MR07

MONTHLY REPORT • ECONOMIC AND FINANCIAL MARKET OUTLOOK

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ECONOMIC & FINANCIAL ENVIRONMENT

DOSSIER: THE NEW ENVIRONMENT FOR BANKING

CaixaBank Research

MONTHLY REPORT - ECONOMIC AND FINANCIAL MARKET OUTLOOK

July-August 2016

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The new environment for banking

Companies constantly face changes in their environment: technology, actions taken by their rivals, society's habits, input prices, demand conditions, regulations... all these factors evolve incessantly. At certain times, however, the speed and extent of such changes escalates, radically transforming entire sectors. Europe's banking sector has undoubtedly been going through such a transformation, and for some years now.

This new environment for banking has been shaped by several factors. Firstly, the loss of reputation suffered during the crisis; and, by definition, a business such as banking cannot prosper in a climate of mistrust. Improving reputation, through humility, focusing on customers and social responsibility, has become a priority.

The new regulatory framework established by the principles of Basel III and European banking union also represents an incredibly important challenge in terms of anticipation and adaptation. The considerable increase in capital and liquidity requirements resulting from Basel III has made bank intermediation more expensive and put pressure on the profitability of the sector. Some rules that have yet to be specified could raise these requirements even further, and we have already seen that transition periods are of little use: the markets demand in advance what regulators demand within a few years.

European banking union also entails a process of regulatory harmonisation that will take years to complete; changes in the supervisory mechanism with adjustment costs for all parties concerned; and new resolution rules (applicable to institutions that may be in trouble), with important aspects that have yet to be detailed. It would certainly be useful to dispel all these uncertainties as soon as possible and enter a period of regulatory stability.

Banking union will also help to create large pan-European institutions; perhaps not in the short term but we are bound to see significant integrations at a European level within a few years. The strongest institutions will take the lead.

But regulation is not the only factor pushing down banks' profits, and not even the most important one. Low interest rates, the still high cost related to provisions and weak growth in business volumes are the strongest headwinds. Given this situation, cost discipline and innovation to offer customers the best value proposition become essential. Achieving sustainable profit levels is not optional; it is the only way to ensure that banks continue to play their fundamental role in financing the real economy. In this area, by the way, a false dilemma is often presented between banks and capital markets when the reality is that both are more complementary than substitutes.

In terms of technology and society's habits, digitalisation is opening up a new world of possibilities to interact with customers, improve our insight into their needs and offer them a better service. It also increases competition with the appearance of new competitors. All this tests the agility and capacity of traditional banks to innovate. Only flexible organisations, those capable of constantly wondering whether the way we did things yesterday is how they should be done today, have a chance for success.

This *Monthly Report's* Dossier deals with some of these issues: the new regulatory framework for banking, the pressures on profits, interaction between the banking sector and capital markets and growth in online marketplace lending. These elements of change are creating a hugely challenging environment for the sector. But the ultimate challenge remains the same: gaining the trust of customers, shareholders and society as a whole.

Enric Fernández
Director of Banking Strategy
30 June 2016

CHRONOLOGY

JUNE 2016

23 The United Kingdom votes to leave the EU, causing huge turbulence in international markets.
26 Early general elections are held in Spain.
29 The ECB restores the eligibility of Greek sovereign debt as collateral in the central bank's regular financing operations and acknowledges the Greek government's commitment to applying the agreed adjustment measures.

MAY 2016

11 The Brazilian Senate temporarily suspends President Dilma Rousseff from office, intensifying the country's political instability.
18 The European Commission proposes new public deficit targets for Spain, of 3.7% of GDP in 2016 and 2.5% in 2017, whose approval is postponed to July, together with the decision regarding a penalty for not meeting the 2015 deficit target.
24 The Eurogroup approves the first review of financial assistance for Greece and payment of the second tranche (10.3 billion euros). It also agrees to extend repayment dates and delay the payment of interest on public debt, but without providing any details.

APRIL 2016

29 The Government presents the 2016-2019 Stability Programme, with a more relaxed fiscal consolidation target. Specifically, the deficit for 2016 has been raised by 0.8 pps to 3.6% while the target of bringing the deficit below the figure of 3% set by the Stability and Growth Pact has been postponed to 2017.

MARCH 2016

10 The ECB cuts its benchmark interest rates (the Refi rate to 0%, the marginal lending facility to 0.25% and the deposit facility yield to –0.40%), makes changes to its asset purchase programme (extending the monthly rate of purchases by 20 billion up to 80 billion and including corporate bonds in the basket of eligible assets) and announces four new 4-year refinancing operations (TLTRO II) at an interest rate that could be –0.40% if lending benchmarks are reached.

FEBRUARY 2016

1 Start of the primaries to elect the candidates for the US presidential elections to be held on 8 November 2016.
24 The European Banking Authority publishes the methodology and macroeconomic scenarios to carry out stress tests on Europe's banking system.

AGENDA

JULY 2016

4 Registration with Social Security and registered unemployment (June).
6 Industrial production index (May).
15 Financial accounts (Q1).
18 Loans, deposits and NPL ratio (May).
21 International trade (May).
Governing Council European Central Bank.
26 State budget execution (June).
Fed Open Market Committee.
28 Labour force survey (Q2).
Economic sentiment index of the euro area (July).
29 Flash GDP (Q2).
GDP of the euro area (Q2).
US GDP (Q2).
Flash CPI (July).
Balance of payments (May).

AUGUST 2016

2 Registration with Social Security and registered unemployment (July).
5 Industrial production index (June).
15 Japan's GDP (Q2).
18 Loans, deposits and NPL ratio (June).
19 Foreign trade (June).
25 Quarterly national accounts (Q2).
30 Flash CPI (August).
Economic sentiment index of the euro area (August).
31 Balance of payments (June).
State budget execution (July).

The post-Brexit panorama

Brexit has opened the door to a new phase of financial volatility. In Q2 the trend in risky asset prices has gone through two very different phases. First, prices continued the rally that had started back in February and continued right up until the end of May. Although this expansion was by no means extremely lively or without fluctuation, the underlying trend was of a clear end to the episode of high volatility in the first month and a half of 2016. But as from the beginning of June the market started to encourage doubts regarding its future direction. Investors were particularly affected by a combination of important events in June (OPEC and Federal Reserve meetings, Spanish general election and especially the highly significant referendum on the UK's membership of the EU), warranting a delay before taking financial decisions. As these different events unfolded, investor confidence gradually returned. Given this situation, the UK voting in favour of Brexit took investors by surprise, resulting in sharp losses in the stock markets and risky assets and with capital making tracks for safe havens. So what can we expect now?

Ultimately the economic impact of the Brexit will largely depend on the political response. There are three broad political areas that will shape the economic effects of the Brexit. The first concerns relations between the Union (and the euro area) and the United Kingdom. The most favourable scenario, and also the most logical, is for some middle ground to be found between the EU taking a tough stance to dissuade other European partners from possibly following suit, and a «velvet divorce» that is excessively favourable for the British. This equilibrium will probably be accompanied by reinforced commitment to the European project and the single currency. The second political area is the crystallisation of populist and Eurosceptic groups. We believe the referendum on Italy's constitutional reform in October and the legislative elections in France and Germany in 2017 will confirm that most of these movements are limited in scope. Lastly, the third front concerns the UK's internal political situation. The Prime Minister's announced resignation, around October, and the Scottish position which is notoriously opposed to the Brexit have weakened the country's governability and heightened pressure to reach an agreement that does not constitute a radical break with the current status quo.

The UK will fall into recession but world growth will withstand the shock. CaixaBank Research expects these three political areas to achieve enough equilibrium to avoid any widespread impact on European and global growth. The UK is expected to suffer from a drop in GDP as the high uncertainty prevailing will act as a brake on decisions to invest and consume. Nevertheless this will be a temporary downturn which will gradually diminish as the negotiations begin, presumably at the end of 2016. For the euro area as a whole, the effect is likely to be a modest slowdown in growth while, in the rest of the world, the impact will be even smaller (moderate for the US, which has relatively close ties to the UK; minimal or zero for the rest of the economies). This limited impact in general terms is also due to the fact that the shock of uncertainty has occurred at a time when the economic situation is reasonably benign. Available indicators confirm that the world economy continued to accelerate its rate of growth in Q2, especially in Europe and the US but also in many emerging countries. Another favourable factor is the fact that monetary conditions are still accommodative and central banks are expected to postpone any monetary restriction over the coming months. Moreover, central bankers have repeated their willingness to provide the liquidity that financial institutions may demand at times of financial uncertainty.

Given this situation, Spain should be relatively immune. Apart from tourism (23% of our tourists are British), the country does not have too many direct links with the UK. There had been a notable inertia in growth in activity over the last few months which, had it continued, would have probably led to a positive revision in CaixaBank Research's GDP growth forecast for 2016 (namely 2.8% growth in GDP). Now the effect of the Brexit has neutralised this upward bias in the scenario for 2016, warranting a minimal downward revision in the 2017 growth forecast from 2.4% to 2.2%. In summary, the Spanish economy exemplifies, like few others, the fortune of being in a good position to tackle the storm of uncertainty thanks to its currently favourable macroeconomic situation. The incoming government will have to work to ensure that our economy is also in a comfortable position to face any potential shocks in the future.

FORECASTS

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

International economy

	2014	2015	2016	2017	2016 Q1	2016 Q2	2016 Q3	2016 Q4	2017 Q1	2017 Q2
GDP GROWTH										
Global	3.4	3.1	3.2	3.5	3.3	3.2	3.2	3.3	3.5	3.5
Developed countries	*1.8*	*1.9*	*1.7*	*1.7*	*1.8*	*1.7*	*1.6*	*1.7*	*1.7*	*1.7*
United States	2.4	2.4	2.0	2.1	2.1	1.8	2.0	2.2	2.4	2.2
Euro area	0.9	1.6	1.4	1.3	1.7	1.6	1.4	1.1	0.9	1.1
Germany	1.6	1.4	1.5	1.4	1.6	1.5	1.4	1.5	1.2	1.3
France	0.7	1.2	1.3	1.0	1.4	1.6	1.2	1.0	0.7	0.9
Italy	–0.3	0.6	0.9	0.8	1.0	0.8	0.9	0.9	0.9	0.9
Spain	1.4	3.2	2.8	2.2	3.4	3.0	2.6	2.3	2.1	2.1
Japan	–0.1	0.6	0.6	0.9	0.0	0.8	0.6	1.2	1.0	0.9
United Kingdom	2.9	2.3	1.1	0.0	2.0	1.6	0.7	0.0	–0.4	–0.6
Emerging countries	*4.6*	*4.0*	*4.3*	*4.9*	*4.3*	*4.2*	*4.3*	*4.5*	*4.9*	*4.9*
China	7.3	6.9	6.5	6.3	6.7	6.3	6.4	6.5	6.6	6.4
India[1]	7.2	7.6	7.4	7.6	7.9	7.3	7.4	7.4	7.6	7.6
Indonesia	5.0	4.8	5.1	5.4	4.9	5.0	5.2	5.3	5.3	5.4
Brazil	0.1	–3.8	–3.4	1.1	–5.4	–4.0	–2.7	–1.3	0.5	1.2
Mexico	2.2	2.5	2.7	3.2	2.6	2.6	2.7	2.9	3.2	3.2
Chile	1.9	2.1	2.2	3.2	1.5	1.7	2.5	2.9	3.0	3.1
Russia	0.7	–3.7	–1.1	1.3	–1.2	–2.0	–1.1	–0.2	1.0	1.3
Turkey	3.1	4.0	2.9	3.4	4.8	2.7	2.0	2.2	3.3	3.4
Poland	3.3	3.6	3.4	3.5	2.6	3.6	3.7	3.7	3.6	3.6
South Africa	1.7	1.2	0.5	1.3	–0.5	0.8	0.9	1.0	1.1	1.2
INFLATION										
Global	3.2	2.8	3.4	3.7	3.4	3.3	3.3	3.5	3.6	3.7
Developed countries	*1.4*	*0.3*	*0.9*	*2.1*	*0.7*	*0.6*	*1.0*	*1.4*	*2.0*	*2.1*
United States	1.6	0.1	1.4	2.5	1.1	1.1	1.4	1.8	2.5	2.5
Euro area	0.4	0.0	0.3	1.5	0.0	–0.1	0.4	0.8	1.5	1.5
Germany	0.8	0.1	0.4	1.6	0.1	0.0	0.5	0.9	1.6	1.6
France	0.6	0.1	0.3	1.5	0.0	0.1	0.4	0.8	1.5	1.5
Italy	0.2	0.1	0.2	1.4	0.0	–0.3	0.3	0.7	1.4	1.4
Spain	–0.1	–0.5	–0.2	1.9	–0.7	–0.9	0.0	1.0	2.2	2.2
Japan	2.7	0.8	0.5	1.7	0.1	–0.1	0.6	1.3	1.3	2.0
United Kingdom	1.5	0.0	0.7	2.1	0.3	0.4	0.8	1.2	1.6	2.0
Emerging countries	*4.7*	*4.7*	*5.6*	*5.8*	*5.8*	*5.7*	*5.5*	*5.5*	*5.8*	*5.9*
China	2.0	1.4	2.0	2.1	2.1	2.1	1.7	2.1	1.6	2.1
India	6.6	4.9	5.3	5.4	5.3	5.5	5.3	5.3	6.3	5.7
Indonesia	6.4	6.4	3.5	4.3	4.3	3.4	2.8	3.5	3.4	4.7
Brazil	6.3	9.0	8.7	6.5	10.2	8.8	8.4	7.3	6.7	6.5
Mexico	4.0	2.7	3.1	3.2	2.7	3.0	3.3	3.5	3.3	3.2
Chile	4.4	4.3	3.9	3.2	4.6	4.0	3.5	3.3	3.0	3.1
Russia	7.8	15.5	7.5	5.7	8.3	8.0	7.0	6.5	5.7	5.8
Turkey	8.9	7.7	7.5	6.3	8.6	8.0	7.0	6.5	6.5	6.3
Poland	0.2	–0.9	0.1	1.9	–1.1	–0.4	0.3	1.4	1.5	1.7
South Africa	6.1	4.6	6.8	6.3	6.5	6.3	6.6	7.7	7.0	6.2

Note: *1. Annual figures represent the fiscal year.*

Forecasts

Spanish economy

	2014	2015	2016	2017	2016 Q1	2016 Q2	2016 Q3	2016 Q4	2017 Q1	2017 Q2
Macroeconomic aggregates										
Household consumption	1.2	3.1	3.2	2.2	3.7	3.5	3.0	2.7	2.3	2.2
General government consumption	0.0	2.7	1.9	0.8	2.6	2.1	1.5	1.3	0.7	0.6
Gross fixed capital formation	3.5	6.4	3.4	2.9	5.2	3.5	2.6	2.1	2.6	2.7
Capital goods	10.7	10.1	5.9	2.5	9.8	6.7	4.3	3.0	2.3	2.1
Construction	–0.1	5.3	2.0	3.2	3.1	1.7	1.5	1.6	2.8	3.1
Domestic demand (contr. Δ GDP)	1.6	3.7	3.0	2.0	3.8	3.3	2.6	2.5	1.9	1.9
Exports of goods and services	5.1	5.4	3.7	4.6	3.7	4.2	3.2	3.6	5.3	4.4
Imports of goods and services	6.4	7.5	4.7	4.3	5.4	5.7	3.4	4.3	5.1	4.2
Gross domestic product	**1.4**	**3.2**	**2.8**	**2.2**	**3.4**	**3.0**	**2.6**	**2.3**	**2.1**	**2.1**
Other variables										
Employment	1.1	3.0	2.5	1.9	3.2	2.6	2.2	2.1	1.7	1.9
Unemployment rate (% labour force)	24.4	22.1	20.0	18.7	21.0	20.0	19.3	19.5	19.8	18.7
Consumer price index	–0.1	–0.5	–0.2	1.9	–0.7	–0.9	0.0	1.0	2.2	2.2
Unit labour costs	–0.8	0.3	0.1	0.8	–0.5	0.4	0.3	0.4	0.7	0.4
Current account balance (cum., % GDP)[1]	1.0	1.4	1.6	1.4	1.4	1.5	1.5	1.6	1.5	1.5
Net lending or borrowing rest of the world (cum., % GDP)[1]	1.4	2.0	2.2	2.0	2.0	2.1	2.1	2.2	2.1	2.1
Fiscal balance (cum., % GDP)[2]	–5.8	–5.0	–3.9	–3.1						

Financial markets

INTEREST RATES										
Dollar										
Fed Funds	0.25	0.26	0.52	1.06	0.50	0.50	0.50	0.58	0.83	1.00
3-month Libor	0.23	0.32	0.70	1.31	0.62	0.64	0.72	0.82	0.99	1.20
12-month Libor	0.56	0.79	1.25	1.69	1.17	1.25	1.27	1.29	1.42	1.60
2-year government bonds	0.44	0.67	0.82	1.58	0.85	0.77	0.75	0.89	1.17	1.45
10-year government bonds	2.53	2.13	1.81	2.44	1.92	1.75	1.70	1.88	2.10	2.33
Euro										
ECB Refi	0.16	0.05	0.01	0.00	0.03	0.00	0.00	0.00	0.00	0.00
3-month Euribor	0.21	–0.02	–0.24	–0.14	–0.19	–0.26	–0.26	–0.26	–0.25	–0.18
12-month Euribor	0.48	0.17	–0.01	0.13	0.01	–0.02	–0.02	–0.02	0.00	0.07
2-year government bonds (Germany)	0.05	–0.24	–0.49	–0.14	–0.46	–0.52	–0.54	–0.45	–0.37	–0.25
10-year government bonds (Germany)	1.23	0.53	0.17	1.00	0.30	0.12	0.06	0.19	0.40	0.80
EXCHANGE RATES										
$/€	1.33	1.11	1.11	1.07	1.10	1.13	1.11	1.09	1.06	1.07
¥/€	140.42	134.35	121.84	123.65	127.28	122.22	119.03	118.82	121.06	123.85
£/€	0.81	0.73	0.81	0.79	0.77	0.79	0.84	0.84	0.82	0.80
OIL										
Brent ($/barrel)	99.45	53.61	46.72	65.58	35.72	47.29	50.60	53.26	58.49	64.39
Brent (€/barrel)	74.54	48.30	42.52	61.23	32.38	41.90	46.01	49.79	55.08	60.31

Note: *1. Four quarter cumulative. 2. Cumulative over four quarters. Does not include aid to financial institutions.*

Forecasts

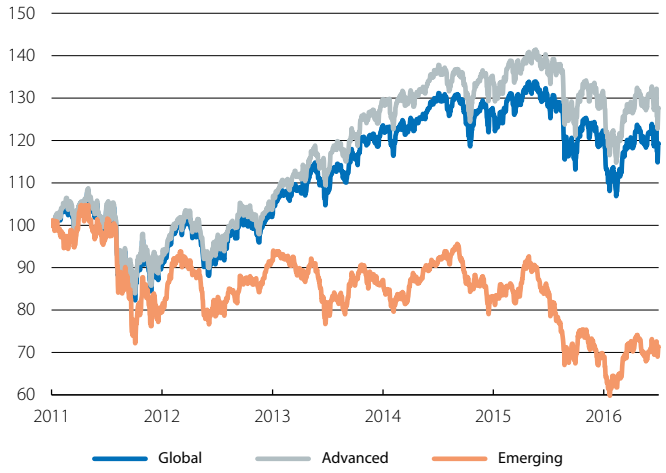
FINANCIAL OUTLOOK · **Brexit sends shockwaves through the markets, causing investors to seek safe havens**

The Brexit referendum cut short the trend in the markets in a month when they had been performing well. The first few days of June continued the rally of the previous month and, as doubts waned regarding the global environment, a renewed appetite for risk led to some recovery in the markets. However, this trend was interrupted mid-June by growing tensions regarding the Brexit referendum and four of the main central banks (Fed, Bank of Japan, Bank of England and Swiss National Bank) kept their monetary policy unchanged given the market situation. Finally, the option to leave the EU won the referendum by a slim margin, resulting in the pound sterling depreciating sharply and a widespread flight in global markets from riskier to safer assets. Most stock markets ended the month with losses and the MSCI World fell by 1.1% while Eurostoxx was hit harder, down by 5.8% in June. Emerging markets, however, recorded the best performance, posting gains of 4.1%. Global corporate bonds were also up, by 1.8% for investment grade and by 0.6% for high yield. On the other hand the price of crude oil continued its upward trend, going 33% higher than its price at the beginning of the year. Given this situation of instability and uncertainty, expectations have grown that the accommodative policies of the Fed and the ECB will be continued for longer than initially expected.

