank bonds have substantially converged and transnational financial flows are less fragmented. However, the differences between countries are still significant, especially when compared with lending conditions before the sovereign debt crisis, when the interest rate spread was practically zero and credit flowed more easily between countries.²

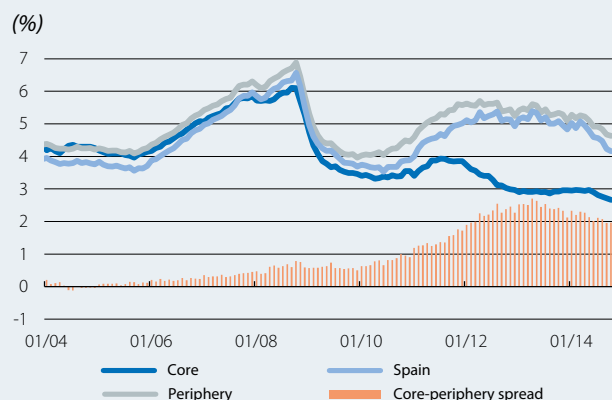
This convergence must therefore continue. Once again the ECB is bound to play an important role. The measures it has announced over the last few months should help to ease monetary conditions in the euro area even further. However, the tepid welcome shown for the first two TLTROs (targeted long-term refinancing operations) and purchases of asset-backed securities (ABS) and covered bonds indicates that they might not be enough to achieve this aim.

The improvement of growth prospects in the periphery has also helped to reduce financial fragmentation. Over the last year analysts revised upwards their growth forecasts for 2014 and 2015 for the periphery countries, including Spain (see the second graph). The economic recovery of these countries has helped to improve the credit quality of those asking for loans and consequently a relaxation in their conditions of access.

Beyond the boost provided by monetary policy and growth in the short and medium term, it is vital to make further progress at an institutional level in order to achieve long-lasting financial integration. Very positive

factors in this respect are the advances made towards banking union, both in supervision and resolution. This new architecture has helped to boost the credibility of the banking sector and break the link between bank and sovereign risk, the initial cause of financial fragmentation. But this is not enough. In a monetary union it is essential to set up mechanisms to improve the coordination of economic policies and to effectively share risk, mechanisms which, for them to be legitimate, must be accompanied by a greater degree of political integration. In short, in order for credit to flow again under equal conditions in all economies of the euro area, it is necessary to continue advancing towards real economic and monetary union, as established in the roadmap agreed at the height of the sovereign debt crisis.

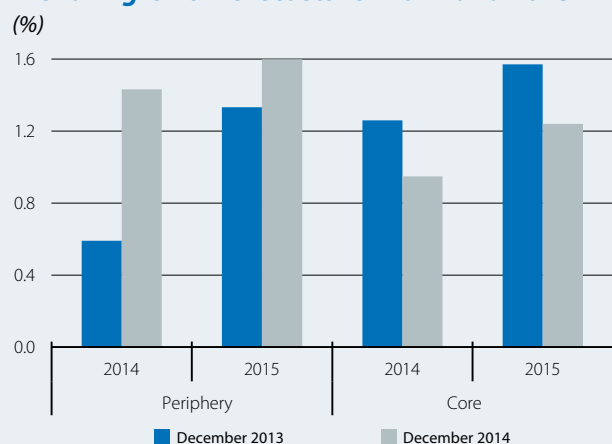
Interest rate on bank loans under one million euros



Note: The core includes Germany, Austria, Belgium, France, Netherlands and Luxembourg, and the periphery, Cyprus, Spain, Greece, Ireland and Portugal.

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

Trend in growth forecasts for 2014 and 2015



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

1. Programme of unlimited sovereign debt purchases in the secondary market, or outright monetary transactions (OMTs).

2. Nonetheless, some difference is likely to persist even at equilibrium level.

FOCUS · Wages, productivity and competitiveness

Over the last few years, one of the good pieces of economic news has been the improvement in competitiveness observed in the Spanish economy. Spain's unit labour costs (ULCs) compared with its trading partners in the euro area (the most widely used benchmark to analyse the trend in price competitiveness) are already at the levels of the 2000s. However, now that economic activity is starting to pick up, the question is whether competitiveness has improved thanks to temporary factors related to the economic cycle or whether this improvement comes from a fundamental change in Spain's economy. A brief analysis of the factors underlying the trend in ULCs offers some interesting pointers.

Between 1999 and 2007, nominal compensation per employee for the economy as a whole rose significantly (3.5% annually on average), far greater than the rise in productivity (0.3% annually). As a result, ULCs increased substantially (see the second graph), much more than the increases recorded by Spain's trading partners, thereby reducing its competitiveness.¹ By sector, wage increases and productivity improvements did not appear to be related in any way. In other words, during this phase, compensation generally grew to a similar extent in all sectors irrespective of the gains in productivity occurring in each of these (see the third graph).

This pattern changed significantly during the recession. Initially the higher fall in employment compared with the drop in GDP meant that productivity increased considerably, pushing down ULCs. As from 2010 a much more contained trend in wages was added to this process and, as can be seen in the second graph, this second factor also played an important role in reducing ULCs. In addition to wage containment, which appears to be relatively widespread in all sectors, the process used to establish compensation also seems to have changed: since the start of the recession it has been more in line with the trend in productivity in each sector. This is shown by the third graph where we can see that wages have risen the most in precisely those sectors whose growth in productivity has been the highest while wage rises have been more limited in those sectors seeing a smaller increase in productivity.

This closer relationship between the trend in wages and productivity suggests that the changes occurring in the system used to establish employee compensation are fundamental and should therefore continue over the coming years. And it is important for this to be the case as they are essential for the Spanish economy to successfully tackle the big challenges it still faces: to continue improving its competitiveness to ensure current account surpluses that help to reduce its external debt, as well as to increase the pace of job creation.

1. Productivity of the labour factor is the quotient of gross value added in constant terms (GVA) divided by employment equivalent to full-time (EETC): $GVA/EETC$. Unit labour costs (ULCs) are the quotient of nominal compensation per employee (w) divided by productivity ($GVA/EETC$). We use the concept of nominal compensation per employee instead of real wages due to the difficulty of obtaining price indices by sector.