The Brexit «yes» vote surprises investors, resulting in a «Black Friday» that has left uncertainty in its wake. Markets had already been affected by the uncertainty caused by the referendum since the middle of June. European stock markets saw several sessions with losses of around 2% followed by gains of more than 3% depending on the polls being published. The pound sterling, which had depreciated by a cumulative 3.2% against the euro during the month, picked up again in the days prior to the referendum (with implied volatility at similar levels to the 2008 crisis). But on Friday, 24 June, the day after the vote, the pound fell by 8% against the dollar and by 7.5% against the euro. International markets were also hit hard, especially in Europe (FTSE: –4.2%, Eurostoxx 50: –8.9%, DAX: –7.1%, MIB Italy: –10.9%, Ibex 35: –12.5%) and particularly Europe's banking sector, which slumped by 18%. One of the expected consequences of this unstable environment has been a demand for safe assets which, together with the decisions taken by the central banks, has pushed yields on German debt to an all-time low. The IRR for the German 10-year bund had fallen into negative terrain for the first time in its history by the middle of the month and, after the referendum, descended by 20 bps to

International stock markets by geographical location

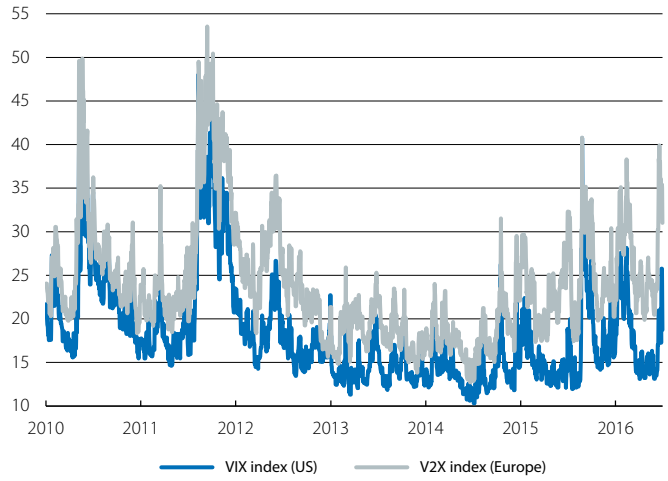
Index (100 = January 2011)



Source: *CaixaBank Research, based on Bloomberg data.*

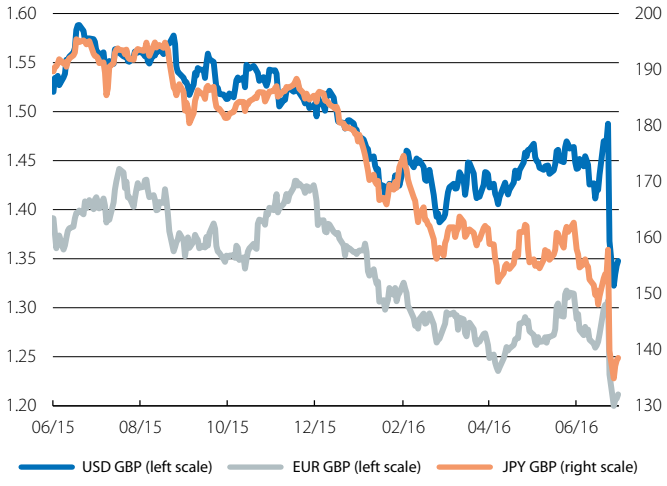
Implied volatility of US and Europe stock markets

(%)



Source: *CaixaBank Research, based on Bloomberg data.*

Exchange rate for the pound sterling against the euro, dollar and yen



Source: *CaixaBank Research, based on Bloomberg data.*

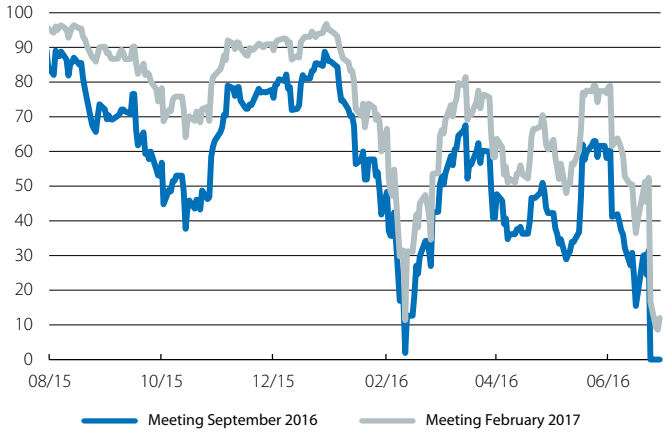
–0.11%. This brought about an increase in peripheral risk premia which, by the end of the month, stood at around 130 bps in Spain, 140 bps in Italy and close to 310 bps in Portugal. Monetary market rates also recorded drops while gold was up by 8.8%, already accumulating a 25% rise this year so far. In the coming weeks this high volatility and risk aversion in financial markets is likely to continue, awaiting clear guidelines to be defined regarding the future relationship between the UK and the EU.

Given this turbulent situation, the Fed is likely to postpone its next interest rate hike for a few months. At the meeting of the Federal Open Market Committee (FOMC) on 15 June, the Fed decided to keep the fed funds rate at 0.25%-0.50%, as had been predicted. In the days prior to the meeting, and given the market volatility, future contracts on interest rates had already eliminated any expectation of an interest rate hike in June. The press release by the FOMC noted that, in spite of higher growth in economic activity, some economic indicators are still not conclusively in favour of raising interest rates. The forecasts published by the Fed after this meeting suggest that the Fed funds rate will end 2016 at 0.75%-1.0%, which implies two hikes this year, each of a quarter of a point. After the Brexit, however, future contracts assigned a 12.5% probability to a hike before March 2017. In any case, the Fed reduced its own forecasts for interest rates in 2017 and 2018 (from 1.9% to 1.6% and from 3.0% to 2.4%, respectively), as well as the long-term rate (from 3.3% to 3.0%). Regarding the macroeconomic forecasts, we should also note the slight downward revision in the trend rate of growth in GDP, which now stands at 2% from this year on. Initially yield on US public debt fell slightly, both for short and long maturities, ending the month at 0.6% and 1.47% respectively, also affected by the British vote (dropping by 25 bps and 30 bps on 24 June).

The ECB starts its corporate sector purchase programme (CSPP) with some of the predicted effects already having occurred. On 8 June the ECB launched its corporate sector purchase programme which covers investment grade corporate bonds issued in euros. The impact since this opening salvo is difficult to measure as it coincided with the start of tension caused by the British referendum but its effects actually started to be felt as from its announcement last March. Since then the average IRR for the Investment Grade European Corporate Bond index (published by Bloomberg) has fallen by more than 35 bps and the volume of issuances keeps on rising. In spite of the fall in corporate yields, the spread compared with German public debt has remained relatively flat due to the considerable drop in the bund's yield. On the other hand, although debt classed as speculative (high yield) is not included in the ECB's purchase programme, this has also benefitted from the CSPP indirectly (via the restructuring of investment portfolios) and has also followed the same downward trend as investment grade bonds.

*US: probability associated with an increase in the federal funds rate **

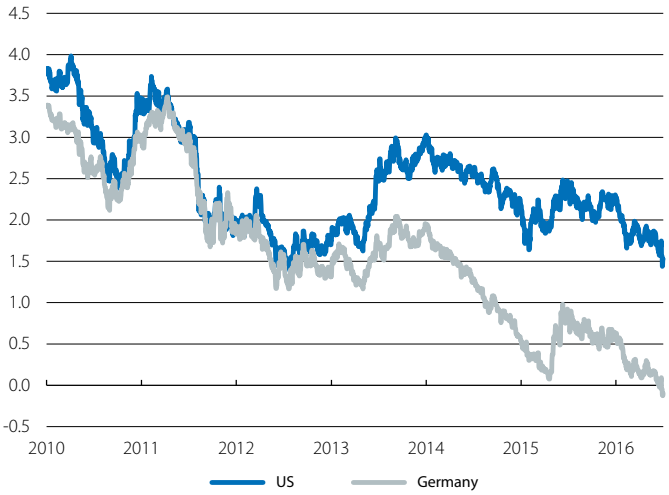
(%)



Note: ** Obtained from fed funds futures.*
Source: *CaixaBank Research, based on Bloomberg data.*

Yields on 10-year public debt

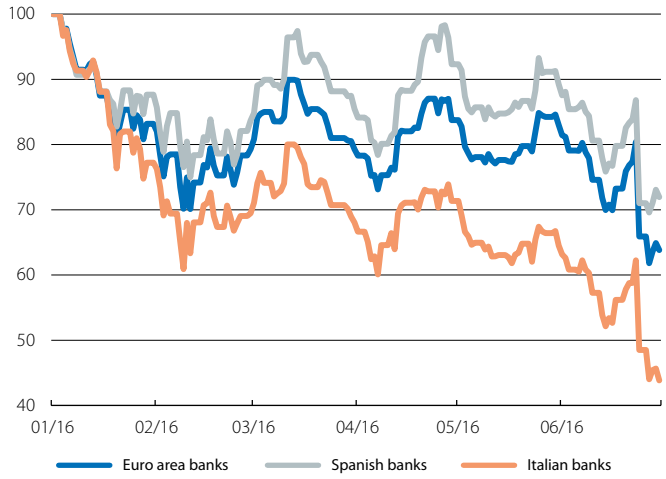
(%)



Source: *CaixaBank Research, based on Bloomberg data.*

Euro area stock market: banking sector

Index (100 = January 2016)



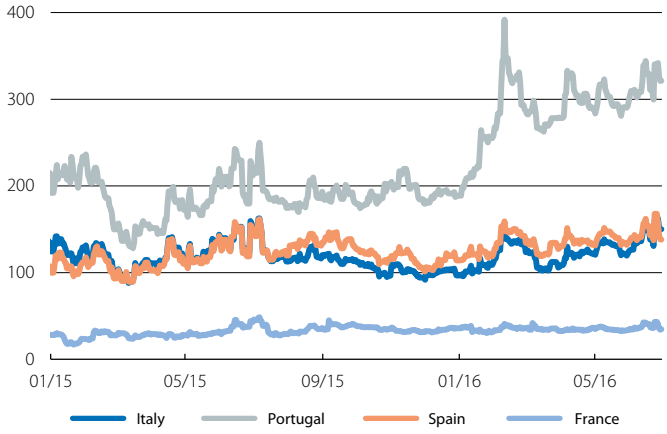
Source: *CaixaBank Research, based on Bloomberg data.*

International equity suffers from the uncertainty produced by the Brexit, recording losses over the month. British risk assets seemed, *a priori*, to be the most vulnerable to the tense trading in the days prior to the Brexit referendum (falling by 5% in 3 days) but it was actually the European index that came under most pressure in these sessions and recorded the most losses (Eurostoxx: –6.3%). The same message could be seen in the implied volatility of European indices, posting a maximum upswing in June of almost 70% (V2X Index for Europe and VFTSE Index for the United Kingdom) while implied volatility in the US stock market rose by 49% (VIX Index). Regarding the overall figure for the month, and with an upswing in the last few days after Brexit doubts had waned, the main US indices ended flat (S&P 500: +0.25%) while the European indices were down by 6%. This brings the cumulative figure for the year to losses ranging from 2% for the Nasdaq to 5% for the Stoxx 600 Europe and 19.5% for the Nikkei. This trend has reduced even further the European stock market's performance compared with the US stock market: the cyclically adjusted price-to-earnings ratio (CAPE) is over 16 in Europe and over 25 in the US, while the Price to Book ratio in Europe is 1.38 compared with 2.80 in the US.

Emerging markets and commodities manage to weather the storm in the midst of an unstable outlook. In spite of these losses for 2016 as a whole, the emerging markets have proved to be the exception, posting gains in excess of 6.5% (MSCI Emerging Market Index) in June although also suffering big losses during the last few days of the month. This performance is due to the improvements in the macroeconomic framework observed at the beginning of the month. In the absence of bad news from China, we should also add the support provided by commodities for this positive trend. So far oil prices have increased by a total of 33% in 2016 while copper and iron ore also picked up at the end of the month, with a cumulative rise of 2% and 23% this year, respectively. Moreover, the flash PMI of the G3 for June (US, the euro area and Japan) was showing signs of improvement. In any case, in the medium term attention will still be focused on the Chinese banking sector (mainly due to problems of asset quality as a result of high debt levels) and on the rise in defaults in its corporate bond market, half of which are from state enterprises. In the short term the trend in emerging assets will be influenced by the effects of the Brexit on risk aversion and on the outlook or doubts regarding world growth. Volatility is very likely to reign supreme in the markets until such uncertainty wanes.

Euro area: risk premia of 10-year public debt

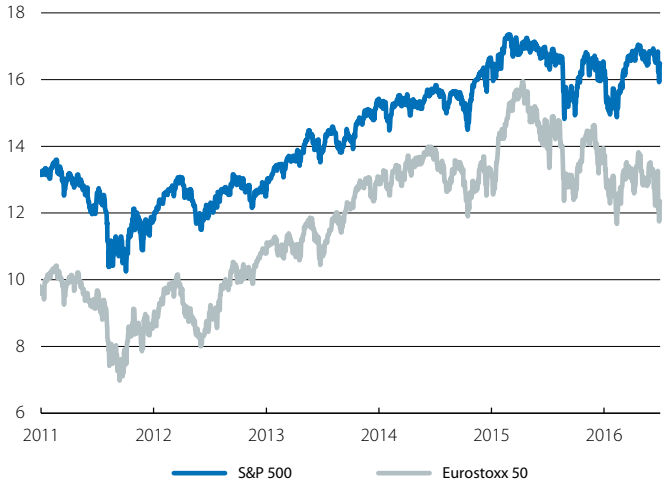
(bps)



Source: *CaixaBank Research, based on Bloomberg data.*

Developed stock markets: price/earnings ratios (P/E ratio)

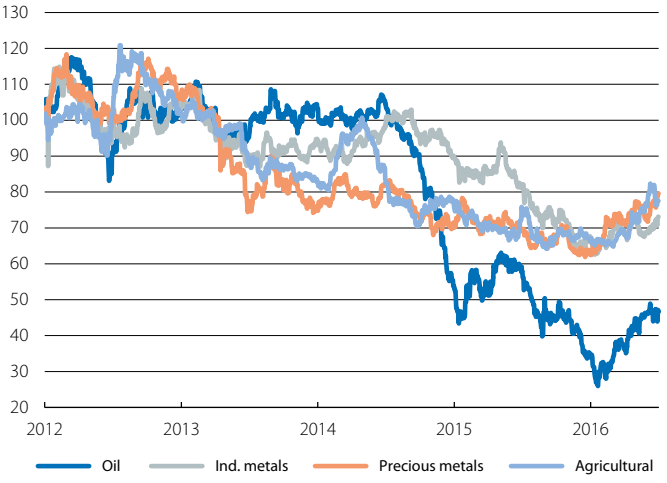
(Ratio)



Source: *CaixaBank Research, based on Bloomberg data.*

Trends in commodities

Index (100 = January 2012)



Source: *CaixaBank Research, based on Bloomberg data.*

FOCUS · Ultra long-dated bonds: the wood for the trees

In the last few months several European countries have issued ultra long-dated bonds; i.e. with maturities superior to 30 years. Since the beginning of 2016, France, Belgium and Spain have sold bonds at 50 years while Ireland and Belgium have issued bonds at 100 years.

Issuing ultra long-dated bonds is nothing new in the bond market nor is it reserved just for sovereign debt: at the beginning of the 1990s large US firms such as Disney and CocaCola issued debt at 100 years and, more recently, Petrobras and the French EDF joined the club of one hundred-year bond issuers. However, since the middle of the 2000s there has been a significant increase in issuances of this kind of bond, whose annual average total has gone from almost 25 in the 1990s to more than 54 between 2006 and 2015.

From the issuer's point of view, placing very long-term securities has an obvious advantage: it lowers refinancing risk as it reduces the proportion of short-term debt. Moreover, within the current context of all-time low interest rates and rock bottom term premiums (reflected in the flat interest rate curve), ultralong financing represents a relatively modest extra cost for issuers. For example, the 50-year bonds issued by Spain last May, totalling 3 billion euros, resulted in a cost (IRR) of 3.4% annually, only 51 bps more than the 30-year financing cost.