Trend in unit labour costs compared with the euro area

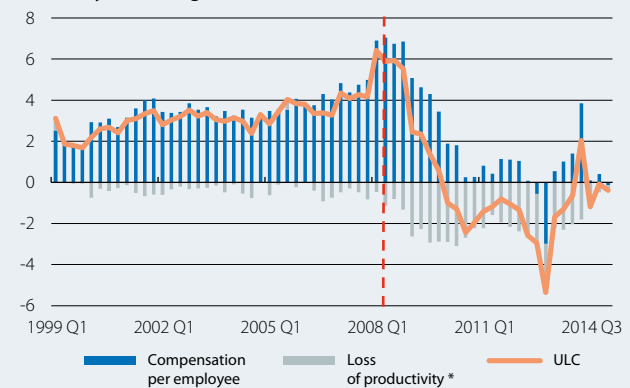
Index (1999 = 100)



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

Breakdown of unit labour costs

Year-on-year change (%)



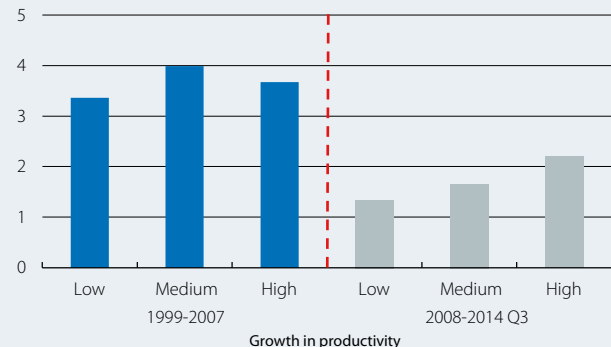
Note: * Positive values indicate a loss of productivity, and vice versa.

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

Relationship between productivity and wages*

Year-on-year change (%)

Nominal compensation per employee**



Notes: * Low refers to negative growth rates for productivity; Medium to a rate between 0% and 2%; and High in excess of 2%. ** Average of sectors according to productivity. Codes from CNAE-2009 (B+C), F, (G+H+I), J, K, L, (M+N), (O+P+Q) and (R+S).

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

FOCUS · On the sustainability of the pension system

Spain's Social Security accounts have become increasingly imbalanced since 2010. In fact, the gap between revenue and expenditure is expected to reach 1.0% of GDP in 2014. The government used that year 14 billion euros from the Social Security Reserve Fund to meet pension payments and the Social Security Budget contains plans for a further 8.5 billion euros to be used in 2015.

This situation is the result both of the fall in social insurance contributions, which is more temporary in nature, and the rise in pension expenditure, which is more structural and due to the larger number of pensioners as well as an increase in the average pension payment. An example of the ageing of country's population is the fact that the number of pensioners went from 7.7 million in 2008 to 8.4 in 2014 Q3, while the size of the average monthly pension also rose from 725 euros in 2008 to 877 euros in 2014, going above 1,000 euros in the case of contributory retirement pensions (see the first graph).

The recently approved reforms of the pension system should make the system more sustainable. Specifically, 2011's reform helps to contain pension spending by progressively raising the retirement age from 65 to 67 and the number of years included in the quota from 15 to 25. Given that this will be implemented gradually, the impact will take some time to be seen.

2013's reform also introduced elements that should help to rebalance the Social Security accounts. Firstly, it adds a generational equity factor that takes life expectancy into account when calculating pensions (implemented as from 2019). It also alters the annual revaluation of pensions which will start to be applied as from 2015. This adjusts the revaluation of pensions according to Social Security's budget flows and the economic cycle, attempting to achieve equilibrium in the medium term between revenue and expenditure, although it also sets a minimum increase (0.25%) and maximum increase (inflation + 0.5%). For 2015 the figure resulting from applying this Pension Revaluation Index to balance revenue and expenditure would be below 0.25% according to the calculations of the AIReF (Independent Authority for Fiscal Responsibility). The government has therefore applied the minimum legal increase (0.25%), something which, given the economic outlook over the medium to long term, is likely to be repeated over the next few years.

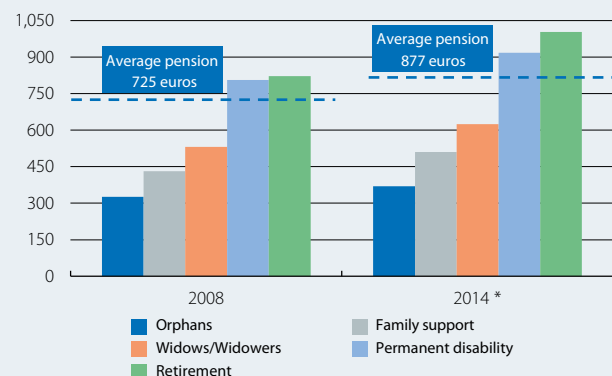
The expected medium-term trend (2015-2020) for Social Security revenue and expenditure shows the gap gradually closing (see the second graph). The mechanisms adopted therefore result in some

adjustment. However, the AIReF has warned that the government's revenue forecasts for this period are too optimistic (those for expenditure appear to be more realistic as they are easier to predict). Moreover their calculation, which models the trend in company contributions as well as the number of pensions and the retiree substitution rate, reveals that additional revenue will be required equivalent to 1.0% of annual GDP during 2015-2020.

In summary, although the reforms have helped to make the system more sustainable, the gap between revenue and expenditure has not been entirely wiped out. The government expects to receive more revenue by introducing payments in kind, a new direct settlement system (CRETA) and by tackling fraud (measures contained in the 2015 Social Security Budget). The ball is still in play.

Trend in the average monthly pension payment, by type

(Euros)

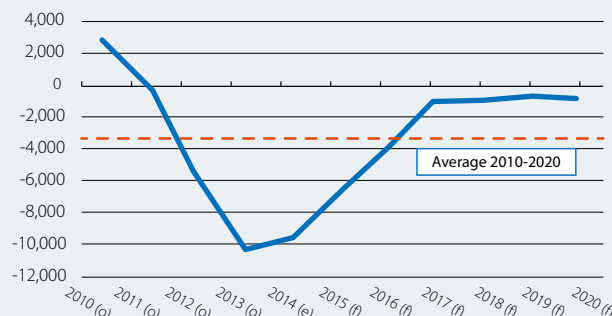


Note: * December 2014.

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

Gap between Social Security revenue and expenditure

(Million euros)



Note: (o) observed; (e) estimated; (f) forecast. Includes revenue and expenditure from the Social Security contributory system.