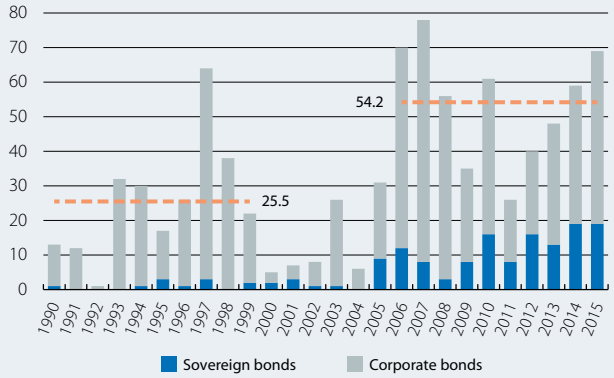
From an investor's point of view, buying a bond whose maturity exceeds life expectancy in the most advanced countries may seem strange at first glance. But 50 or 100-year debt provides higher yields than 30-year bonds without significantly increasing interest rate risk; i.e. the risk entailed in a variation in the IRR on the price of the bond. This is because a change in interest rate has less impact on the price of bonds whose maturity is over 30 years (see the second graph). At a similar level of uncertainty and interest rate risk, ultra long debt provides more attractive returns than 30-year debt.

The recent and relatively high demand for these bonds is also due to temporary factors. In a context of very low interest rates, lengthening the maturity of an investment is one of the strategies to achieve higher yields. For some investors, such as insurers and pension funds, this strategy is preferable to investing in debt with a lower credit rating, for regulatory reasons. The positioning of investors who anticipate a possible enlargement of eligible bonds in the ECB's asset purchase programme is also helping, albeit probably marginally, to push up the demand for bonds with maturities in excess of 30 years.

Issuing ultralong bonds forms part of a more general trend towards longer debt maturities. According to the Bloomberg index for euro area sovereign bonds, the weighted average maturity for bonds from the countries of the monetary union went from six and a half years in 2010 to more than nine at present. And the same pattern can also be seen in other segments of the bond market, such as corporate debt or debt issued in US dollars. Persistently rock bottom interest rates should continue to support these trends, which might even intensify with the ECB starting to buy corporate bonds at the beginning of June.

*New issuances of sovereign and corporate bonds with ultra long maturities **

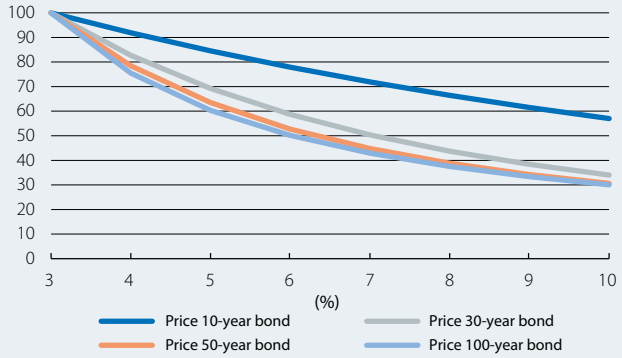
(Number of new issuances)



Note: ** Maturities over 30 years at the time of issuance.*
Source: *CaixaBank Research, based on Bloomberg data.*

*Bond price with different maturities by the IRR level **

(Nominal bond value)



Note: ** Simulation based on a hypothetical bond with a nominal value of 100 and an annual coupon of 3%. IRR: internal rate of return.*
Source: *CaixaBank Research.*

FOCUS · Europe *vs.* US stock market: mind the gap

Over the last few years, recommendations for shares to buy on Europe's stock exchange have abounded, arguing that there are more potential gains than in the US stock market. At the same time there have also been warnings about the rise in price of US equity. Nevertheless, European shares have not managed to keep up with US shares.

The main stock market indices on both sides of the Atlantic, the S&P 500 and Eurostoxx, have performed quite differently between the beginning of 2010 and mid-June 2016. In this period, the S&P 500 rose by 117.7% while Eurostoxx only gained 49.3%. The correlation between their monthly performances during this period is still high (80%) although below the level recorded in the period 2000-2009 (87%). Rallying early in 2015, European shares closed part of this gap in yield but losses in the summer of 2015 and at the beginning of 2016 have hit stock markets on the Old Continent harder. Note that these figures refer to total return indices which include dividend payments. But even when dividends are not included, Europe still comes off worse in the comparison because it distributes a larger percentage of profits (61.1% compared with 41% in the US) and the dividend yield is higher (3.7% compared with 2.0%).

Underlying economic fundamentals are probably the main factor behind this gap between the two stock markets. Since 2010 average GDP growth in the euro area has been 0.9% year-on-year while it has been 2.1% in the US. This is directly reflected in companies' earnings per share (EPS) which has grown, on average and over the same period, by 9.4% year-on-year in the US compared with 2.9% in the euro area. But the impact of the regions' respective monetary policies is no less important. Both in its expansion of its balance sheet and in lowering interest rates, the Federal Reserve (Fed) has acted more quickly and more aggressively than the ECB, benefitting US equity. Moreover the euro area has had to tackle significant local episodes of risk aversion, such as the sovereign debt crisis and, more recently, the Brexit referendum.

On the other hand, a clear pattern emerges when we analyse the performance of both markets by sector. As can be seen in the table, Europe has lost the battle with the US in all sectors; those related to consumption, health and technology have achieved good results but have still been outperformed by their American peers. The other side of the coin can be found in the financial sector, telecommunications and utilities, which have performed considerably worse than the corresponding sectors in the US market.

This weak performance by the European stock market has placed its valuation metrics at relatively attractive levels (euro area P/E ratio: 16.3; US P/E ratio: 25.8, at 15 June), allowing for larger gains in the long term. In fact, analysts predict a strong rise in profits in 2016 although historically they tend to be overly optimistic. However, much will depend on the repercussions of Brexit, the strength of Europe's political project, the effective implementation of structural reforms and regulation in key sectors.

Yields of the S&P 500 and Eurostoxx

Index (100 = December 2005)

Source: *CaixaBank Research, based on Bloomberg data.*

Stock market returns by sector

Average annual return since 2010 (%)

Sector	US	Euro area
Energy	4.3%	2.4%
Materials	8.9%	4.8%
Industry	13.9%	8.7%
Consumer discretionary	17.9%	13.2%
Consumer essentials	14.4%	12.9%
Health	15.6%	11.4%
Finance	9.3%	–1.0%
Information technologies	12.2%	10.1%
Telecommunications	12.1%	1.9%
Utilities	12.1%	–6.4%
General index	**12.3%**	**5.6%**

Source: *CaixaBank Research, based on Bloomberg data.*

KEY INDICATORS

Interest rates (%)

	30-June	31-May	Monthly change (bps)	Year-to-date (bps)	Year-on-year change (bps)
Euro area					
ECB Refi	0.00	0.00	0	–5.0	–5.0
3-month Euribor	–0.29	–0.26	–3	–15.5	–27.2
1-year Euribor	–0.05	–0.02	–3	–11.0	–21.4
1-year government bonds (Germany)	–0.62	–0.53	–9	–24.2	–38.4
2-year government bonds (Germany)	–0.66	–0.51	–15	–31.5	–43.3
10-year government bonds (Germany)	–0.13	0.14	–27	–75.9	–89.4
10-year government bonds (Spain)	1.16	1.47	–31	–61.1	–114.1
10-year spread (bps) [1]	129	133	–4	15.1	–24.4
US					
Fed funds	0.50	0.50	0	0.0	25.0
3-month Libor	0.63	0.69	–6	1.2	34.2
12-month Libor	1.21	1.34	–13	3.2	43.9
1-year government bonds	0.43	0.67	–24	–16.7	16.5
2-year government bonds	0.58	0.88	–30	–46.8	–6.3
10-year government bonds	1.47	1.85	–38	–79.9	–88.3

Spreads corporate bonds (bps)

	30-June	31-May	Monthly change (bps)	Year-to-date (bps)	Year-on-year change (bps)
Itraxx Corporate	84	72	12	6.7	9.2
Itraxx Financials Senior	112	90	22	35.2	22.2
Itraxx Subordinated Financials	233	194	40	77.6	54.1

Exchange rates

	30-June	31-May	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
$/€	1.111	1.113	–0.2	2.2	–0.4
¥/€	114.610	123.250	–7.0	–12.3	–16.1
£/€	0.834	0.769	8.6	13.2	17.6
¥/$	103.200	110.730	–6.8	–14.2	–15.8

Commodities

	30-June	31-May	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
CRB Commodity Index	401.2	412.3	–2.7	7.1	–5.9
Brent ($/barrel)	48.4	48.3	0.2	35.4	–21.1
Gold ($/ounce)	1,322.2	1,215.3	8.8	24.6	12.8

Equity

	30-June	31-May	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
S&P 500 (USA)	2,098.9	2,097.0	0.1	2.7	1.7
Eurostoxx 50 (euro area)	2,864.7	3,063.5	–6.5	–12.3	–16.3
Ibex 35 (Spain)	8,163.3	9,034.0	–9.6	–14.5	–24.2
Nikkei 225 (Japan)	15,575.9	17,235.0	–9.6	–18.2	–23.0
MSCI Emerging	834.1	807.5	3.3	5.0	–14.2
Nasdaq (USA)	4,842.7	4,948.1	–2.1	–3.3	–2.9

Note: *1. Spread between the yields on Spanish and German 10-year bonds.*

ECONOMIC OUTLOOK · **Global economy is growing in spite of the risks resulting from the Brexit**

Brexit will have a negative impact on world growth, albeit very slight. The forecasts by CaixaBank Research still place global economic growth at 3.2% in 2016, slightly higher than 2015's figure of 3.1%, and at 3.5% in 2017. The repercussions from the United Kingdom's decision to leave the EU will particularly affect the country itself. Nonetheless, given the UK's economic importance and also its degree of economic, commercial and financial integration, we expect these repercussions to extend beyond its borders and particularly to the rest of the countries within the EU. In the financial area, risk aversion and volatility will remain high for several weeks while doubts persist regarding the exit process. The actions carried out by the different central banks will be key to mitigating the effects of the Brexit. In addition to the UK probably lowering its interest rates and the ECB speeding up its rate of asset purchases, the Federal Reserve (Fed) may decide to delay its next increase of the Fed funds rate a little longer.

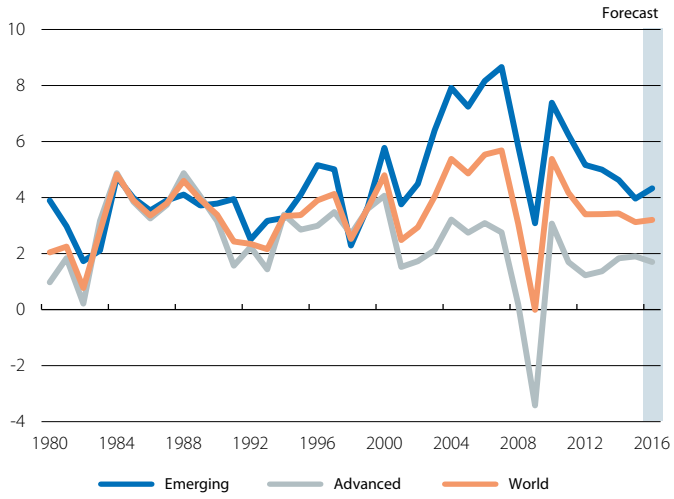
UNITED STATES

The Fed: from getting ready for a second hike to putting everything on hold. Undoubtedly the surprising outcome of the UK referendum, together with the markedly more dovish tone of the minutes from its June meeting, will affect the decisions taken by the US Fed over the coming months. Those voices most strongly advocating the need to continue with monetary normalisation that were heard in April will surely be quieter at the next few meetings. Given this situation, the second interest rate hike is very likely to be delayed until December 2016 according to CaixaBank Research forecasts, once the strength of the US economy has been confirmed and global tailwind risks have eased. We also expect the rate at which the Fed normalises its monetary policy to be somewhat more gradual with increases of 75 bps a year in 2017 and 2018 (instead of the 100 bps predicted in the previous forecast scenarios), as suggested by the projections provided by the Fed Open Market Committee in June.

In any case the recovery in inflation and the good performance by the labour market will support interest rate hikes starting again at the end of the year. The US' general CPI grew by 1.0% year-on-year in May, 0.1 pps below the previous month's figure, while the core CPI grew by 2.2%, 0.1 pps above April's figure. In monthly terms (with the series seasonally adjusted), both the general CPI and the core CPI grew by a significant 0.2% month-on-month. Once again the solid advance in energy component was particularly noticeable (+1.2% month-on-month). General inflation is

World GDP: CaixaBank Research forecasts

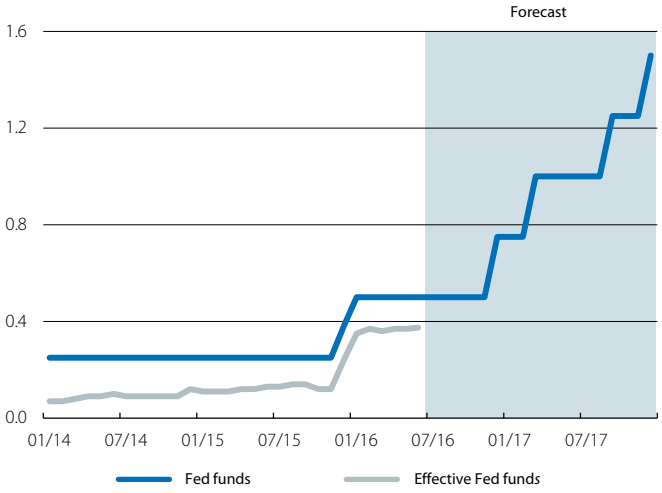
Annual change (%)



Source: *CaixaBank Research, based on data from the IMF and Thomson Reuters Datastream.*

US: Fed interest rate

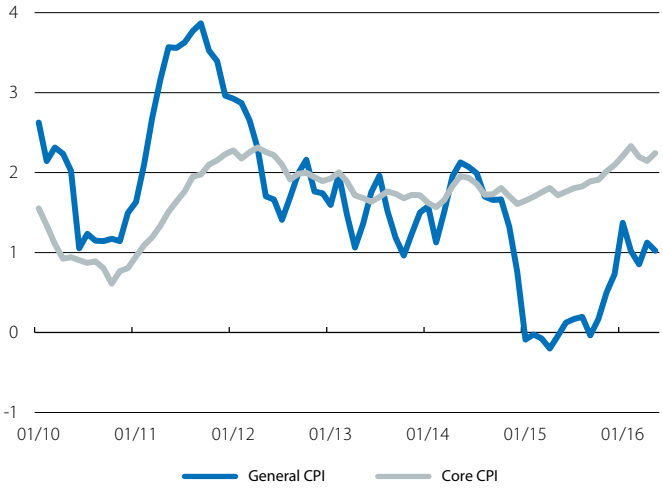
(%)



Source: *CaixaBank Research, based on data from Thomson Reuters Datastream.*

US: inflation

Year-on-year change (%)



Source: *CaixaBank Research, based on data from the Bureau of Labor Statistics.*

therefore expected to pick up over the coming months (close to 2.0% by December 2016) due to the recovery in oil prices and strong consumption. This upswing, together with continued improvements in the labour market, will help the Fed to restart interest rate hikes at the end of the year. In fact, the negative surprise provided by the labour market figures in May (38,000 jobs were created, the lowest figure in the last six years) is temporary. The potential effect on statistics of the strike by the workers of a large telecom company, the strong recovery in the labour market since 2009 (4.7% unemployment rate) and positive wage rises (2.5% year-on-year) balance out this bad figure (see the Focus «An overview of the improvement in the US labour market» in this *Monthly Report*).

The US economy continues to expand strongly. Activity data for Q2 point to growth accelerating in the world's largest economy. Growth in retail sales and consumer goods and the strong figures posted by the consumer confidence index published by the Conference Board in June (at 98.0 points, considerably higher than its historical average) reflect the improvement in private consumption, which represents almost 70% of GDP. Similarly, according to the third estimate produced by the Bureau of Economic Analysis (BEA), the US' GDP grew by 0.3% quarter-on-quarter in Q1 (2.0% year-on-year), exceeding the first and second estimates (0.1% and 0.2%, respectively). In spite of this upward revision of Q1, the forecast for the annual figure for 2016 remains at 2.0% as a consequence of the downward pressure resulting from the Brexit process. In 2017, CaixaBank Research has lowered its forecast slightly (by 0.1 pps) to 2.1% for to the same reason.

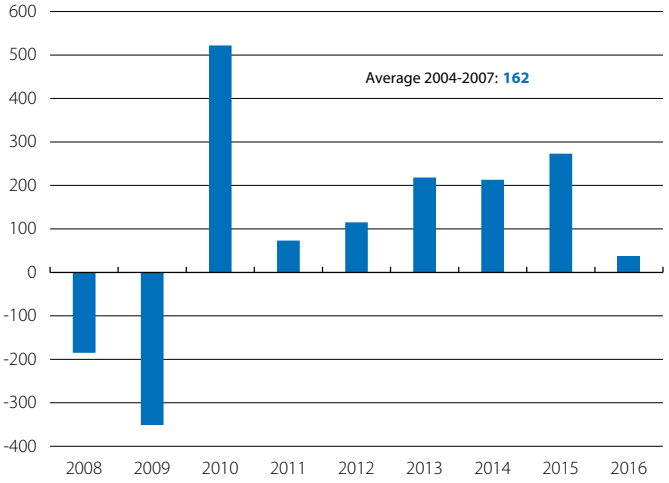
JAPAN

Japan postpones its VAT hike planned for April 2017 (from 8% to 10%) until October 2019, given the country's persistent weakness in domestic demand, deflationary tensions and doubts regarding growth in China. This delay indicates better growth prospects for the Japanese economy in 2017 (now at +0.9%). Given this situation, the Bank of Japan made no changes at its June meeting (before the UK referendum) although the monetary institution is very likely to decide to increase asset purchases (now totalling 80 trillion yen a year) at its July meeting, particularly after the financial turbulence caused by the United Kingdom's decision.

The Japanese economy is still weak. Domestic demand is particularly fragile, affected by poor consumer and business expectations given the country's lack of commitment to reforms. The yen's appreciation is also weighing heavily on the foreign sector. In May exports fell in nominal terms by 11.3% year-on-year due to a drop in sales to China, the countries of South East Asia and the US. They also fell by 2.4% year-on-year in terms of volume, especially because of lower sales to the US.