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

KEY INDICATORS

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

Activity indicators

	2012	2013	2013 Q4	2014 Q1	2014 Q2	2014 Q3	10/14	11/14
Industry								
Electricity consumption	-2.2	-2.2	0.1	-0.4	0.8	0.3	-1.0	-0.9
Industrial production index	-6.6	-1.5	1.1	1.5	2.6	0.6	0.9	...
Indicator of confidence in industry (<i>value</i>)	-17.5	-13.9	-11.6	-9.1	-8.2	-5.7	-6.0	-4.0
Manufacturing PMI (<i>value</i>)	43.8	48.5	50.1	52.5	53.4	53.1	52.6	54.7
Construction								
Building permits	-42.7	-21.4	-6.5	-8.9	14.4	26.5	15.6	...
House sales	-8.7	-2.4	-9.8	-9.3	6.5	7.8	16.0	...
Services								
Foreign tourists	2.0	5.6	10.8	8.1	7.8	7.6	7.8	2.9
Services PMI (<i>value</i>)	43.1	48.3	51.8	54.2	55.7	56.7	55.9	52.7
Consumption								
Retail sales	-7.1	-3.7	0.4	-0.1	0.7	0.4	0.7	2.3
Car registrations	-13.5	5.6	22.6	11.8	23.2	17.0	26.1	17.4
Consumer confidence index	-31.7	-25.3	-19.4	-11.8	-6.1	-7.9	-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	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	0.9
Construction	-17.0	-12.1	-7.9	-5.3	-2.3	-0.5	0.5	1.6
Services	-1.7	-2.0	-0.4	1.1	2.2	2.6	2.7	2.8
Employment by professional status								
Employees	-3.8	-3.8	-1.8	0.1	1.4	1.9	1.9	2.5
Self-employed and others	-1.4	-0.6	0.4	1.4	2.3	2.5	2.6	2.5
TOTAL	-3.4	-3.2	-1.4	0.4	1.5	2.0	2.0	2.5
Employment²	-4.3	-2.8	-1.2	-0.5	1.1	1.6	...	-
Hiring contracts registered³								
Permanent	29.7	-14.2	-2.1	6.8	24.0	21.5	24.7	25.1
Temporary	-4.0	6.4	15.0	19.4	14.2	11.1	6.2	10.5
TOTAL	-1.6	4.0	13.5	18.2	15.0	11.8	7.6	11.6
Unemployment claimant count³								
Under 25	4.5	-6.2	-8.0	-9.4	-10.9	-5.5	-6.9	-7.8
All aged 25 and over	11.7	3.7	-1.2	-3.7	-5.9	-5.9	-5.8	-6.0
TOTAL	10.9	2.7	-1.8	-4.2	-6.4	-5.9	-5.9	-6.2

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	10/14	11/14	12/14
General	2.4	1.4	0.1	0.0	0.2	-0.3	-0.1	-0.4	-1.1
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	1.7	1.2	...
Energy products	8.8	0.1	-1.1	-1.0	2.4	-0.2	-1.1	-3.2	...

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	09/14	10/14
Trade of goods								
Exports (year-on-year change)	3.8	5.2	0.8	3.2	-2.0	4.8	9.6	4.1
Imports (year-on-year change)	-2.8	-1.3	2.0	7.0	3.7	7.3	7.5	7.7
Current balance¹	-3.0	15.1	15.1	11.2	3.5	0.1	0.1	-1.5
Goods and services	16.5	35.7	35.7	33.6	28.9	26.7	26.7	25.6
Primary and secondary income	-19.4	-20.6	-20.6	-22.4	-25.5	-26.6	-26.6	-27.0
Net lending (+) / borrowing (-) capacity¹	2.3	22.0	22.0	18.3	9.9	6.0	6.0	4.2

Note: 1. Data from the Bank of Spain using a new methodology for the balance of payments (MBP6).

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	10/14	11/14
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	-2.9	-3.3
Autonomous regions	-1.8	-1.5	-1.5	-0.3	-1.1	-1.1	-1.3	...
Local government	0.3	0.5	0.5	0.2	0.1	0.4	-	...
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	96.4	96.8	-	...

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

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

Financing and deposits of non-financial sectors

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

	2012	2013	2013 Q4	2014 Q1	2014 Q2	2014 Q3	09/14	10/14	Balance 10/14 ¹
Financing of non-financial sectors²									
Private sector	-4.3	-8.2	-7.9	-6.4	-5.7	-5.1	-4.8	-5.2	1,715.1
Non-financial firms	-4.7	-10.6	-9.7	-6.9	-6.1	-5.1	-4.9	-5.6	961.7
Households ³	-3.8	-5.0	-5.5	-5.6	-5.2	-5.0	-4.7	-4.7	753.4
General government ⁴	15.0	16.8	13.0	8.5	6.6	5.9	6.1	6.2	1,017.0
TOTAL	0.6	-1.1	-1.6	-1.5	-1.6	-1.3	-1.0	-1.8	2,718.5
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	-1.7	1,155.7
On demand deposits	0.2	4.2	8.1	7.4	7.4	13.6	13.5	12.8	311.3
Savings deposits	-2.8	-0.1	1.4	3.8	5.9	6.9	7.1	6.4	211.2
Term deposits	-6.7	1.7	0.2	-3.6	-6.1	-9.4	-10.0	-10.2	612.2
Deposits in foreign currency	-4.0	16.8	-0.1	-1.1	0.1	0.3	0.5	6.1	21.1
Rest of liabilities ⁵	-13.2	-16.8	-12.7	-11.1	-8.3	-6.8	-10.7	-6.7	117.0
TOTAL	-5.7	-0.2	0.5	-1.1	-1.6	-1.7	-2.3	-2.2	1,272.7
NPL ratio (%)⁶	10.4	13.6	13.6	13.4	13.1	13.0	13.0	12.9	-
Coverage ratio (%)⁶	73.8	58.0	58.0	58.6	59.4	59.1	59.1	59.3	-

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.

REASON AND EMOTION IN DECISION-MAKING

Price formation in financial markets: between reason and emotion

Throughout our lives we face a series of dilemmas which are often dealt with almost automatically whereas other, more complex choices require greater attention. Understanding the decision-making process that lies behind choosing whether, for example, to consume or to save, to invest in bonds or in equity or even to buy or rent our home is a complex but crucial task for handling our finances. The emergence of behavioural finance in the final decades of the 20th century has introduced concepts from the field of psychology to help determine how we take such decisions. This trend contrasts with the classic financial paradigm in force until now, based on rationality. Both disciplines have significantly improved our understanding of how asset prices are set, an insight which may be of great help given the warning voices of the possible formation of bubbles in some areas.

The awarding, in 2013, of the Nobel Prize for Economics to three authors with very different approaches to asset valuation, namely Eugene Fama, Robert Shiller and Lars Peter Hansen, highlights the importance of this concept within financial theory. The first of these three, Fama, can be considered as one of the most renowned voices among those in favour of the traditional paradigm. This theoretical approach defines economic agents as rational; i.e. they correctly process the information available in markets and, based on this, take optimal decisions. As part of this framework, in 1970 Fama coined the concept of an efficient market, defining it as a market in which «security prices reflect all available information».¹ In other words, in an efficient market the price of an asset will always be equivalent to its fundamental or intrinsic value, understood as the present value based on all discounted future income. The reason is simple: any deviation in an asset's price from this fundamental value represents an opportunity for arbitrage (i.e. producing a profit without assuming any risk) for rational investors and, on carrying this out, they immediately return the price to its equilibrium level.

The main achievement of traditional financial theory has been its capacity to explain, based on a relatively simple conceptual framework, some of the forces underlying the mechanism of price formation for assets. One clear example of this is the Capital Asset Pricing Model developed by Sharpe in 1964.² This model intuitively explains the dilemma faced by investors, namely the choice between the potential risk and return of a portfolio, whereby the latter can only increase if investors are prepared to take on a higher associated risk.

However, empirical evidence has shown that this rational paradigm is considerably limited in explaining the behaviour observed with asset prices. One of the first authors to reveal such problems was, in 1981, another Nobel prize-winner Robert Shiller, who showed the inability of traditional models to explain the high degree of volatility in stock market indices.³ Many economists believe this study marks the beginning of behavioural finance. Since then numerous publications have identified episodes in which share prices have deviated significantly from their intrinsic value, questioning the overall validity of the traditional financial paradigm. Indeed, the first decade of the 21st century provided countless examples of such deviations, firstly with the appearance of the dot.com bubble and then the housing bubble in some developed countries.

The advances observed over the last few decades have placed behavioural finance as a possible alternative to classic financial theory in terms of explaining how asset prices are formed. Its key difference to the traditional paradigm is its relaxation of rationality standards for market participants. To this end, it identifies several cognitive dysfunctions that affect how individuals make a decision. One initial dysfunction comes from prospect theory, based on the empirical studies carried out by Kahneman and Tversky on the decision-making process of individuals in uncertain situations.⁴ According to their findings, individuals evaluate potential losses and gains very differently. In particular, there is a natural tendency to avoid a loss rather than make a gain (also known as loss aversion). Other dysfunctions are related to the tendency of individuals to overestimate their ability to make future projections (overconfidence) and to follow the strategies employed by the majority without considering whether these are logical (herding).⁵

1. See Fama, J. F. (1970) «Efficient Capital Markets: A Review of Theory and Empirical Work», *Journal of Finance*.

2. Sharpe, W. F. (1964) «Capital asset prices: A theory of market equilibrium under conditions of risk», *Journal of Finance*.

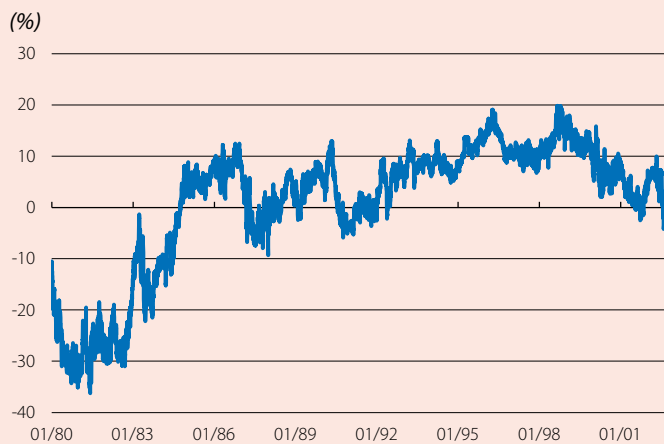
3. See Shiller, R. J. (1981) «Do stock prices move too much to be justified by subsequent changes in dividends?», *American Economic Review*.

4. Kahneman, D. & Tversky, A. (1979) «Prospect Theory: An analysis of decision under risk», *Econometrica*.

5. For more information, see the article «Portfolio management: from theory to practice» in the Dossier in this *Report*.

However, the existence of cognitive dysfunctions is not enough to explain such deviations in asset prices. In fact, as has already been mentioned, although the vast majority of market participants are biased when taking decisions, the fact that there are also rational participants should return prices to their fundamental value. Consequently, for participants' bias in decision-making to result in deviations of asset prices from their intrinsic value there must also be limits to the arbitrage capacity of rational participants. Economics literature provides numerous examples of this. One of these is that markets are not complete, so investors do not know which assets can help them to implement an arbitrage strategy without taking on additional risks. On other occasions the cost of arbitrage is high, either operational due to trading costs or because of the costs involved in obtaining the necessary knowledge in order to carry out arbitrage. One final element that helps to explain the limits to arbitrage can be summed up in the words of John Maynard Keynes: «The market can remain irrational longer than you can remain solvent». In other words, should the deviation in the asset price continue for too long, such a strategy could incur considerable losses for arbitrageurs and might ultimately impede arbitrage.

Deviation of relative share prices between Royal Dutch and Shell



Source: "la Caixa" Research, based on data from «The Risk and Return of Arbitrage in Dual-Listed Companies».

One example that illustrates this concept perfectly is the famous case of Royal Dutch and Shell Transport. In 1907, both companies decided to merge and allocate their profits on a 60:40 basis but they continued to exist as legally separate entities and were listed separately on international stock markets. They also agreed to pay out their dividends in the same proportion. According to classic financial theory, the relative market value between both companies should always remain constant and in line with this ratio. Therefore rational investors should have taken advantage of any deviation for arbitrage, buying any relatively cheap shares and selling expensive ones, thereby bringing prices back to their equilibrium value. However, as can be seen in the graph, this was not the case: the deviation between the relative share prices exceeded 10% on many occasions. Does this mean there is no such thing as a rational participant? No. In fact, numerous hedge funds

attempted to exploit the potential arbitrage between both companies. However, the fact that these deviations remained high between 1993 and 1999 meant that most of these funds saw huge losses.

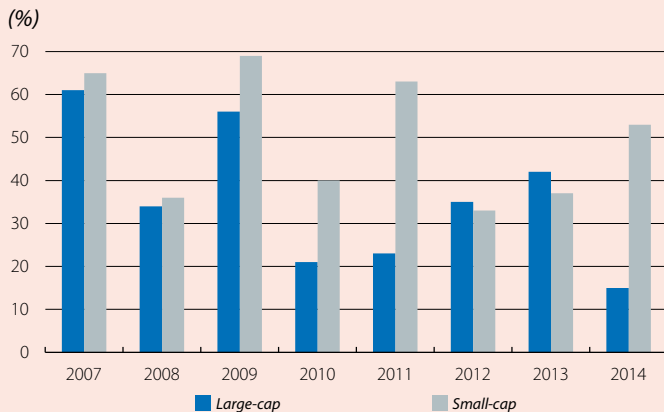
In short, although behavioural finance is not a mature discipline yet, it has helped to explain the deviation of asset prices from their intrinsic values. Nevertheless, it is unlikely to completely replace the paradigm of traditional financial theory. The bulk of the evidence suggests that both theories are therefore required, since emotion and reason form part of the very nature of human beings.