US: employees

Change in May (thousands)



Source: *CaixaBank Research, based on data from the Bureau of Labor Statistics.*

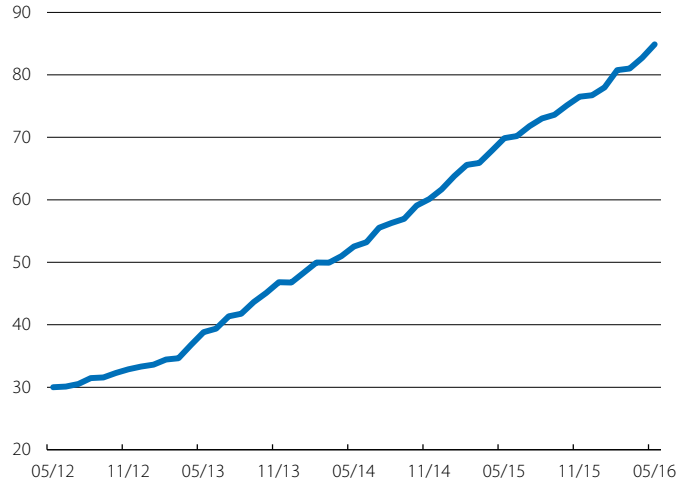
US: unemployment rate

(%)

Source: *CaixaBank Research, based on data from the Bureau of Labor Statistics.*

Japan: Bank of Japan's assets

(% of GDP)



Source: *CaixaBank Research, based on data from the Bank of Japan and the Ministry of the Interior.*

EMERGING ECONOMIES

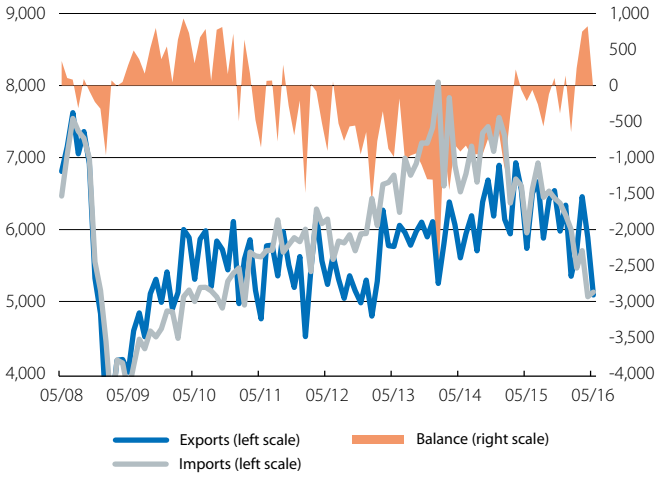
China's economic activity indicators stabilise in May but the sources of risk continue. Although exports fell again (–4.1% year-on-year), imports recorded a slight drop (–0.4%) after months of sharp declines (–13% on average between January and April), indicating that domestic demand is stabilising. Similarly industrial production grew by 6.0% year-on-year, in line with the previous month, while retail sales rose by 10.0% year-on-year, without showing either clear improvement or evident deterioration compared with the figure of 10.7% posted in 2015.

China's high and increasing level of debt is a cause for concern, particularly corporate debt. The country's total debt is around 250% of GDP (while corporate debt is equivalent to about 166% of GDP). The IMF has recommended three actions that should be taken to tackle such a large increase in corporate debt: acting quickly and effectively, sorting out the problems both of lenders (banks) and borrowers (companies) and resolving problems of corporate governance (both in companies and in banks). China has manifest experience in the area of governance. Between 2003 and 2005 the government sorted out a large proportion of its big banks that were seriously affected by high NPL ratios, caused for the most part by state companies: in three years close to 130 billion dollars were invested in restructuring the country's financial system. A decade later, the problem is back.

The response capacity of emerging countries is varied. In spite of the risk supposed by the level of corporate debt in China, it is obvious that the world's second largest economy has options to act that are not available to all emerging economies: a high level of reserves (in spite of the drop over the last few months), a current account surplus and contained inflation represent three important points of support to tackle its problems. India and Mexico are two other countries with reasonable macroeconomic imbalances and room to manoeuvre while, at the other end of the scale, we have the case of Brazil and Russia with imbalances that are difficult to correct, particularly given their current recessionary situation.

Japan: trade balance

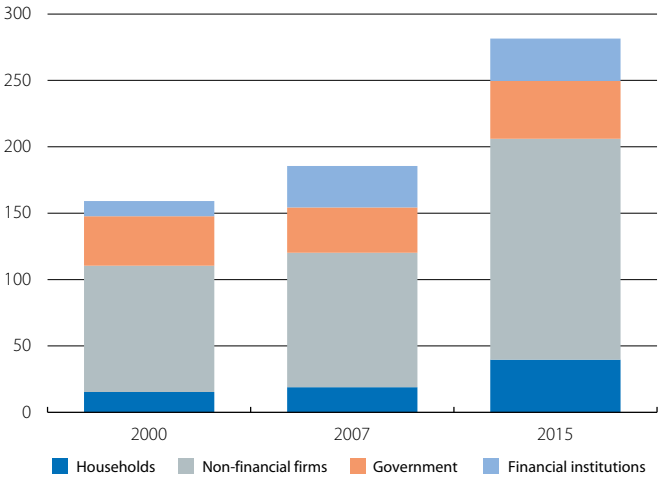
Monthly data (billions yen) *Monthly data (billions yen)*



Source: *CaixaBank Research, based on data from the Department of Trade.*

China: total debt

(% of GDP)



Source: *CaixaBank Research, based on data from the IIF.*

Emerging countries: macroeconomic imbalances and instruments

	Current account (% of GDP)	Inflation	Fiscal balance (% of GDP)	Reserves (% of GDP)	Exchange rate
India	–1.1	5.8	–7.2	16	Managed floating
Mexico	–2.8	2.6	–4.1	15	Floating
Morocco	–1.4	1.6	–4.3	22	Peg composite
China	2.7	2.0	–3.5	30	Fluctuation band
Turkey	–4.4	6.6	–1.4	13	Floating
South Africa	–4.4	6.2	–4.1	13	Floating
Russia	5.0	7.3	–5.7	26	Floating
Brazil	–3.3	9.3	–10.3	20	Floating

Source: *CaixaBank Research, based on data from Thomson Reuters Datastream.*

FOCUS · An overview of the improvement in the US labour market

The US unemployment rate has improved non-stop since it reached 10% in 2009. Specifically, in May it stood at 4.7%, close to the minimum level reached in 2005 and 2006. These data, together with relatively weak job creation figures, have led to debate regarding whether the US labour market has now achieved full employment. A debate of the utmost importance as this affects, for example, how quickly the Fed must raise interest rates.

For a more accurate assessment of the state of the US labour market, we will examine two key elements that have changed extensively in the last few years: the demographic composition of the labour force and the participation rate.[1]

Demographic change is relevant insofar as the different age groups tend to have different unemployment rates. Young people normally have a higher unemployment rate than older segments of the population. Therefore, given that the relative weight of the different age groups has changed in the last few years (see the first graph), the same thing might also have occurred with the equilibrium unemployment rate.

Although this hypothesis is plausible and is often used to argue that structural unemployment is now lower, the ageing of the population over the last few years is not having much of a quantitative impact. For example, if the share of the different segments were the same as in 2005, unemployment would only be 0.1 pp higher than the current figure.

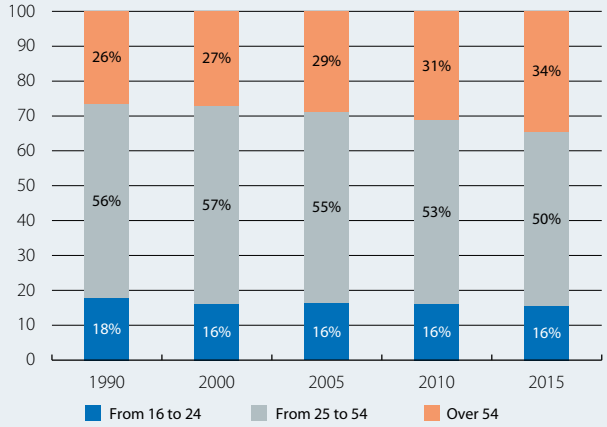
The second factor to take into account to evaluate today's unemployment rate is the large drop in the participation rate, going from 66.0% in 2006 to 62.6% in May 2016. In this case the potential impact on the unemployment rate could be considerable in quantitative terms. By way of example, if those people who have left the labour market had remained in the labour force looking for employment, the unemployment rate would be 6.5%, 1.8 pps higher than the current figure.

This sharp drop in the participation rate has led to intense debate regarding what proportion of those who have left the labour market will return as economic conditions improve and what proportion will remain outside the labour force structurally. Although there is no clear consensus regarding how much of the decrease in the participation rate is structural, several studies have estimated this at around 30%.[2] Assuming this estimate is valid, we can repeat our previous exercise, this time adding to the labour force only those people who have become discouraged and have temporarily stopped looking for a job. In this case the unemployment rate would still be a low 5.9%.

In summary, although several factors need to be taken into account when assessing the low unemployment rate in the US, its labour market is very close to full employment. Consequently, pressure on wages is likely to increase over the next few months, an element which the Fed will have to bear in mind in deciding when is the right time to raise interest rates, in addition to the turbulent international financial conditions.

US: population by age group

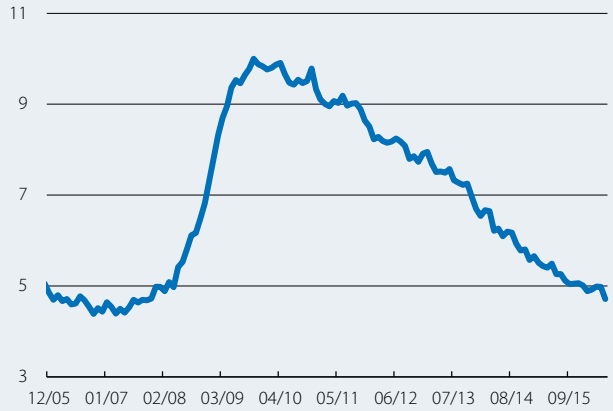
(% of the total)



Source: *CaixaBank Research, based on data from the Bureau of Labor Statistics.*

US: unemployment rate

(%)



Source: *CaixaBank Research, based on data from the Bureau of Labor Statistics.*

1. The participation rate is the ratio between the labour force and the population aged 16 and over.

2. See Aaronson, Daniel, Luojia Hu, Arian Seifoddini, and Daniel G. Sullivan, «Declining labor force participation and its implications for unemployment and employment growth», Economic Perspectives 38, no. 4 (2014).

FOCUS · Emerging currencies: where they are and where they are going

Between 1st July 2014 and 31 December 2015 the emerging currencies lost heavily against the dollar. The rouble's value fell by 53%, the Brazilian real by 45%, the Colombian peso by 41%, the Argentine peso by 37% and the South African rand by 31%. Although these are the five emerging currencies recording the largest depreciation, the emerging currencies on the whole tended to lose value. The J. P. Morgan emerging market currency index (a basket of 10 benchmark currencies) shows a decline of 26% for this period which was also accompanied by increased volatility. Although this movement had been reversed to some extent up to June this year (the aforementioned basket appreciated by 4.1%), volatility is still high and the ground lost is far from being regained.

Given this situation, we need to ask whether, after these fluctuations, the emerging currencies are still some distance from their equilibrium exchange rate (i.e. the exchange rate that corresponds to their underlying macroeconomic fundamentals). If we compare the most recent real effective exchange rate (REER) with the equilibrium rate estimated by the IMF, it can be seen that the aforementioned episode has led to almost all the emerging currencies being clearly undervalued.[1] The gap between the REER and the equilibrium rate is strongly negative (with differences in the order of 30%) in South Africa, Russia, Malaysia and Mexico, and somewhat less marked in Brazil and Poland. However, Turkey and India would only be slightly overvalued.

Based on this situation, how are the emerging currencies likely to perform in the coming years? In order to answer this question we need to look at two groups of factors that will probably affect these currencies; global factors and those of a more idiosyncratic nature. With regard to the former, at present we can identify three major conditioning factors influencing the emerging economies as a whole. Firstly, the emerging currencies will be affected by the financial repercussions of the Brexit. In the days following the British referendum these currencies have seen widespread depreciation, this being particularly severe in the case of the South African rand, the Polish zloty, the Hungarian forint, the Argentine peso and the Romanian leu.

A second global conditioning factor has been in effect for some time now and is likely to continue, namely the impact on emerging currencies of the monetary policy normalisation carried out by the US Federal Reserve (Fed).

1. The REER is an index that takes into account bilateral nominal exchange rates and the relative variation in national prices compared with the price of trading partners, weighted by the share of each trading partner in the total international trade of the country in question.

During the widespread depreciation of the emerging currencies in 2014-2015, some of the most virulent episodes of depreciation coincided with moments when the market expected US interest rate hikes in the near future. But in addition to acting as a temporary catalyst, expectations of US monetary normalisation have also placed quite a constant pressure on the emerging currencies and this is likely to intensify once the Fed's current inaction gives way, surely at the end of the year, to renewed hikes in the reference interest rate.

Lastly, a third global factor which has recently tended to push down the value of the emerging currencies is related to decisions to devalue the yuan, especially when these have coincided with macroeconomic data that suggest China's soft landing may be veering towards a relatively uncontrolled slowdown in activity. As is the case with the other two global conditioning factors already mentioned, we believe that China will continue to be a source of risk over the coming months, keeping a lid on the value of the emerging currencies.

These global conditioning factors will have more or less impact at a national level depending on the specific situation of each emerging market. Two relevant vulnerabilities can be observed in particular: the presence of macroeconomic imbalances and the political uncertainty faced by some of these countries. Regarding the former of these blocks of local factors, the most worrying due to its nature is the excessive dependence on external financing. In this respect Turkey, South Africa and Brazil particularly stand out as a result of their current account deficit, countries in which the situation is further complicated by a clearly inflationary trend. Brazil, moreover, is also facing the threat of alarmingly imbalanced public accounts. The political source of risk is relevant in countries such as Russia (in this case of a geopolitical nature) and Brazil (due to its recent institutional situation, complicating the country's governability and economic policymaking).

Uncertainty regarding the Brexit, the Fed and China is unlikely to dissipate appreciably or quickly. Neither do the more fragile emerging countries seem able to earn their right to leave the danger zone thanks to appreciable macroeconomic adjustments or favourable turnarounds in their political situation. Unfortunately all this makes up a context that is ripe for further episodes of depreciation among the emerging currencies, probably as a result of relatively unselective dynamics based on increasing global risk aversion.

KEY INDICATORS

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

UNITED STATES

	2014	2015	2015 Q2	2015 Q3	2015 Q4	2016 Q1	04/16	05/16
Activity								
Real GDP	2.4	2.4	2.7	2.1	2.0	2.0	–	...
Retail sales (excluding cars and petrol)	4.5	4.3	4.1	4.1	3.5	4.0	4.4	4.1
Consumer confidence *(value)*	86.9	98.0	96.2	98.3	96.0	96.0	94.7	92.6
Industrial production	2.9	0.3	0.4	0.1	–1.6	–1.6	–1.2	–1.4
Manufacturing activity index (ISM) *(value)*	55.6	51.3	52.6	51.0	48.6	49.8	50.8	51.3
Housing starts *(thousands)*	1,001	1,108	1,156	1,156	1,135	1,146.7	1,167	1,164
Case-Shiller home price index *(value)*	171	179	179	179	182	187	189	...
Unemployment rate *(% lab. force)*	6.2	5.3	5.4	5.2	5.0	4.9	5.0	4.7
Employment-population ratio *(% pop. > 16 years)*	59.0	59.3	59.3	59.3	59.4	59.8	59.7	59.7
Trade balance[1] *(% GDP)*	–2.9	–3.0	–3.0	–3.0	–3.0	–3.0	–3.6	...
Prices								
Consumer prices	1.6	0.1	0.0	0.1	0.5	1.1	1.1	1.0
Core consumer prices	1.7	1.8	1.8	1.8	2.0	2.2	2.1	2.2

Note: *1. Cumulative figure over last 12 months.*
Source: *CaixaBank Research, based on data from the Department of Economic Analysis, Department of Labor, Federal Reserve, Standard & Poor's, ISM and Thomson Reuters Datastream.*

JAPAN

	2014	2015	2015 Q2	2015 Q3	2015 Q4	2016 Q1	04/16	05/16
Activity								
Real GDP	–0.1	0.6	0.7	1.8	0.8	0.0	–	...
Consumer confidence *(value)*	39.3	41.3	41.5	41.0	42.2	41.4	40.8	40.9
Industrial production	2.1	–1.2	–0.8	–0.4	–1.1	–3.2	–1.7	–1.8
Business activity index (Tankan) *(value)*	13.5	12.8	15.0	12.0	12.0	6.0	–	...
Unemployment rate *(% lab. force)*	3.6	3.4	3.4	3.4	3.3	3.2	3.2	...
Trade balance[1] *(% GDP)*	–2.6	–0.6	–1.4	–1.0	–0.6	–0.2	–0.1	0.0
Prices								
Consumer prices	2.7	0.8	0.5	0.2	0.3	0.1	–0.3	...
Core consumer prices	1.8	1.0	0.4	0.8	0.8	0.7	0.7	...

Note: *1. Cumulative figure over last 12 months.*
Source: *CaixaBank Research, based on data from the Communications Department, Bank of Japan and Thomson Reuters Datastream.*

CHINA

	2014	2015	2015 Q2	2015 Q3	2015 Q4	2016 Q1	04/16	05/16
Activity								
Real GDP	7.3	6.9	7.0	6.9	6.8	6.7	–	...
Retail sales	12.0	10.7	10.2	10.7	11.1	10.3	10.1	10.0
Industrial production	8.3	6.1	6.3	5.9	5.9	5.9	6.0	6.0
PMI manufacturing *(value)*	50.7	49.9	50.2	49.8	49.7	49.5	50.1	50.1
Foreign sector								
Trade balance[1] *(value)*	383	595	537	570	595	595	606	599
Exports	6.0	–2.9	–2.9	–6.4	–5.2	–10.2	–2.5	–4.1
Imports	0.4	–14.3	–13.5	–14.5	–11.8	–13.4	–10.9	–0.4
Prices								
Consumer prices	2.0	1.4	1.4	1.7	1.5	2.1	2.3	2.0
Official interest rate[2] *(value)*	5.60	4.35	4.85	4.60	4.35	4.35	4.35	4.35
Renminbi per dollar *(value)*	6.2	6.3	6.2	6.3	6.4	6.5	6.5	6.5

Notes: *1. Cumulative figure over last 12 months. Billion dollars. 2. End of period.*
Source: *CaixaBank Research, based on data from the National Bureau of Statistics of China and Thomson Reuters Datastream.*

ECONOMIC OUTLOOK · **Brexit: strong impact on the United Kingdom, more diffused in the EU**

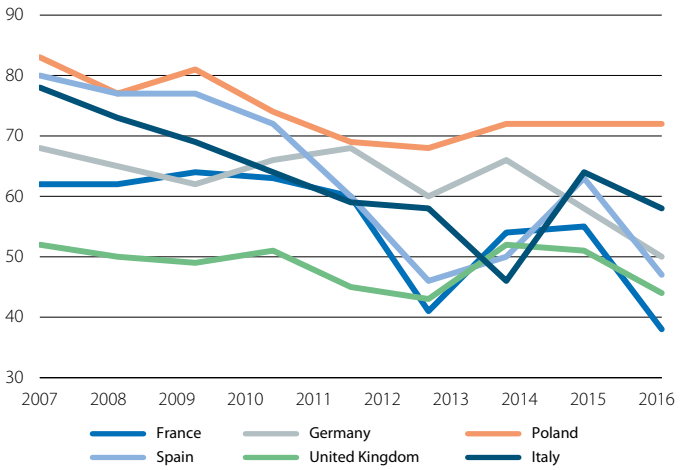
The decision to leave the EU by the United Kingdom brings with it important political consequences. The Brexit vote won the referendum on 23 June by a narrow margin (52% vs. 48%). Meanwhile the country has begun to suffer from considerable political crisis which is causing great uncertainty. One initial political repercussion has been the resignation of the British Prime Minister, David Cameron. This will come into effect in October when a new leader of the Conservative party will be nominated, who will have to lead negotiations with the EU. Scotland, which voted overwhelmingly to remain in the EU, could rethink its relationship with the rest of the country.