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Portfolio management: from theory to practice

Portfolio management is an eminently practical issue but, one way or another, both private and professional investors (who are increasingly delegated such management) seem to endorse the saying that there is nothing so practical as a good theory. In fact, asset pricing and portfolio choice are among those areas in economics where the contribution of theories has the greatest effect beyond the borders of academia. Naturally various theories have been proposed over the years, contradictory in some aspects and complementary in others. Today they exist side by side without any one theory clearly dominating the rest, providing conceptual support for various ways of tackling management, although the dichotomy between passive and active management is probably the biggest dividing line.

USA: share of investment funds outperforming their benchmark *



Note: * The Large-cap category contains firms with large market capitalisation and their benchmark index is the S&P 500. The Small-cap category covers firms with small market capitalisation and their benchmark index is the Russell 2000.

Source: "la Caixa" Research, based on data from Goldman Sachs Investment Research.

In fact, the study of price formation in the case of financial assets, of the factors underlying such prices and particularly how they change over time is an issue that has remained at the epicentre of debate in academic circles since modern finance came into existence at the beginning of the second half of the 20th century. The main current of thought, clearly dominant until the early 1980s, is of neo-classical inspiration and revolves around the postulates of the efficient market hypothesis (EMH). This approach still has some standing today but has had to make room for other theoretical frameworks that include elements such as the cognitive bias suffered by individuals when taking decisions to invest, or the friction present in the workings of markets (impeding arbitrage), or problems of asymmetric information due to the agent relationship established between investors (the principal) and professional portfolio managers (the agent). Rather than imposing one theory and rejecting others, a combination provides a more useful overall view that helps to reach three important conclusions. Firstly, any systematically correct prediction of the short-term trend in stock markets is unlikely.

Secondly, such predictability increases in line with the timescale due to the existence of a series of patterns that tend to be repeated again and again, such as momentum¹ and mean reversion. And thirdly, in the vast majority of cases, the downside to achieving higher returns than the market average is the assumption of a larger amount of risk.

Those economists in favour of the EMH argue that it is impossible to predict any future trend for share prices since these quickly reflect any relevant information, either private or public in nature. There are three basic ingredients that result in an efficient market: investors need to be rational, their errors random and there cannot be any impediments to arbitrage. Consequently, if it is a waste of time to try to outperform the market, these economists claim that passive management strategies (which attempt to replicate the trend of a benchmark index for the market as a whole) are much more appropriate for investors than active management strategies (which move away from the market portfolio, hoping to improve the return-reward ratio), as the latter entail considerably higher trading and management costs than the former. In this respect, the passive strategy *par excellence* is the one known as buy and hold, which essentially consists of holding, over a substantial period of time, a diversified portfolio that at least in broad terms replicates the composition of an extensive stock market index, without getting carried away by speculation or passing fads. The increase, in the last decade, of some financial innovations such as ETFs (exchange-traded funds) and funds listed on indices for equity, bonds, currencies and commodities has helped to make passive management more effective and sophisticated.

The behavioural finance approach defies the assumption of rationality that underlies the EMH. Using both natural and artificial experiments, several authors have shown that, when investing, individuals' decision-making is subject to numerous psychological and cognitive biases that have little to do with rationality. This has significant implications both for the investor's own portfolio and also for the trend in the market as a whole. A wealth of investment strategies have appeared within the active management universe that are based on the lessons provided by behavioural finance in an attempt to improve the results of this market in risk-reward terms. Some of the most important cognitive dysfunctions identified by behavioural literature are those of overconfidence, biased opinions, loss aversion and herd behaviour. In fact, herd behaviour is probably one of the best-known aspects of behavioural finance, referring to the tendency to follow the opinions of the group in detriment to one's own beliefs even when the former appear to lack any logic or common sense. Some active management strategies are based on identifying where the herd is moving towards and heading in the same direction. Having reached this point, readers are surely asking themselves the following question:

1. For a thorough explanation of this issue, see Shiller, R. J. (1981) «The use of volatility measures in assessing market efficiency», Journal of Finance.

alright but if, as those who support behavioural theories argue, share prices do not follow a random pattern and can be predicted,² should it not be the case that rational investors, by means of arbitrage (buying underpriced shares and selling overpriced ones) ultimately help to correct any deviations observed in the stock market? In spite of the logic of this argument, there are several factors that limit the rebalancing effect of arbitrage in practice. The list is long and ranges from the possibility that the proportion of wealth controlled by rational agents is very small compared with that of the rest of investors to the difficulty and risk involved in shortselling overpriced shares (see the article «Price formation in financial markets: between reason and emotion» in this Dossier). In line with the findings of Abreu and Brunnermeier³ (2002, 2003), the existence of a principal-agent problem between the investor (acting as the principal) and the investment fund manager (acting as the agent) diminishes the role of those financial brokers with a long-term investment mandate: should an episode of enthusiasm or pessimism be too strong or last too long, investors are likely to be tempted to switch their investment if their fund manager resists following the herd.

On a broader scale, quantitative investment strategies are one of the main styles of active management that attempt to apply lessons from behavioural finance by using algorithms designed to carry out trading operations in accordance with specific rules and parameters. So-called momentum strategies are one of the main exponents of quantitative investment. In short, they consist of taking advantage of any upward or downward momentum observed in stock markets in the short or medium term (one of the most complex elements to explain using the approach of rational EMH models). One simple example of this kind of strategy is the buying of shares that have recently performed better than a benchmark index and selling those that have performed worse. Another well-known active strategy is the value investing approach. Value investing prioritises the identification of shares with low value ratios such as the price-earnings ratio (P/E) or the price-to-book value (P/BV), given the predictive power of these ratios for future returns. This circumstance has been conceived by some academics and investment professionals as another clear example of «anomaly» (in the sense of deviating from the EMH's rationality paradigm), whose origin lies in the existence of the aforementioned cognitive biases which temporarily move markets away from their equilibrium levels. For others, however, this is a phenomenon caused purely by rational forces: namely the compensation received by the investor, in terms of returns, on taking up a position in this type of security, which would suffer from some kind of non-diversifiable risk in addition to the market risk entailed by CAPM type standard models. As can be seen, one important difference between value strategies and momentum strategies lies in the medium and long-term timescale that characterises the former as opposed to the much shorter timescale of the latter. To some extent, a simile could be proposed between managers who implement value strategies and the figure of the contrarian since, on several occasions, the former do the opposite to the market fluctuations if this is justified in terms of the intrinsic value of a share or group of shares. In other words, they buy shares that have fallen and become cheaper. Although there are also managers who attempt to take the middle ground between both strategies: buying cheap shares that are already showing signs of upward momentum.

However, implementing a momentum or value focus, or any other kind, in a share portfolio in no way guarantees, *per se*, that risk-adjusted returns will be achieved above the average or better than the market, since both strategies are subject to considerable risk. In the first case, momentum tends to occur more sharply in smaller firms or those with less liquidity, which may be detrimental during episodes of high aversion or volatility in financial markets. In the second case low value ratios may be justified if, for example, they reflect other aspects such as the difficult financial situation of a company or the unlikelihood of success or viability of a business project. On many occasions the hidden factor behind high or extraordinary returns is the risk incurred by taking up a position in a security or by adopting a certain management style. Should a highly unlikely but potentially negative event occur (i.e. a black swan), the associated risk premia which had previously played in the investor's favour could change direction and become much more harmful for the stock portfolio. Over the last few years, the development of investment according to risk factors⁴ (factor investing) as opposed to investment according to the type of asset (equity, government and private bonds, currencies, commodities, etc.) has come to the fore. Specifically, this new investment approach highlights the importance of managing and diversifying our portfolio's exposure to the many different risk premia existing in different segments of financial markets (stock market risk premia, the term premium for public debt, credit risk premia and liquidity risk premia, among others) and to any underlying macroeconomic factors (economic growth, inflation, real interest rates, etc.). By way of example, investors who hold a certain amount of their portfolio in corporate bonds or venture capital will be implicitly increasing their exposure to equity as both these types of assets are influenced substantially by the same risk factors that affect stock market performance.

In conclusion, the existence of a series of behavioural patterns that can be used to deduce future stock market trends does not represent the death of the EMH. Although markets sometimes show signs of relatively irrational behaviour, such mismatches in share prices do not last forever and inexorably end up correcting themselves. As professional portfolio managers know only too well, the probability of outperforming the market on a regular basis without assuming any additional risk is very low. As in many other areas, there is no such thing as a free lunch in financial markets so that, when fortune smiles and one appears, investors should make sure they get a taste before it goes cold and disappears from the table.

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2. Lo, A. W. and Mackinlay, A. C. (1988) «Stock market prices do not follow random walks: evidence from a simple specification test», *Review of Financial Studies* 1, 41-66.

3. Abreu, D. and Brunnermeier, M. (2002) «Synchronization risk and delayed arbitrage», *Journal of Financial Economics* 66 (2-3), 341-360.

4. For readers interested in this field, see Ang, A. (2013) «Factor investing», Columbia Business School Research Paper No. 13-42, and Asness, C. S., Moskowitz, T. J. & Pedersen, L. H. (2013) «Value and momentum everywhere», *Journal of Finance* 68, 929-985.

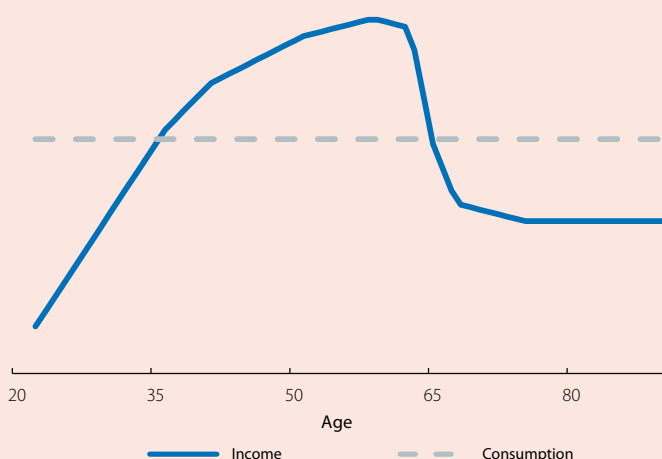
The transformation of household confidence after a crisis

The worldwide economic crisis of 2007 and 2008 and the sovereign debt crisis subsequently suffered by the euro area led to huge losses, both in production and employment, from which some regions have yet to recover. Households were one of the economic agents most badly hit by the crisis: some saw their sources of income disappear or a proportion of their savings vanish, as well as the value of their properties diminish. All this affected the confidence of households as well as their behaviour regarding the decisions they take. In a recovery such as the present, it is crucial to reactivate consumption and investment among these agents and this necessarily means improving their confidence. This article analyses how certain cognitive biases inherent in individuals make it difficult for our decisions to consume and invest to resemble those of *Homo economicus*, the name given in economics to the theoretical being capable of taking decisions based on rational assessments,¹ as well as examining the effects that may occur regarding household behaviour as a result of the interaction of these cognitive dysfunctions after a financial crisis, such as the one we have recently gone through.

The life cycle theory of consumption, developed by Franco Modigliani in the 1950s, proposes the fundamental behaviour of agents in terms of consumption and savings, suggesting that individuals prefer to keep consumption more or less stable over time. To this end, when we are young we have to borrow while, in our more mature years, we prefer to save so that we can consume our reserves in our old age. Based on this theory, when temporary shocks occur that affect our income, we tend to cushion the shock as far as possible in order to maintain similar levels of consumption. However, if the shock is permanent then we alter our consumption. Nevertheless, in practice consumption tends to shrink after a temporary shock such as a crisis, as can be seen in the graph for the Spanish economy.

This basic theoretical framework has been used to lay the foundations of an extensive economic literature that has helped to improve our analysis of agents' decision-making behaviour, as well as bring the model closer to reality. The initial steps taken were to adjust the model to an uncertain environment in which agents might tend, for instance, to save more due as a precaution and in response to possible uncertain future events, known as precautionary savings. This effect can also be seen in the case of Spain where there was a substantial rise in savings in response to the outbreak of the crisis. Another extension to the initial model was the introduction of factors limiting or modifying household decisions, such as taxes, Social Security contributions and restricted access to the financial system.

Modigliani's life cycle theory of consumption



Source: "la Caixa" Research.