EU negotiations, a key factor over the coming months. The EU has communicated its desire to quickly negotiate the terms of the UK's exit so as not to prolong uncertainty and attempt to keep the country as a close partner. In these negotiations the EU will have to find some middle ground between a tough stance, which avoids a knock-on effect and further referendums, and an accommodative stance that minimises the impact on the real economy. The member states are also facing a difficult political calendar (referendum on Italian constitutional reform in October, legislative elections in Germany and France in 2017, etc.) and an increase in the dissatisfaction of European citizens with the EU project, with the added factor of advances being made by Eurosceptic and populist parties. Over a longer timeframe, the United Kingdom's exit might act as a catalyst to reinforce commitment to the European project and the euro in the rest of the countries. One possibility would be to accentuate the different speeds of integration in Europe, with greater intensity in the euro area. However, the lack of strong leadership in the EU and growing Euroscepticism could derail this scenario of greater European integration.

Appreciable economic impact of the Brexit for the United Kingdom in the short term. The United Kingdom is likely to imminently fall into a recession due to the high level of uncertainty which will act as a brake on decisions to invest, hire and consume. Its size and depth will depend on how this uncertainty develops. Should it increase, there will be more pressure to achieve an exit that does not entail a radical break with the current situation. We expect the economy to start to normalise as negotiations begin with the EU, probably at the end of 2016 or beginning of 2017. For the moment, the Bank of England has injected additional liquidity and could soon cut interest rates. In the long term, the cost of the Brexit will largely depend on the nature of the UK's new relationship with the EU, in particular agreements on trade and the circulation of people, and also with other countries (for more details see the Focus «Brexit: a gamble with more costs than benefits» in MR05/2016). Estimates of the cost in terms of GDP by various organisations fluctuate between –1% and –10%.

*European Union: favourable opinion about the EU **

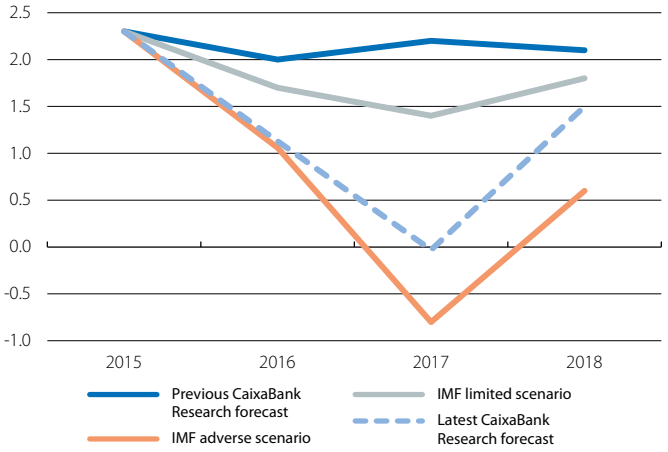
(%)



Note: ** Percentage of individuals with a favourable opinion of the EU.*
Source: *CaixaBank Research, based on data from Pew Global Attitudes Survey (June 2016).*

United Kingdom: growth forecasts under different scenarios

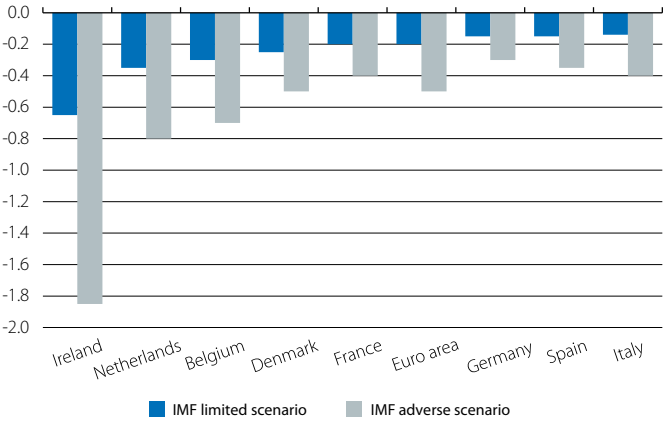
Annual change (%)



Source: *CaixaBank Research, based on IMF data.*

Economic impact of the Brexit on different countries in the medium term

Change in level of GDP (%)



Note: *Deviation of the GDP level of the non-exit scenario compared with the minimum level for the limited scenario (2018) and for the adverse scenario (2019).*
Source: *CaixaBank Research, based on IMF data.*

The economic consequences for the rest of the member states should be moderate. The Brexit will tend to have a direct impact (via the commercial channel) on the rest of the EU countries due to the recession in the UK and, indirectly, to an upswing in uncertainty. However, the overall effect should be modest, equivalent to few tenths of a percentage point for most countries. Repercussions in some economies such as Ireland and the Netherlands will be greater due to their strong links with the United Kingdom. The macroeconomic deterioration could be worse if political cohesion wanes in the EU, if economic policies (monetary, fiscal, etc.) lose their effectiveness or if other external risks materialise, both geopolitical and economic.

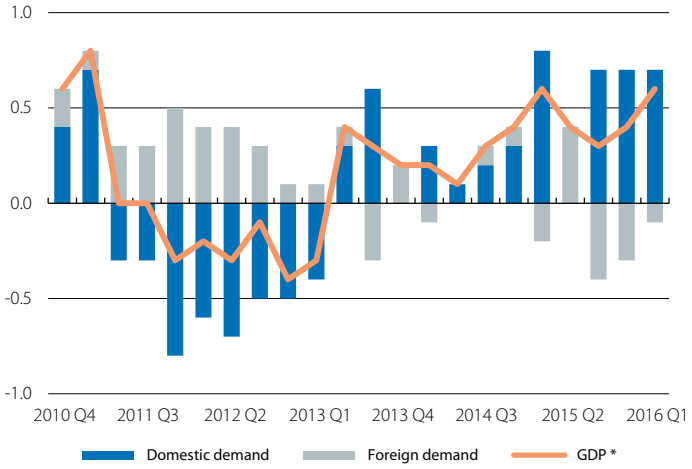
The economy of the euro area, in a condition to withstand the shock. The context in which this economic shock of the Brexit is occurring is nevertheless relatively positive. In 2016 Q1 the euro area added its thirteenth consecutive quarter with GDP growth (and has now recovered the real GDP level it had before the crisis in 2008). Specifically, in Q1 the quarter-on-quarter increase in GDP was 0.6%, slightly higher than the figure of 0.4% posted in 2015 Q4. In addition to its favourable rate of activity, we should also note the balanced composition of this growth. Domestic demand continued to be the major contributor to the change in GDP (+0.7 pps), in particular thanks to private consumption (+0.3 pps), whose contribution increased. Public consumption and investment contributed, respectively, with +0.1 pps and +0.2 pps and, together with private consumption, these are likely to be the pillars for growth in the euro area over the coming months. Given the inertia that tends to be shown by domestic demand, its strength comes from certain margin of autonomy of the cycle of countries in the euro area in relation to the more direct economic channels through which the Brexit effect will be transmitted. Exports reduced their negative contribution to growth in Q1 (–0.1 pps), especially because of the lower growth in imports compared with exports.

Activity increases in Q2. This good economic performance is not limited to the first three months of the year. In May, the euro area's economic sentiment index reached its highest level in the last four months (104.5 points). Of note is the rise in France (+1.5 points) and, to a lesser extent, in Germany (+0.4 points) and Italy (+0.3 points). These good figures more than offset the slight drop posted by Spain (–0.4 points). Other indicators, such as industrial production and the PMI indices, also point to the progress made by activity being similar in Q2 to that recorded in Q1.

Consumption keeps up a notable pace. Consumption indicators suggest that household spending grew a little less in Q2 than in the previous quarter but is still within a reasonably positive zone. The euro area's consumer confidence index reached –7.3 points in June, recovering almost all the ground lost in Q1. The data available point to this improvement in consumption reaching expenditure on durables, in particular car purchases, a trend undoubtedly related to the progressive normalisation of credit. In addition to private

Euro area: GDP

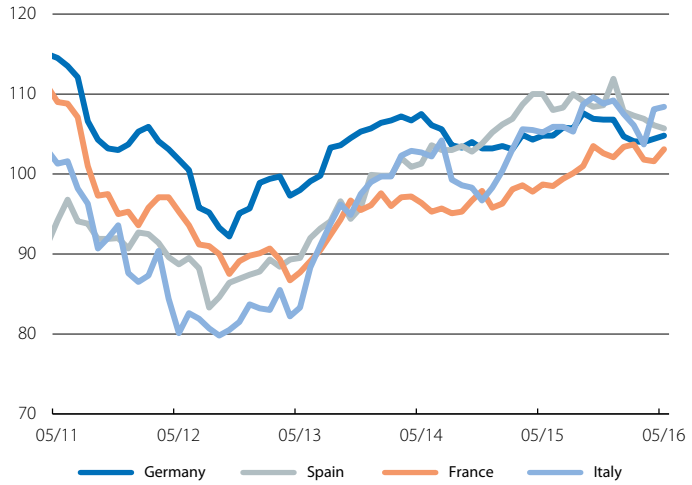
Contribution to quarter-on-quarter growth (pps)



Note: ** Quarter-on-quarter change (%).*
Source: *CaixaBank Research, based on Eurostat data.*

Euro area: economic sentiment index

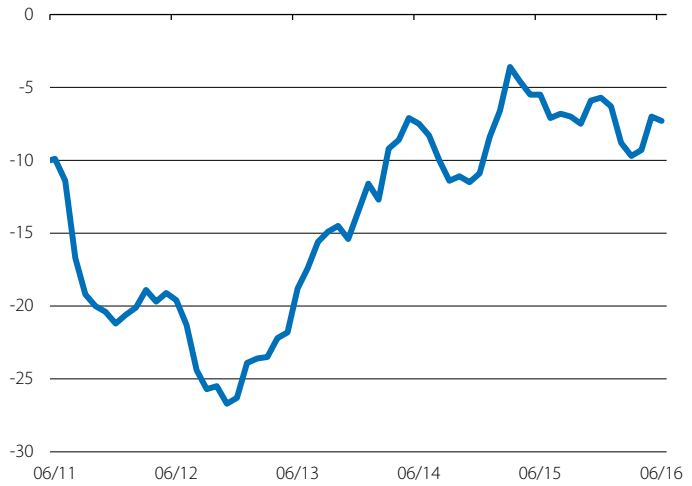
Level



Source: *CaixaBank Research, based on European Commission data.*

Euro area: consumer confidence

Level



Source: *CaixaBank Research, based on Eurostat data.*

consumption, investment is another support for appreciable growth, as witnessed by the industrial production of capital goods which approximates the trend in gross fixed capital formation.

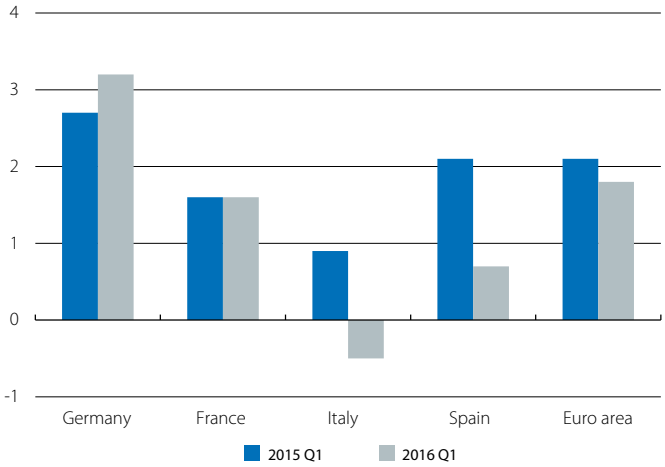
A moderate but continued improvement in the labour market. This expansion by consumption is largely supported by the continued expansion in the labour market. In 2016 Q1 the rate of job creation in the euro area was equivalent to the rate in the second half of 2015 (0.3% quarter-on-quarter) while unemployment stood at 10.2% of the labour force in April, its lowest figure since early in 2011. With regard to wage costs, in 2016 Q1 the year-on-year growth was 1.8%. Although this shows some acceleration compared with year-on-year figure of 1.5% for Q3 and 2015 Q4, the rate of growth is lower than the one recorded a year earlier when was 2.1% and, in any case, it is still in line with the economic expansion taking place in the euro area. It should be noted, however, that the trend in wage costs is notably different depending on the country in question. While wages grew by 3.2% year-on-year in Q1 in Germany, in Spain the rise was more moderate (0.7%). Nonetheless the most contained situation is in Italy, a country that posted a 0.5% drop in its wage costs.

Inflation returns to positive terrain in June. The harmonised index of consumer prices (HICP) grew by 0.1% year-on-year in June, its first positive rate since last January. In May the HICP had fallen by 0.1%. This growth in the general level of prices was especially due to the smaller drop in the energy component whereas core inflation remained stable in June at 0.8% year-on-year. Over the coming months, and should the CaixaBank Research scenario come about, inflation will gradually reflect the rise in oil prices, with the energy component notably reducing its negative contribution as from August.

Italy has a high risk profile. The Brexit has increased the perceived risk of peripheral economies. One of the states that fully embody investors' concerns is Italy. This country has a threefold source of risk. First of all, the economic recovery it has been enjoying since the crisis has been much more moderate than for the euro area as a whole, a situation that has yet to correct itself (Italian growth was 0.3% quarter-on-quarter in Q1 compared with 0.6% for the euro area).
A second source of risk results from doubts regarding the solvency of Italy's banks. In spite of having set up a private fund which should accumulate a significant part of doubtful bank assets, there are still questions regarding whether it will be able to fulfil its function, questions which have been increased by the fact that the government and the Bank of Italy are considering an injection of liquidity of around 40 billion euros. The third source of risk is political. Next October there will be a referendum to accept the Senate's change in role, a modification which will help policymaking. The results of June's municipal elections suggest that support for the incumbent party is waning, which adds uncertainty regarding the capacity for effective reform which the Italian electorate may be in a condition to take on.

Euro area: hourly wage costs *

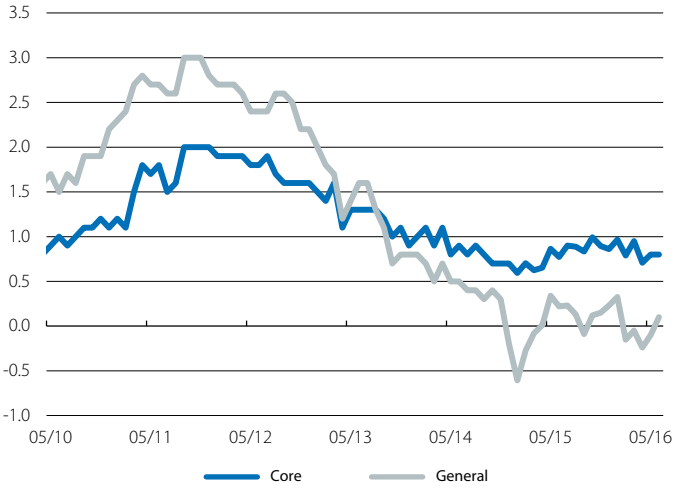
Year-on-year change (%)



Note: ** Data seasonally adjusted.*
Source: *CaixaBank Research, based on Eurostat data.*

Euro area: harmonised CPI

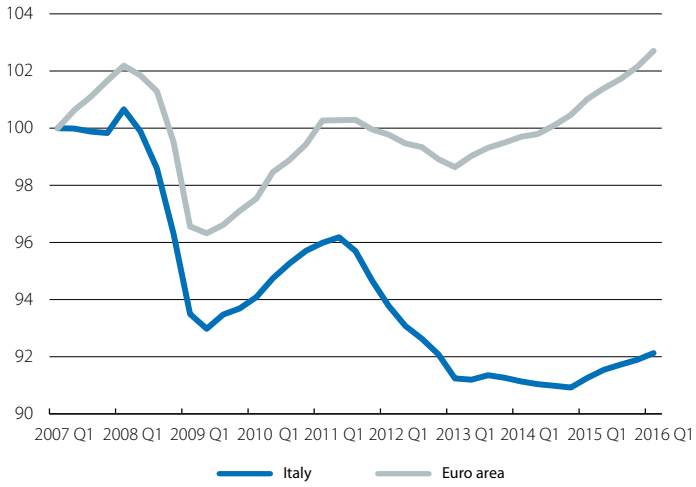
Year-on-year change (%)



Source: *CaixaBank Research, based on Eurostat data.*

Italy and the euro area: GDP

Index (100 = 2007 Q1)



Source: *CaixaBank Research, based on data from Eurostat and Istat.*

FOCUS · TARGET2: operation liquidity

The European Central Bank (ECB) delegates part of the implementation of its functions to national central banks (NCB), such as processing transactions between commercial banks in different countries. During the crisis the system used by NCB to manage these transactions, called TARGET2,[1] provided one of the signs of imbalances in the euro area between the core and periphery. Here we explain how this system works.

The TARGET2 system is a mechanism used by NCB in the euro area to channel payments between the residents of different countries. For example, when Juan, a Spanish citizen with an account at CaixaBank, transfers 100 euros to Hans, a German citizen with an account at Deutsche Bank, this movement is carried out via the reserves held by CaixaBank and Deutsche Bank with the Bank of Spain and the Bundesbank, respectively, so that CaixaBank's reserves decrease by 100 euros while Deutsche Bank's reserves increase by 100 euros. This means that the Bank of Spain eliminates 100 euros from the economy while the Bundesbank adds it. As a form of settlement, instead of the Bank of Spain transferring assets to the Bundesbank, the ECB takes over the Bundesbank's right and registers the Bank of Spain's obligation. So Juan's transfer to Hans means that the Bank of Spain enters into an obligation with the ECB (TARGET2 liability) and the Bundesbank obtains a claim with regard to the ECB (TARGET2 claims).

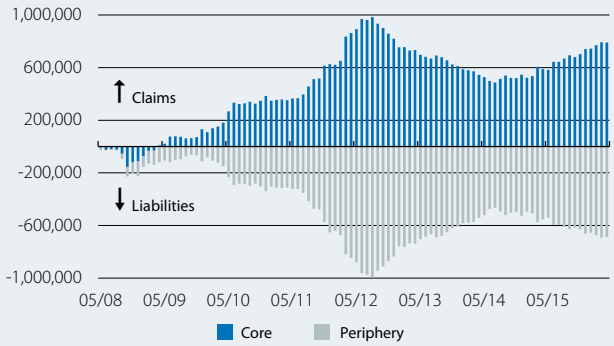
As long as international trade generates transfers between commercial banks, the TARGET2 balance for each country should relate to its international trade. For example, when a country's imports from the rest of the euro area exceed its exports, citizens must carry out net payments. However, between 2000 and 2008 the periphery of the euro area had a current account deficit in its balance of payments although its TARGET2 obligations were not quantitatively significant (see the graph). The reason is because the financing of this current account deficit came from the banks in Europe's core. In other words, going back to our previous example, Juan's transfer of 100 euros to Hans came from a loan that Juan had previously requested from a German bank. So the flow of the transfer from Juan to Hans was offset by the flow of the loan from the German bank to Juan: overall, the transaction produced no TARGET2 balances. However, after the interbank market was frozen due to the outbreak of the crisis, Juan could only finance the transfer with a loan obtained by his commercial bank from the Bank of Spain. Consequently, without any compensatory flow from Germany, the Bank of Spain took on a TARGET2 liability and the Bundesbank received a TARGET2 claim. So TARGET2 balances can point to current account imbalances when these are financed by ECB liquidity (channelled through NCB). Or, in other words, they indicate each euro area country's need for ECB liquidity. As we have seen in a previous Focus,[2] the periphery requests most of the liquidity provided by the ECB while the core mainly stores this liquidity. Similarly, the trend in TARGET2 balances underlines the periphery's need for liquidity (which is translated into an increase in TARGET2 liabilities) while this is in ample supply in the core (whose deposits with the ECB are reflected in the TARGET2 claims accumulated).

However, there are elements that «contaminate» the information provided by TARGET2 balances. One of these is the geographical organisation of a commercial bank: for example, when a bank that belongs to a German head company decides to obtain funding via its subsidiary in Italy (i.e. via the Bank of Italy) and redistribute this liquidity towards its parent bank, TARGET2 balances are produced which do not actually reflect the countries' different liquidity requirements. Another factor is that banks outside the euro area, such as those in the City of London, operate with TARGET2 through European NCB so their transactions also distort the information provided by TARGET2 balances. Lastly, we should also remember that not all transactions are carried out through the TARGET2 system.[3]

In conclusion, although under normal circumstances the balances in the TARGET2 balance are a natural product of international trade, when the interbank market was frozen they reflected the substitution of private financing with that provided by the ECB and thereby the different liquidity needs of the core and periphery. Their persistence shows that there are still financial imbalances to be corrected.

TARGET2 balances of national central banks with regard to the ECB

(Billion euros)



Note: *Core includes Germany, Austria, Belgium, Finland, France, Netherlands and Luxembourg; Periphery includes Spain, Greece, Ireland, Italy and Portugal.*
Source: *CaixaBank Research, based on data from the ECB.*

1. Trans-European Automated Real-time Gross settlement Express Transfer.

2. «ECB liquidity in the core and periphery», MR06/2016.
3. Although TARGET2 handles a large proportion of them: in 2015, it recorded transactions totalling 469.8 trillion euros, 45 times the GDP of the euro area.

FOCUS · Smaller and less productive firms in a fragmented European market

In the last 15 years the euro area has seen less growth than the US in spite of both economies having similar sizes and levels of development. The main factor behind the euro area's weakness is its lower growth in productivity which is still hindered, among other factors, by the fragmentation of national markets.

Although Europe's single market is theoretically a reality, in practice there are still a host of barriers that make it difficult for European firms to grow. For example, the cost of doing business in several countries remains high as, in most sectors, regulation is still very different in each country and companies have to adapt their products or services to local standards. However, in the US regulation is more standardised between the different states and this helps firms to grow.

Empirical evidence regarding the greater dispersion of European companies and how this relates to the fragmentation of Europe's market is convincing. For example, large firms (with more than 250 workers) are smaller in the euro area than in the US; in fact the average size of a large company in the US is 1,903 employees while in the euro area it is around 1,000 employees. Moreover, this difference is particularly marked in industries with a higher degree of regulation, such as energy and public services; US companies in non-regulated sectors are 1.9 times larger than their European peers but, in regulated industries, they are 2.5 times larger than European firms.

It is also important to note that it is precisely in regulated industries where economies of scale tend to be greater. Consequently, the potential benefits of enlarging market size (and the costs of not doing so) are particularly high for companies in such sectors. In the US, firms with more than 250 employees are larger in regulated industries than in non-regulated whereas in Europe there is no significant difference in company size between sectors (see the table).

Concern for the extensive fragmentation of Europe's business fabric is not to be ignored as company size and productivity always tend to go hand in hand. The second graph shows this clearly: labour productivity is much higher in companies with more than 250 employees than in smaller firms. It is also interesting to note that the productivity gap between companies of different sizes is greater in manufacturing than in services, probably due to manufacturing's greater need for investment in fixed assets. Lastly, to illustrate the importance of company structure on productivity, we should note that if the euro area had a similar distribution of company sizes as the US, its average labour productivity would be 14% higher than it is today.[1]

In short, the potential benefits of having a business fabric with larger firms is huge, whichever way you look at it and measures aimed at reducing regulatory and non-regulatory barriers that diminish the advantages of Europe's single market should therefore be the order of the day on the agenda of European reforms. Europe's economic and social situation makes this vital.

Average company size in the US and euro area

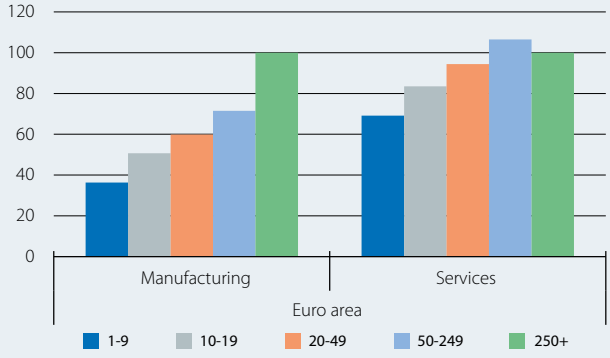
*Average number of employees in large firms **

	US	Euro area	Relative size (US/euro area) (%)
Regulated industries **	2,605	1,027	254
Non-regulated industries **	1,903	997	191
Relative size (regulated/ non-regulated industry) (%)	137	103	

Notes: ** Large firms are those with more than 250 employees.*
*** The regulated industries included are utility firms of gas, electricity, water, etc. (ISIC 4, sectors 35 to 39). Information on the banking and insurance sector is not available.*
Source: *CaixaBank Research, based on data from OECD Structural and Demographic Business Statistics.*

Labour productivity in the euro area by company size

*Value-added per employee, index (100 = large firms *)*



Note: ** Large firms are those with more than 250 employees.*
Source: *CaixaBank Research, based on data from OECD Structural and Demographic Business Statistics.*

1. Assuming that labour productivity by company size remains constant.

KEY INDICATORS

Activity and employment indicators

Values, unless otherwise specified

	2014	2015	2015 Q2	2015 Q3	2015 Q4	2016 Q1	04/16	05/16	06/16
Retail sales *(year-on-year change)*	1.4	2.8	2.7	3.4	2.5	2.3	1.4	...	...
Industrial production *(year-on-year change)*	0.9	1.6	1.4	2.0	1.3	1.6	2.0	...	...
Consumer confidence	–10.2	–6.2	–5.2	–7.0	–6.4	–8.3	–9.3	–7.0	–7.3
Economic sentiment	101.5	104.2	103.7	104.5	106.2	104.0	104.0	104.6	104.4
Manufacturing PMI	51.8	52.2	52.2	52.2	52.8	51.7	51.7	51.5	52.6
Services PMI	52.5	54.0	54.1	54.0	54.2	53.3	53.1	53.3	52.4
Labour market									
Employment (people) *(year-on-year change)*	0.6	1.1	1.0	1.1	1.3	1.4	–	...	–
Unemployment rate: euro area *(% labour force)*	11.6	10.9	11.0	10.7	10.5	10.3	10.2	...	...
Germany *(% labour force)*	5.0	4.6	4.7	4.6	4.4	4.3	4.2	...	...
France *(% labour force)*	10.3	10.4	10.4	10.5	10.2	10.1	9.9	...	...
Italy *(% labour force)*	12.6	11.9	12.2	11.6	11.6	11.6	11.7	...	...
Spain *(% labour force)*	24.5	22.1	22.5	21.6	20.9	20.4	20.1	...	...

Source: *CaixaBank 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

	2014	2015	2015 Q2	2015 Q3	2015 Q4	2016 Q1	04/16	05/16
Current balance: euro area	**2.6**	**3.4**	**3.1**	**3.3**	**3.4**	**3.3**	**3.4**	**...**
Germany	7.3	8.5	8.0	8.3	8.5	8.7	8.9	...
France	–0.9	–0.2	–0.1	0.0	–0.2	–0.9	–0.9	...
Italy	1.9	2.2	2.0	2.2	2.2	2.3	2.4	...
Spain	1.0	1.4	1.3	1.4	1.4	1.4	1.7	...
Nominal effective exchange rate[1] *(value)*	**101.8**	**92.3**	**91.1**	**92.7**	**92.4**	**94.1**	**94.8**	**95.0**

Note: *1. Weighted by flow of foreign trade. Higher figures indicate the currency has appreciated.*
Source: *CaixaBank 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

	2014	2015	2015 Q2	2015 Q3	2015 Q4	2016 Q1	04/16	05/16
Private sector financing								
Credit to non-financial firms[1]	–2.6	–0.1	–0.4	0.2	0.5	0.9	1.2	1.4
Credit to households[1, 2]	–0.1	0.7	0.5	1.0	1.3	1.5	1.5	1.6
Interest rate on loans to non-financial firms[3] *(%)*	2.0	1.6	1.6	1.5	1.5	1.4	1.4	...
Interest rate on loans to households for house purchases[4] *(%)*	2.6	2.1	2.0	2.1	2.0	2.0	1.9	...
Deposits								
On demand deposits	6.0	11.5	11.8	12.5	11.9	11.2	10.7	10.0
Other short-term deposits	–2.0	–3.9	–4.0	–4.7	–4.0	–2.6	–2.8	–2.0
Marketable instruments	–7.2	3.0	5.7	2.0	0.7	–1.3	–2.1	2.8
Interest rate on deposits up to 1 year from households *(%)*	1.3	0.8	0.9	0.7	0.7	0.6	0.6	...

Notes: *1. Data adjusted for sales and securitization. 2. Including NPISH. 3. Loans of more than one million euros with a floating rate and an initial rate fixation period of up to one year. 4. Loans with a floating rate and an initial rate fixation period of up to one year.*
Source: *CaixaBank Research, based on data from the European Central Bank.*

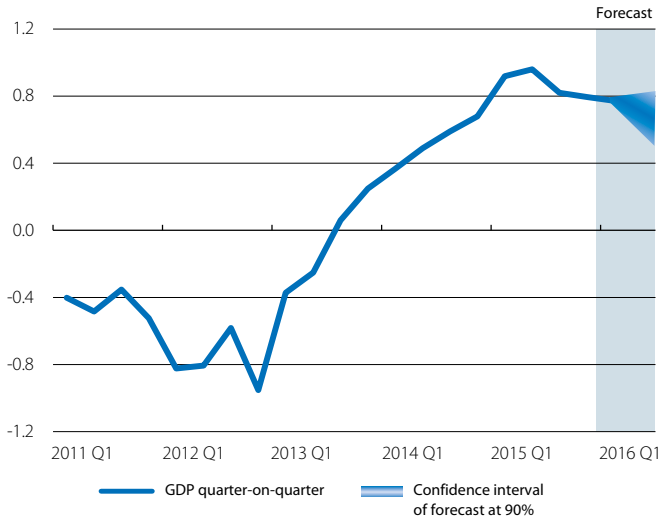
ECONOMIC OUTLOOK · The Spanish economy is navigating more unfavourable external waters

The Spanish economy has held firm in the first half of the year but the second half looks stormier. The information available for the months of April to June, still very incomplete, shows that economic growth was still strong in 2016 Q2. Specifically, the CaixaBank Research leading GDP indicator predicts 0.7% growth quarter-on-quarter, a minimal slowdown compared with Q1 (0.8% quarter-on-quarter). This slower rate of growth was expected and is largely due to the gradual diminishing of a series of factors that had temporarily been supporting the Spanish economy, especially tax cuts and lower oil prices. This trend will accentuate during the second half of the year as these factors will continue to lose steam while new clouds have appeared on the horizon: The UK's decision to leave the EU (Brexit) has sparked a period of strong uncertainty and financial turbulence that will lessen the already meagre European growth. For the Spanish economy we forecast more modest growth in GDP of 0.5% quarter-on-quarter in the coming quarters, bringing the annual figure to 2.8% for 2016 and 2.2% for 2017 (previously 2.4%).

The impact of the Brexit on the Spanish economy will be moderate. Spain has important economic and commercial relations with the UK so the Spanish economy is likely to feel the effect of the Anglo-Saxon country entering a recession, although the impact will tend to be moderate. The effect via the channel of trade will be modest compared with other European countries as the UK is the destination for 7.3% of exports of Spanish goods (equivalent to 1.7% of Spanish GDP), approximately half the exposure the euro area has to the UK. However, the UK is particularly important to Spain's tourist industry as it is the leading country in terms of international tourists (close to 23% of the total). It should also be noted that a significant number of Anglo-Saxon visitors have a permanent or temporary residence in Spain (800,000 people in 2015). On the other hand Spanish companies hold a large stock of foreign direct investment (FDI) in the UK (17% of all Spanish FDI, equivalent to 7% of Spain's GDP). A weak pound and worsening growth prospects for the UK could negatively affect the value of these investments, as has been reflected in the stock market losses after the referendum. The UK is also an important source of FDI for Spain: British investment accounts for 12.4% of all Spain's FDI although inflows of FDI from the UK have been very limited (around 0.1% of GDP) in the last few years. In addition to these direct effects, the impact on the Spanish economy could be greater depending on the final effect on the euro area and especially if the uncertain situation continues for some time, leading to further episodes of financial turbulence.

CaixaBank Research leading GDP indicator

Quarter-on-quarter change (%)



Source: *CaixaBank Research.*

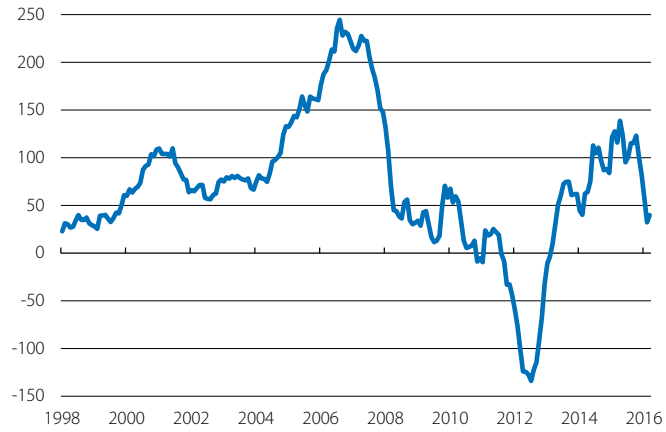
Economic relations between Spain and the United Kingdom

	Million euros	% of the total
Exports of goods to the UK	18,231	7.3
Imports of goods from the UK	12,584	4.6
Expenditure of tourists from the UK	9,558	19.5
Spanish FDI in the UK	75,568	17.1
UK FDI in Spain	59,439	12.4

Note: *Latest figure available.*
Source: *CaixaBank Research, based on data from the Bank of Spain and the Customs Dept.*

Inflows of foreign direct investment and portfolio investment *

Cumulative over 12 months (billion euros)



Note: ** Net of divestment.*
Source: *CaixaBank Research, based on data from the Bank of Spain.*

This financial turbulence could slow down the rate of capital inflows into the Spanish economy. One of the factors that have boosted the recovery since 2013 has been the positive capital flows received by the economy, both in the form of portfolio investment (especially public debt) and FDI. In the 12 months up to March, net inflows of FDI and portfolio investment came close to 40 billion euros, slightly below the figure for the two previous years but still very significant. Moreover it is vital to retain the confidence of international investors as the Spanish economy is highly in debt with the rest of the world (its net international debt position totalled 90.8% of GDP in 2016 Q1). The danger of a risk-off episode in global financial markets reducing investor appetite towards the peripheral countries cannot be ruled out, and this would hinder the economic recovery.

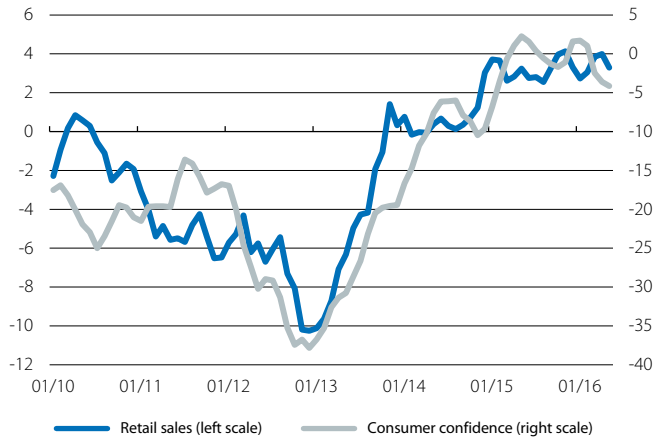
For the time being the elements supporting the economic recovery remain strong. Regarding demand, indicators related to private consumption (retail sales and consumer confidence) are still very robust, indicating that this component continues to drive domestic demand in Q2. Dynamic consumption is based on the continued improvement in financing conditions and in the gross disposable income of households (2.3% year-on-year in Q1). On the whole households managed to increase their consumption whilst also keeping their savings capacity at a reasonable level; specifically, the savings rate stood at 9.3% of gross disposable income in Q1, somewhat lower than the historical average of 9.7%.

The rate of job creation is very dynamic but wage moderation continues. The growth in gross disposable income of households in Q1 can be explained by the increase in wages (3.2% year-on-year), and this by the increase in employment (3.5% year-on-year) as remuneration per employee has remained almost static (–0.3% year-on-year). Judging by the moderate rise in wages in employment agreements in May, namely 1.1% year-on-year, wages will continue to be contained over the coming quarters and this will help to keep job creation dynamic (the rate of growth in affiliation to Social Security remains high at 2.6% year-on-year in May).