However, all this was not enough to capture the complexity of the decision-making process, so a new branch of economics emerged, namely behavioural economics, whose aim is to incorporate evidence that the individuals involved in this process do not always act according to the dictates of reason but that there are numerous cognitive biases that push us away from the optimum decision. This notion of cognitive bias was introduced for the first time by Kahneman and Tversky, resulting from their observation of how difficult it is for individuals to think in terms of probability or act rationally when faced with very large problems. Based on this dysfunction, numerous experiments were carried out to demonstrate the existence of more situations in which human judgement and decision differ from the theory of rational choice. Some such phenomena are procrastination, consisting of delaying decisions; short-sightedness or not taking the future into account; and the tendency to depend too much on a certain piece of information when taking a decision, either the most recent or the one with the most impact in our past experience.²

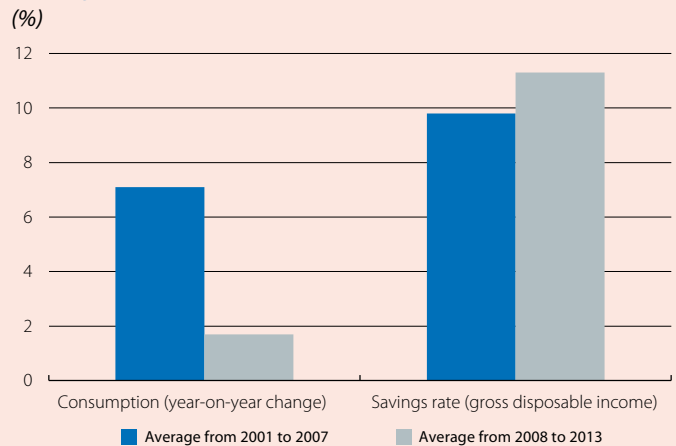
All these cognitive biases become relevant when there is a considerable negative shock to a household's income, as in a financial crisis. Several studies have shown that the beliefs and behaviour of agents change as a result of crises they have experienced

1. For more information on standards of rationality, see the article «Price formation in financial markets: between reason and emotion» in this Dossier.

2. For more information on cognitive bias among investors, see the article «Portfolio management: from theory to practice» in this Dossier.

previously. Specifically, this has been analysed in a working document by the Chicago Federal Reserve,³ showing that personal experience of a financial crisis⁴ has a lasting effect on individuals' behaviour. Specifically, the authors analyse the savings decisions of immigrants residing in the US who have suffered financial crises in their countries of origin (for example, an Argentine immigrant who suffered the bank run between 2001 and 2002). This methodology has produced two samples of the population: one group that has altered their beliefs and behaviour as a result of their experience of a crisis and another that has not. At the same time both groups also share the same institutional and financial framework so that, if they did not have such cognitive biases, the decisions to save and consume would not differ between individuals with similar personal and economic characteristics.⁵ The results show that having experienced a financial crisis in the past reduces the likelihood of having bank deposits in the US by 10.8 pps. They also show that the severity of the crisis plays a key role. For example, financial crises that are accompanied by an economic crisis⁶ cause a greater impact on people's behaviour and therefore reduce even further the probability of having this kind of savings. Regarding the role of institutions, the authors have found evidence that a country's legal and regulatory framework during a crisis is crucially important in terms of the future behaviour of individuals. In particular, those experiencing a crisis in a country with regulations that guarantee deposits are just as likely to have bank deposits in US institutions as their compatriots who have not experienced a crisis.

Spain: changes in consumption and savings during times of crisis



Note: Data in nominal terms.

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

Nevertheless, the consequences of recessions appear to be greater than their impact on people's decisions to consume or save. A recent study⁷ shows that recessions permanently affect the formation of people's socioeconomic beliefs. Specifically, this argues that the recessions in the US have affected the formation of such beliefs in those agents suffering during their formative years (between 18 and 25). The authors have found evidence that these individuals, affected by a recession in the past, believe that the main factor behind personal success is luck rather than hard work. Consequently they tend to prefer the government to be in charge of redistributing wealth in order to reduce inequality. However, paradoxically, these same individuals have significantly less confidence in public institutions and in their capacity to provide the necessary services.

The impact the crisis has had on families is undeniable, damaging household confidence and affecting the decisions they take. Within the context of the current economic recovery, household confidence is likely to improve gradually and, as it does, consumption should also increase and investment decisions become less conservative. However, as has already been mentioned, the impact of the crisis on agents' behaviour can make this process much slower than is desirable, which would hinder the economic recovery. Public institutions play a very important role in this respect. They must take on this role responsibly and act accordingly.

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3. See Osili, U. and Paulson, A. (2008) «Bank Crises and Investor Confidence», Federal Reserve Bank of Chicago.

4. Financial crises are defined as episodes of stress in the financial system that are considered to be systemic (when doubtful assets reach at least 10% of all assets, when the cost of bail-out is at least 2% of GDP or when large-scale emergency measures or state buy-outs have been implemented).

5. Controlling individual factors such as education, wealth, income and age, among others.

6. An economic crisis is defined as when there is negative growth in GDP for three consecutive years.

7. See Giuliano, P. and Spilimbergo, A. (2009) «Growing up in a recession: Beliefs and the macroeconomy», IZA.

The soul of companies

In the classrooms of most business schools students learn that companies must aim to maximise value for their shareholders. In practice this has generally been interpreted as maximising the share price. However, taking decisions based purely on the value of shares may result in a short-sighted view that can damage the company's long-term viability and ultimately harm the interests of the shareholders themselves. In order to avoid such an approach, companies can adopt corporate governance mechanisms that protect the interests of all those affected and/or related to the company, i.e. its stakeholders. This article analyses the concept of maximising value for shareholders and its limits and then looks at some alternative proposals that promote the generation of long-term value for all stakeholders.

According to neo-classical economic theory, the aim of a company is to maximise profit. In an efficient market, with perfect competition and complete information, the share price is the best estimate of a company's worth since it corresponds to the present value of the profits expected in the future. As the company's owners, shareholders are concerned about getting maximum return from their investment and, consequently, the decisions to be taken by the company can be summed up very simply: it must accept all those projects that increase the share value and reject all those that reduce it.

In practice, given that large listed firms have a highly dispersed ownership structure, each individual shareholder has little incentive to exercise control over the company's management. Given this situation, market discipline plays a key role in controlling how companies are managed. On the one hand, on an individual basis, shareholders can opt to sell their shares on the market (called the Wall Street walk). On the other hand, from the overall view of the company, the market for corporate control allows that another firm may take advantage of the opportunity to take over the management at a low price, known as a hostile tender offer or takeover. In any case, for such external control mechanisms to work, it is vital for the stock market to be extensive, agile and highly liquid, for the share price to broadly reflect the company's intrinsic value and for there to be no legal impediments to the takeover.