Corporate investment slows down, as is customary in this more advanced phase of the cycle. Available indicators point to the expansionary tone of business activity continuing in Q2 although at a somewhat more moderate pace than in the first three months of the year. Specifically, the business sentiment indicator (PMI) for manufacturing dipped in May and the number of businesses in industry fell slightly in April (–0.7% year-on-year). Nonetheless the increase in industrial orders from abroad (6.0% year-on-year, cumulative over 12 months), both from the euro area (7.3% year-on-year) and from other destinations (4.4% year-on-year) augurs an improvement in industry over the next few months. With regard to the services sector, on the whole indicators also point to activity remaining dynamic. The PMI improved slightly, rising above the average for Q1. Another indicator that reflects how the Spanish

Consumption indicators

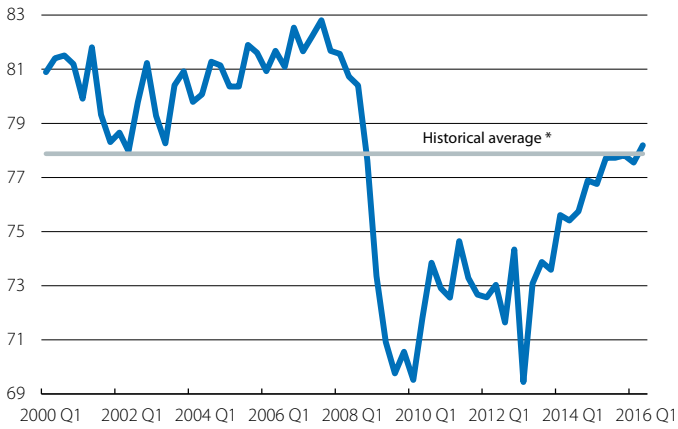
Annual change in the moving 3-month average (%) *Moving 3-month average (level)*



Source: *CaixaBank Research, based on data from the INE and the European Commission.*

Degree of production capacity utilisation in industry

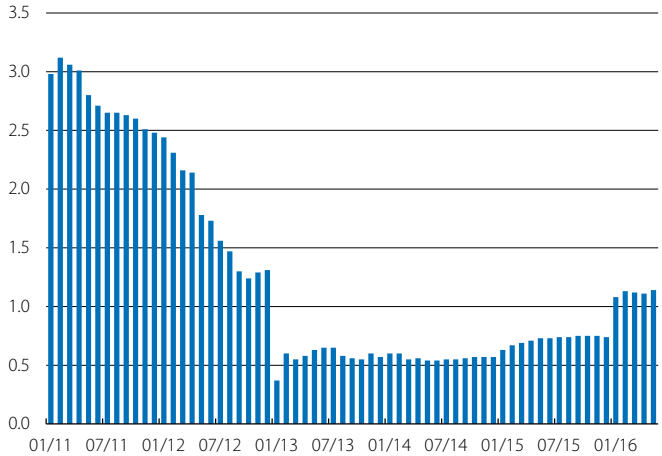
(%)



Note: ** Historical average since 1980.*
Source: *CaixaBank Research, based on data from the Ministry of Finance and Competitiveness.*

Wage rises contained in collective bargaining agreements

(%)



Source: *CaixaBank Research, based on data from the Ministry of Finance.*

economy is gradually entering a more mature phase of the economic cycle is industrial capacity utilisation, which stood at 78.2% in 2016 Q2, slightly above its historical average since 1980.

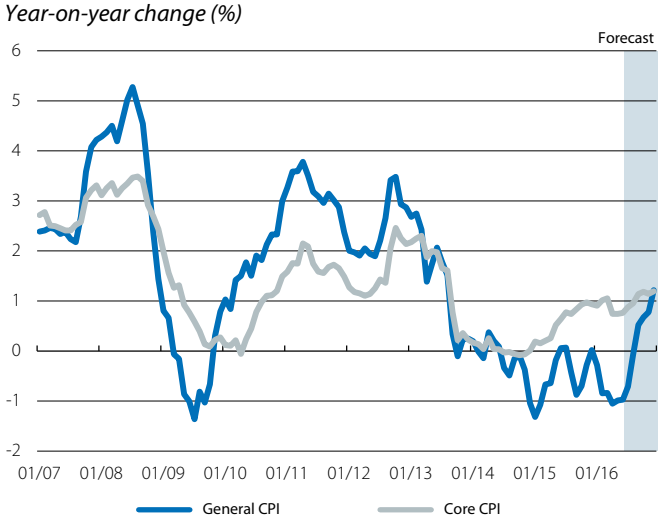
Inflation will soon reflect the cyclic situation of the economy. The economic recovery started over three years ago now but inflation is still in negative figures. Although this situation is largely due to the slump in oil prices in the last year, the lack of inflationary pressure in a context of high economic growth could seem surprising. But this situation is about to change. In June inflation rose by 0.2 pps to –0.8% and is expected to start on a rapid upward trend in the coming months as the base effect of falling oil prices disappears. Similarly, after a bad patch in May, the core CPI will return to its slightly upward trend thanks to the constant dynamism of private consumption.

The adjustment of the general government deficit is still pending. The budget executed up to April places the deficit (excluding local government corporations) at 1.2% of GDP, 0.1 pps higher than the figure posted last year. Although the central government and autonomous communities have improved their balance sheets, the Social Security surplus is still shrinking (see the Focus «The sustainability of the Social Security accounts: a job to be done» in this *Monthly Report*). The lack of adjustment of the national accounts in the first half of the year suggests that, in order to achieve the 3.6% public deficit target in the Updated Stability Plan presented by the government, measures will have to be taken in the second half of the year.

Bank credit continues to recover and doubtful loans to fall. The breakdown of credit in 2016 Q1 shows that an increasing number of segments are starting to record positive year-on-year rates of change. In addition to consumer credit and loans to the agricultural sector, which started to grow in 2015, in Q1 this was also the case of loans to industry, yet another sign that credit is supporting the recovery in corporate productive activity. The NPL ratio also continued to fall in all the segments although it should be noted that the figures for construction and development loans are still very high. This trend will continue thanks to the expansionary policies of the ECB, boosting consumption and investment.

CPI

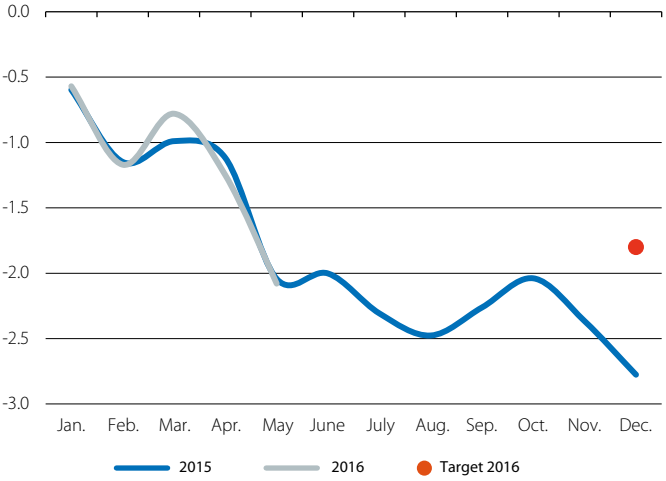
Year-on-year change (%)



Source: *CaixaBank Research, based on INE data.*

State budget execution

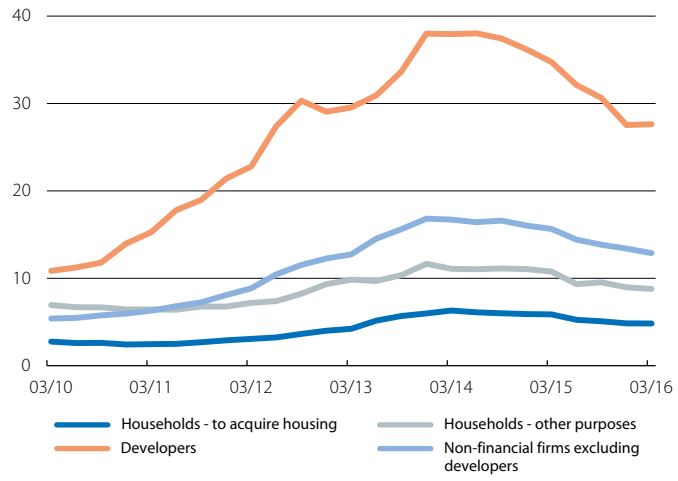
(% of GDP)



Source: *CaixaBank Research, based on data from the State Public Accounts.*

NPL ratio by segment

(%)



Source: *CaixaBank Research, based on data from the Bank of Spain.*

FOCUS · Internal devaluation, key to boosting exports

The rise in exports of Spanish goods and services, whose share in the country's GDP went from 24% in 2009 to an unprecedented 33% in 2015, has been crucial in reducing the current account deficit and boosting the economy. One fundamental factor behind this trend is increased competitiveness, as shown by the 18.5% depreciation in the real effective exchange rate over the same period (see the first graph).[1]

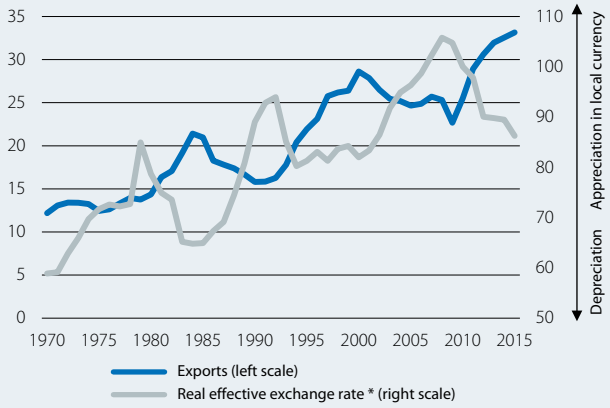
From a historical perspective, the first big devaluation in the peseta since 1970 occurred at the end of this decade, in the midst of Spain's transition to a democracy and within a context of great political uncertainty and high inflation. The second devaluation took place in 1982, in this case reducing the value of the peseta by 8% against the dollar. Three more devaluations were carried out between 1992 and 1993, of 5%, 6% and 8% respectively. All these devaluations were characterised by a nominal devaluation of the currency, a foreign exchange instrument that boosts exports as it makes them cheaper. However, with the introduction of the euro in 1999, Spain lost this authority and the latest episode of depreciation in the real effective exchange rate, underway since 2009, has largely been achieved by reducing relative unit labour costs (ULC), a phenomenon known as «internal devaluation». Specifically, the ULC of the Spanish economy compared with that of its main trading partners has fallen by 17%, resulting in a larger drop in the real exchange rate than in the previous episodes (see the second graph).

Also notable is the fact that the response by exports to gains in competitiveness has been similar to the one occurring after the nominal devaluation of the peseta. Specifically, for each 1% reduction in the real effective exchange rate, the share of exports in GDP increases by 0.6 pps. Moreover, the effects of internal devaluation over the medium to long term tend to last longer. Nominal devaluations typically bring about an immediate response in the real exchange rate but a large part of their effect is temporary as, sooner or later, nominal devaluation pushes up inflation, thereby undoing the initial gains made in competitiveness. The effects of internal devaluation may take longer to be seen initially but, *a priori*, there is no force that «automatically» reverses the gains achieved in competitiveness. In fact, two factors suggest this improved competitiveness will consolidate or even increase over the coming years. Firstly, wage rises are usually more closely connected to growth in productivity in exporting companies.[2] In this respect, it is encouraging that many of the firms making the leap onto the international market are establishing themselves as regular exporters.[3] Secondly, the reforms carried out over the last few years, such as the law to remove inflation-indexing in the Spanish economy and improved instruments to help workers and companies adjust employment conditions to the economic cycle should bring labour costs more in line with overall productivity.

However, although there are reasons to expect this trend will consolidate in the future and that the share of exports will approach, perhaps in the medium term, the figure of 47% recorded by Germany in 2015, it is vital to continue adopting measures that promote the international competitiveness of Spain's economy.

Exports and exchange rate

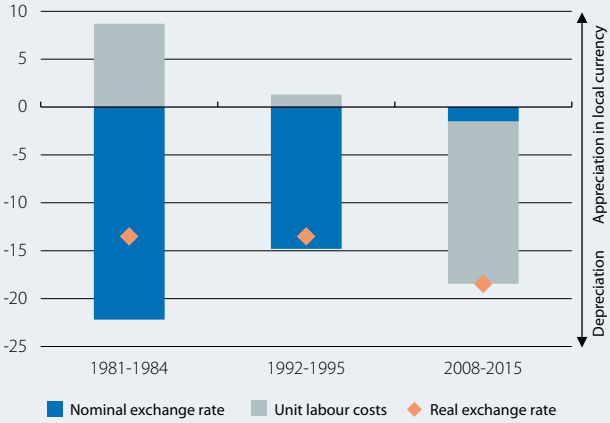
(% of GDP) *Índex (100 = 2010)*



Note: ** Real effective exchange rate based on unit labour costs.*
Source: *CaixaBank Research, based on data from the World Bank and the OECD.*

Breakdown of devaluations

Cumulative change in the period in question (%)



Source: *CaixaBank Research, based on OECD data.*

1. The real effective exchange rate is calculated by deflating the nominal effective exchange rate using a measure of relative prices, such as relative CPI, unit labour costs or export prices.
2. Moreover, growth in productivity tends to be greater in companies that export.
3. See the Focus «Spanish exports are consolidating» in MR05/2016.

FOCUS · The sustainability of the Social Security accounts: a job to be done

2015 was a very good year for Spain in terms of economic activity: GDP grew by 3.2% and more than half a million jobs were created. However, the economy's good performance was not enough to resolve the Social Security's budget problems: its deficit worsened by 0.1 pp compared with 2014, to 1.26% of GDP, exceeding the target of 0.6%. As the deficit does not look like correcting itself to any great extent in the medium term, this situation warrants discussion.

The Revised Stability Programme (*Actualización del Programa de Estabilidad* or APE) presented by the government in April sets a new deficit target for Social Security of 1.1% in 2016 while the target set a year ago was 0.3%. Moreover, it is particularly worrying that the APE expects Social Security to continue recording a deficit of 0.7% in 2019 (see the first graph), a year in which the Spanish economy should have closed its output gap.[1] The fact that this deficit is now chronic, persisting even during the expansionary stage of the cycle, highlights the structural problems affecting Social Security. Neither do the deficit targets presented seem to be achievable without additional measures being taken, as warned by AIReF.[2]

Consequently, all the evidence seems to suggest that Social Security will continue in deficit in the medium term. In the last few years this deficit has been financed by the Reserve Fund. This fund was set up in 2003 and holds the assets (basically Spanish sovereign debt) resulting from investing the Social Security surpluses between 2003 and 2008. The objective was well-defined: to be able to pay out contributory pensions when there is a prolonged deficit in Social Security. Initially, use of the Fund's resources was limited to 3% of the total aforementioned expenditure per year.[3] However, this limit was exceptionally suspended as from 2012 so that, between that year and 2015, a total of 47,201 million euros was used, representing more than 70% of the assets held by the Fund in 2011.

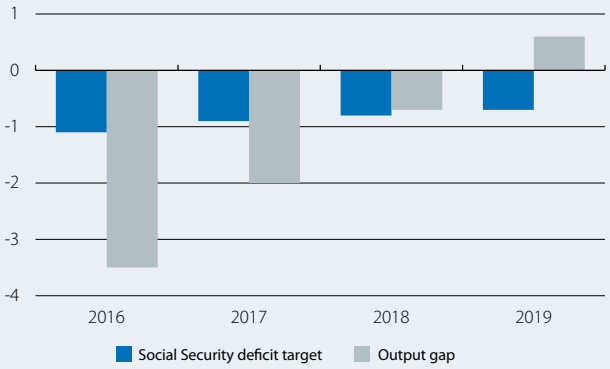
At the end of 2015, the Reserve Fund contained 32,481 million euros. If the exception to the 3% limit is extended over the coming years and the Social Security deficit continues to be financed by the Fund, this will run out by 2018.

If, on the other hand, this suspension of the 3% limit is eliminated as from 2017, the Fund will shrink more gradually (see the second graph). However, in that case the Social Security deficit would have to be financed directly by transfers from central government and, in fact, the State Budget for 2016 includes the possibility of enlarging pensions deemed non-contributory, financed by transfers from central government.

In any case the crux of the matter lies in the Social Security deficit *per se* and not so much how it is financed. It is therefore vital to tackle the structural imbalance of the Social Security system and take the necessary decisions to correct this without delay.

Social Security deficit target and the output gap according to the APE

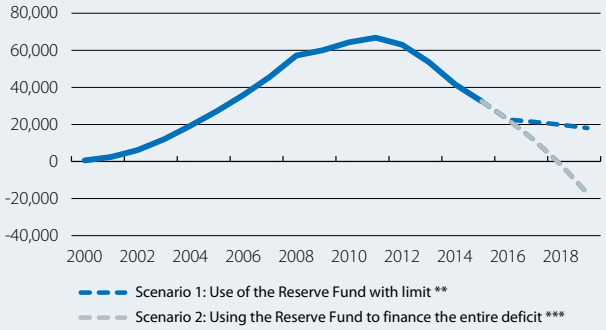
(% of GDP)



Source: *CaixaBank Research, based on data from the* Actualización del Programa de Estabilidad *(APE) 2016-2019.*

*Reserve Fund **

(Million euros)



Notes: ** Assets are calculated at total acquisition price. ** Assuming the limit on the use of funds is restored as from 2017. *** Assuming the exception for the limit on the use of funds is extended.*
Source: *CaixaBank Research, based on the Informe a las Cortes Generales del Fondo de Reserva de la Seguridad Social.*

1. The APE estimates that GDP will exceed potential GDP by 2019; i.e. the output gap will have closed, which is the difference between the observed GDP and the potential GDP if all input factors were used.
2. See AIReF (2016), «Informe sobre la actualización del Programa de Estabilidad del Reino de España 2016-2019».
3. This expenditure includes the payment of contributory pensions and the costs resulting from their administration.

FOCUS · Spain's agri-food sector: the garden of Europe and much more

In spite of its secular trend towards tertiarisation, the agri-food sector is a fundamental pillar for Spain's economy. Although primary sectors have gradually lost share,[1] the food industry, responsible for producing processed foods with greater value added, has kept its contribution at around 3.0% of total GVA and has consolidated its position as the leading industrial branch: contributing 22.3% of the GVA for manufacturing in 2014 and employing 430,400 people. Also notable is the fact that the number of people employed by this branch has not fallen as much as in other sectors (see the first graph).