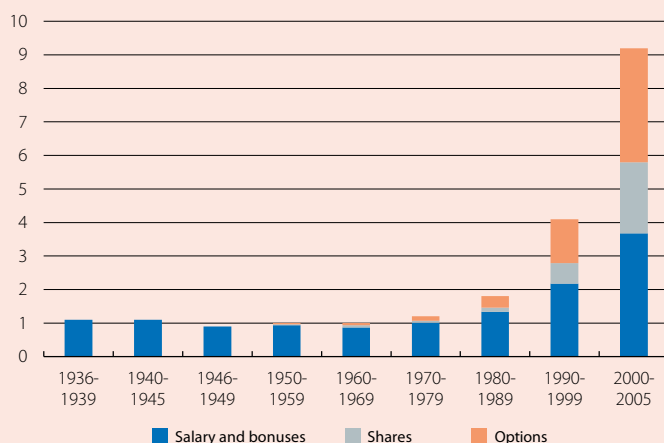
In reality, however, companies operate within an environment of imperfect markets and uncertainty. This means that the share price may deviate from its intrinsic value (see the article «Price formation in financial markets: between reason and emotion» in this Dossier), seriously limiting the possibility of the aforementioned market discipline mechanisms to work properly. Internal

control mechanisms are therefore usually adopted that help to achieve the aim of maximising value for shareholders. The theory developed by Jensen and Meckling (1976) represented an important step forward in explicitly recognising the problems of incentives resulting from the separation between ownership and control. They argue that, in order to bring managers' incentives in line with the interests of shareholders, performance-linked compensation systems must be designed for managers. The business world has widely adopted such practices: variable management compensation systems have increased exponentially over the last two decades. In addition, to make payment more sensitive to developments in the share price, formulas have also been adopted such as stock options, linking management pay to any increase (but not decrease) in share price (see the first graph).¹

Nonetheless there is increasing evidence of the harmful consequences of such incentive systems, particularly because they reward the achievement of short-term profits in

Compensation for an average CEO

(Million dollars)



Note: Constant dollars in 2011.

Source: "la Caixa" Research, based on data from Frydman and Jenter (2010).

detriment to creating long-term value. The pressure on managers to increase the present share price is further reinforced by analysts who make very short-term predictions for corporate trends, as well as by some shareholders with a very short investment horizon. The work of Graham et al. (2005)² clearly illustrates this phenomenon. After surveying the financial directors of large

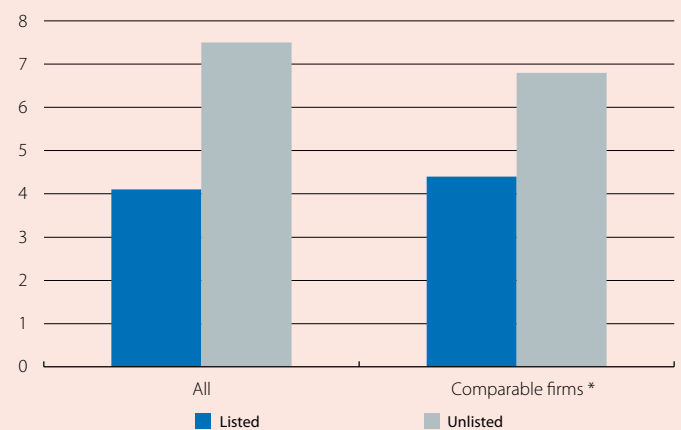
1. Frydman and Jenter (2010) «CEO Compensation».

2. Graham, Harvey and Rajgopal (2005) «The Economic Implications of Corporate Financial Reporting», Journal of Accounting and Economics.

firms in the US, they found that almost half of these would reject positive net present value projects if accepting them meant not meeting analysts' expectations in terms of quarterly earnings. In other words, most managers are prepared to sacrifice long-term value for short-term gains in order not to disappoint market expectations. This finding shows that the market pressures on listed companies have significant impact on their investment decisions. According to a study by Asker et al. (2013), the annual investment of listed companies accounts for 4.4% of all assets on average, a figure that is appreciably lower than the investment ratio of a comparable group of unlisted companies, namely 6.8% (see the second graph). Moreover, investment in R&D is also lower as this typically requires more time and involves more uncertainty until cash flow is obtained, and the distribution of dividends tends to be greater. This ends up reducing the company's value, harming all its stakeholders including the shareholders themselves. Moreover, such a widespread problem of corporate underinvestment could have relevant macroeconomic consequences, reducing capital accumulation and diminishing the competitiveness of companies at a global level.

Investment of listed and unlisted companies

(% assets)



Note: * Comparable firms refers to similar listed and unlisted firms in terms of size, sector, debt, cash, sales, growth and profit.

Source: "la Caixa" Research, based on data from Asker et al. (2013).

Given this evidence, more and more people are criticising the paradigm of maximising value for shareholders while those theories that take into account a broader view of company aims are gaining support.³ According to these theories, shareholders are not the only owners of a company; the employees, suppliers, customers and bondholders, as well as the shareholders, also have a contractual interest in the firm that confers on them rights of ownership regarding the corporate earnings generated. A company is seen as a mechanism to coordinate the specific investments of all stakeholders, making it necessary for their relations to be based on mutual trust and commitment to the company. Achieving this, however, is no easy task. Some companies opt to make certain corporate values explicit or to define a mission that goes beyond achieving corporate earnings. The aim of this is, for example, for employees to have more intrinsic motivation as they identify with the company's values, or to ensure that clients see this as a differential for the company.

Achieving the long-term commitment of capital may be somewhat more complex as shareholders can always sell their shares and remove capital from the company at any time. This could be harmful for the rest of the stakeholders as the value of their specific investments would fall should shareholders take the opportunistic route. To avoid this, mechanisms need to be established that commit capital over the long term. In this respect, of note is the proposal made by Colin Mayer (2013), namely to assign voting rights to shareholders according to the time their investment has been committed.⁴ There are also some interesting new business models that, in addition to maximising profit, also aim to achieve objectives of a social or environmental nature, such as benefit corporations or B corps. Such companies recognise the diversity of shareholders' aims and interests who, in addition to getting a return for their investment, also want to respond to global social and environmental challenges and have a positive impact on the world. Far from being a utopian model, B corps are an example of business success and the commitment acquired by such firms is not merely rhetorical. While a traditional firm may abandon its altruistic aims when it deems this opportune, B corps are answerable to their shareholders regarding the achievement of the company's social mission in the same way as they are regarding its profits. The reputational cost of abandoning such social aims would be too great.

In conclusion, the debate regarding which aims a company should pursue is still ongoing. A short-term approach has inflicted a lot of harm and, consequently, those business practices prioritising more long-term objectives are a positive step, while investors also need mechanisms to help them make a long-term commitment.

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3. Stout, L. (2013) «The shareholder value myth».

4. Mayer, C. (2013) «Firm Commitment: Why the corporation is failing us and how to restore trust in it».



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"la Caixa" GROUP: KEY FIGURES

As of December 31, 2013

Financial activity

MILLION €

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

Commercial activity and resources

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

Community projects: budget for activities in 2014

MILLION €

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

TOTAL BUDGET

500

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