One of the supports for this good performance by the agri-food sector is the continued rise in exports. Averaging 6.5% growth in the last 10 years, higher than the 5.1% achieved by the rest of the sectors, it totalled 40.5 billion euros in 2015 (16.2% of all goods exported), a figure on a par with the 42.6 billion recorded by the automobile industry. The internationalisation of companies in this sector has been spectacular: 17,375 firms exported food to the rest of the world in 2015, almost doubling the figure recorded in 2000 of 10,000 firms and, unlike the stabilisation observed in the total number of exporting firms in the two last years, this industry has continued its upward trend (see the second graph).

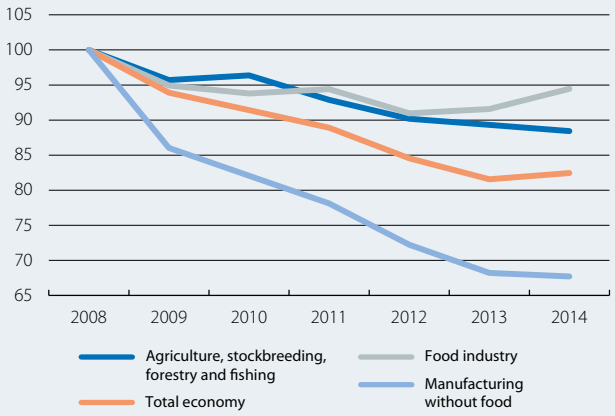
With a 40% share of all agri-food exports, fruit and vegetables make up most of these foreign sales, with Spain being known as the «garden of Europe». But the range of products exported is widening and with increasing value added. The sector has also been able to increase and develop its range of destinations: although the euro area is still the destination for most food exports (60.0% in 2015), its share has been falling in favour of more distant markets such as Asia, Africa and Latin America (8.6%, 4.3% and 2.8% respectively in 2015). This positive trend in the sector has helped Spain to remain eighth in the world ranking of countries exporting agri-food products.[2]

In spite of these achievements, which are largely thanks to the modernisation carried out and the increased use of technology, the industry is still highly fragmented: only 3.6% of companies in the food industry employ more than 50 people. An analysis of the sub-sectors in the food industry reveals that exports grew more in those with a higher proportion of large firms (see the third graph). Increasing company size is therefore one way of continuing to improve the competitiveness of agri-food companies in an increasingly global market.

1. The share of GVA for agriculture, stockbreeding, forestry and fishing fell from 4.2% in 1995 to 2.5% in 2014. In terms of full-time equivalent employment, the reduction in its share was even greater: from 7.3% to 4.2%, although it still employs 685,500 people.
2. Spain' share in the world market of agri-food goods is 3.1%, higher than its 1.7% share for total goods (WTO).

Employment by sector

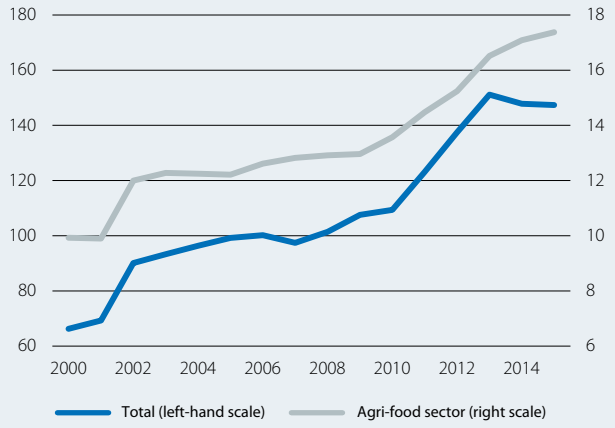
Index (100 = 2008)



Source: *CaixaBank Research, based on INE data.*

Number of exporting firms

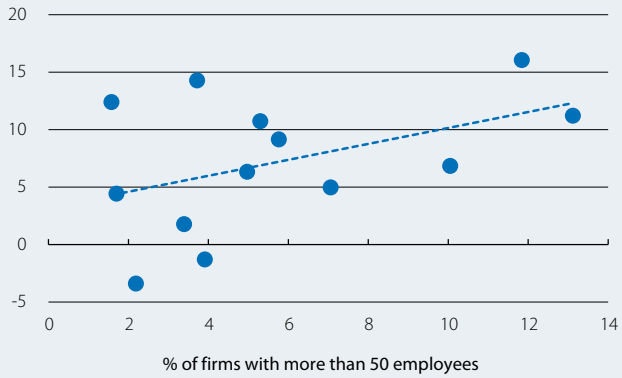
(Thousands) *(Thousands)*



Source: *CaixaBank Research, based on ICEX data.*

Relationship between company size and exports in the agri-food sector

Change in exports 2014-2015 (%)



Note: *Each point represents a food industry sub-sector.*
Source: *CaixaBank Research, based on data from the Ministry of Agriculture.*

KEY INDICATORS

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

Activity indicators

	2014	2015	2015 Q2	2015 Q3	2015 Q4	2016 Q1	04/16	05/16	06/16
Industry									
Electricity consumption	–0.1	1.6	–0.1	2.5	2.5	–0.6	3.0	–0.5	...
Industrial production index	1.3	3.3	3.5	4.0	4.2	2.6	2.7	...	...
Indicator of confidence in industry *(value)*	–7.1	–0.3	0.9	0.7	0.3	–1.9	–2.2	–4.2	–2.1
Manufacturing PMI *(value)*	53.2	53.6	54.8	52.8	52.5	54.3	53.5	51.8	...
Construction									
Building permits *(cumulative over 12 months)*	–7.7	20.0	17.0	19.7	31.1	45.2	46.2	...	...
House sales *(cumulative over 12 months)*	–5.6	10.8	10.3	12.3	11.6	10.3	12.7	...	...
Services									
Foreign tourists *(cumulative over 12 months)*	7.2	5.6	5.9	5.0	4.8	5.9	7.1	7.2	...
Services PMI *(value)*	55.2	57.3	58.3	58.1	55.9	54.7	55.1	55.4	...
Consumption									
Retail sales	1.0	3.0	2.8	3.3	3.4	3.9	4.2	1.8	...
Car registrations	18.4	21.3	13.6	23.1	17.1	8.0	21.2	20.9	...
Consumer confidence index *(value)*	–8.9	0.3	1.6	–1.3	1.6	–2.5	–4.3	–3.0	–2.4

Source: *CaixaBank Research, based on data from the Ministry of Finance, Ministry of Public Works, INE, Markit and European Commission.*

Employment indicators

	2014	2015	2015 Q2	2015 Q3	2015 Q4	2016 Q1	04/16	05/16
Registered as employed with Social Security [1]								
Employment by industry sector								
Manufacturing	0.1	2.2	2.2	2.4	2.7	2.8	2.8	2.6
Construction	–1.6	4.7	5.6	4.6	4.1	2.6	2.2	1.6
Services	2.2	3.5	3.7	3.5	3.4	3.1	2.9	2.9
Employment by professional status								
Employees	1.4	3.5	3.8	3.6	3.6	3.4	3.0	2.9
Self-employed and others	2.2	1.9	2.2	1.7	1.4	1.2	1.1	1.0
TOTAL	**1.6**	**3.2**	**3.5**	**3.3**	**3.2**	**3.0**	**2.7**	**2.6**
Employment [2]	**1.2**	**3.0**	**3.0**	**3.1**	**3.0**	**3.3**	**–**	**...**
Hiring contracts registered [3]								
Permanent	18.8	12.3	7.7	9.7	7.6	8.3	18.2	17.0
Temporary	13.1	11.2	11.2	9.7	11.8	6.2	6.0	10.6
TOTAL	**13.4**	**11.3**	**10.9**	**9.7**	**11.5**	**6.4**	**7.0**	**11.1**
Unemployment claimant count [3]								
Under 25	–8.2	–11.0	–9.3	–13.4	–11.7	–10.9	–10.7	–12.4
All aged 25 and over	–5.3	–7.2	–7.4	–7.7	–7.5	–7.8	–7.1	–7.2
TOTAL	**–5.6**	**–7.5**	**–7.6**	**–8.2**	**–7.9**	**–8.1**	**–7.4**	**–7.7**

Notes: *1. Mean monthly figures. 2. LFS estimate. 3. Public Employment Offices.*
Source: *CaixaBank Research, based on data from the Ministry of Employment and Social Security, INE and Public Employment Offices.*

Prices

	2014	2015	2015 Q2	2015 Q3	2015 Q4	2016 Q1	04/16	05/16	06/16
General	**–0.1**	**–0.5**	**–0.3**	**–0.4**	**–0.3**	**–0.7**	**–1.1**	**–1.0**	**–0.8**
Core	0.0	0.6	0.5	0.8	0.9	1.0	0.7	0.7	...
Unprocessed foods	–1.2	1.8	1.9	2.3	2.5	2.1	3.2	2.6	...
Energy products	–0.8	–9.0	–6.4	–9.7	–10.2	–13.1	–15.1	–14.0	...

Source: *CaixaBank Research, based on data from the INE.*

Foreign sector

Cumulative balance over the last 12 months in billions of euros, unless otherwise specified

	2014	2015	2015 Q2	2015 Q3	2015 Q4	2016 Q1	03/16	04/16
Trade of goods								
Exports *(year-on-year change)*	2.5	4.3	5.4	3.4	3.8	0.2	–3.3	6.3
Imports *(year-on-year change)*	5.7	3.7	5.8	3.3	3.3	–0.7	–3.6	–1.2
Current balance	**10.2**	**15.0**	**14.3**	**15.1**	**15.0**	**15.5**	**15.5**	**18.4**
Goods and services	26.0	25.6	27.1	26.5	25.6	25.2	25.2	27.1
Primary and secondary income	–15.7	–10.5	–12.8	–11.4	–10.5	–9.7	–9.7	–8.6
Net lending (+) / borrowing (–) capacity	**14.7**	**21.0**	**18.4**	**20.8**	**21.0**	**21.4**	**21.4**	**23.6**

Source: *CaixaBank 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

	2014	2015	2015 Q2	2015 Q3	2015 Q4	2016 Q1	04/16
Net lending (+) / borrowing (–) capacity[1]	**–5.9**	**–5.1**	**–2.9**	**–3.1**	**–5.1**	**–0.7**	**–**
Central government	–3.7	–2.6	–1.8	–2.1	–2.6	–0.8	–1.1
Autonomous regions	–1.7	–1.7	–0.8	–1.1	–1.7	–0.1	–0.2
Local government	0.6	0.4	0.2	0.3	0.4	0.1	–
Social Security	–1.0	–1.3	–0.4	–0.3	–1.3	0.2	0.1
Public debt *(% GDP)*	**99.3**	**99.2**	**99.8**	**99.7**	**99.2**	**100.5**	**...**

Note: *1. Includes aid to financial institutions.*
Source: *CaixaBank 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

	2014	2015	2015 Q2	2015 Q3	2015 Q4	2016 Q1	04/16	Balance 04/16[1]
Financing of non-financial sectors[2]								
Private sector	–6.2	–3.9	–3.9	–4.0	–3.1	–3.6	–4.0	1,626.1
Non-financial firms	–7.1	–4.0	–4.0	–4.3	–3.0	–4.1	–4.8	908.2
Households[3]	–5.1	–3.7	–3.7	–3.6	–3.3	–3.1	–3.0	717.9
General government[4]	6.9	4.7	4.6	4.3	4.3	3.5	3.9	1,078.8
TOTAL	**–1.8**	**–0.7**	**–0.8**	**–1.0**	**–0.3**	**–0.9**	**–1.0**	**2,704.9**
Liabilities of financial institutions due to firms and households								
Total deposits	–0.9	–1.0	–1.2	–1.1	–0.5	–0.4	–0.7	1,148.2
On demand deposits	10.8	18.5	19.5	18.8	17.7	16.2	15.7	402.5
Savings deposits	5.8	12.9	12.3	13.7	15.2	13.4	13.1	258.3
Term deposits	–7.6	–15.3	–15.5	–16.3	–15.8	–15.4	–16.3	466.3
Deposits in foreign currency	1.1	5.6	10.5	5.1	–2.3	–4.0	–6.4	21.1
Rest of liabilities[5]	–8.2	–13.0	–11.5	–14.0	–15.1	–16.7	–14.8	92.9
TOTAL	**–1.7**	**–2.2**	**–2.2**	**–2.3**	**–1.9**	**–1.9**	**–1.9**	**1,241.1**
NPL ratio *(%)*[6]	**12.5**	**10.1**	**11.0**	**10.7**	**10.1**	**10.0**	**9.9**	**...**
Coverage ratio *(%)*[6]	**58.1**	**59.2**	**60.0**	**60.6**	**59.2**	**59.0**	**59.0**	**...**

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: *CaixaBank Research, based on data from the Bank of Spain.*

THE NEW ENVIRONMENT FOR BANKING

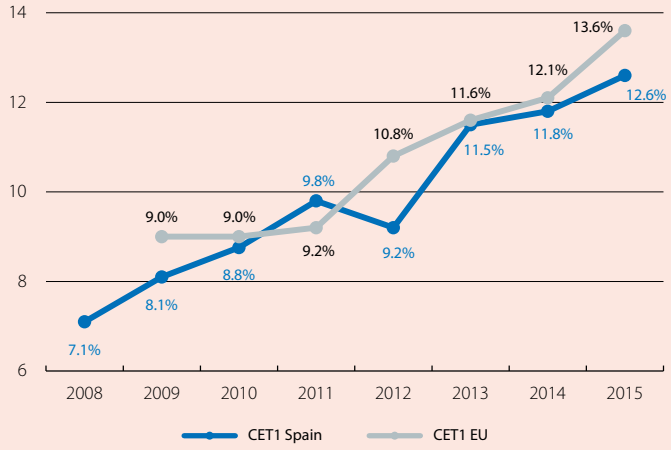
The (r)evolution in the regulatory and supervisory framework resulting from the crisis

Almost 87 years have passed since «Black Tuesday», better known as the Wall Street crash of 1929. This terrible event was the beginning of a long period of worldwide economic depression. Among the consequences of this crisis were tougher regulations on the financial sector (in 1933 the *Banking Act* was passed in the US which, among other measures, introduced a deposit guarantee system and separated commercial and investment banking). We are all aware that this old acquaintance of the financial sector, the crisis, visited us again in 2008. Similar to the previous collapse, the main response by economic authorities has been aimed, once again, at strengthening the regulatory framework for banks in order to make the sector more robust and better able to withstand shocks.

This article reviews the most important regulatory reforms introduced over the last few years. But first, to understand these measures better, we will look at some evidence provided by the financial crisis. On the one hand, the sector's low levels of capital to withstand unexpected shocks made public aid necessary to recapitalise some banks, known as bail-outs. The crisis also highlighted deficiencies in the supervisory system, as well as systemic risks caused by banks deemed «too big to fail» but also groups of small banks which were «too many to fail». On the other hand, the crisis also led to the indiscriminate closure of wholesale markets, underlining the inadequate funding structure of some banks in relation to their business model.

Capital ratio for Spanish and European banks

*Basel III phase-in CET1 ratio * (%)*



Note: ** The phase-in ratio considers the requirements applicable each year (not all those that will be applied once Basel III is fully implemented).*
Source: *CaixaBank Research, based on data from the Bank of Spain and the EBA.*

One of the most important global regulatory measures implemented as a result of the crisis has been the reformulation of the capital framework, known as Basel III, which takes the form of the Capital Requirements Directive (CRD IV) in Europe, in practice establishing larger and better quality capital requirements, as well as introducing liquidity requirements to tackle adverse scenarios. To implement these greater requirements whilst also minimising the impact on financial stability, a transition period was established up to 2019. Nonetheless, a preference prevails among the various players (markets, supervisors, etc.) for fully-loaded ratios; i.e. once all the measures required have been applied in 2019. As a result of all this, the last few years have seen a continual rise in solvency, both in Spanish banks (with the exception of 2012, a year when high provisions were made) and European banks as a whole (see the graph). Although the Basel framework has evolved substantially with Basel III, it is fair to say that the previous framework which just started to be implemented in many countries when the great crisis of 2008 was about to erupt, Basel II, already represented significant progress in the measurement and management of risk in banks (although it did not arrive in time and certainly would not have been enough to prevent the crisis).

In Europe, another important regulatory event has been the creation of the banking union, a project arising from the sovereign debt crisis in 2012 and which fundamentally aims to separate sovereign risk from bank risk. With this goal in mind, the banking union has been built up on three basic pillars: the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and the European Deposit Insurance Scheme (EDIS). The SSM came into force in 2014, giving the ECB the role of sole supervisor for all banks in the euro area, a task it carries out in coordination with the competent national authorities. In order to use a standard procedure to supervise and assess banks, the SSM has adopted a forward-looking, risk-oriented approach. This process, known as the Supervisory Review and Evaluation Process (SREP), analyses four key aspects: the business model, governance and management of risk, capital structure and liquidity structure of banks. This analysis allows the SSM, as a prudential supervisor, to set the capital and liquidity requirements for each bank.

The second pillar, the SRM, established a regulatory framework (the Bank Recovery and Resolution Directive or BRRD) with specific powers and instruments to intervene quickly financial institutions in difficulty, and at the lowest possible cost for the public treasury. One of the cornerstones of this resolution system is the internal recapitalisation or bail-in, which has come into force in 2016 and extends the obligation to absorb losses to the bank's creditors. Those liabilities that can be written down or converted into capital to recapitalise the bank («eligible liabilities») have been determined following a pre-established order of seniority: shareholders absorb losses first, followed by holders of hybrid and subordinated debt, etc. Recently some institutions, including the governor of the Bank of Italy and the IMF, have suggested that the new resolution framework should be more flexible, for instance allowing for the use of temporary public aid within the BRRD.

The third and last pillar is still being intensely debated. The aim of the EDIS is to ensure that all deposits within the banking union enjoy the same degree of protection irrespective of the bank and the country of origin. The proposal made by the European Commission, if accepted, would gradually be introduced in three stages, going from a reinsurance system (national systems could access the European fund once their resources had run out), a phase of progressive mutualisation via a co-insurance scheme (both funds would be responsible for costs) and finally full mutualisation (planned for 2024). Some governments, such as in Germany, are asking for progress in EDIS to be conditional on a reduction in the exposure of European banks to the public debt of their respective governments, most of which have high levels of debt.

The creation of the banking union should promote greater consolidation at a crossborder level which would help to improve banks' profits in a highly complex environment, as pointed out by the ECB. In any case, at present this consolidation is making slow progress as there are still considerable regulatory, economic and cultural barriers that limit economies of scale at a pan-European level.

The far-reaching changes entailed by CRD IV and the banking union create a great deal of uncertainty regarding how this new regulatory framework should be applied and operate. Although many of the initiatives reviewed here have already been implemented (or are in the process of being implemented), certain rules have yet to be tested (such as bail-ins) so there are still doubts regarding their effectiveness in practice. This regulatory uncertainty is affecting many other areas. For example, precisely in relation to bail-ins, all European banks must comply with a minimum requirement for own funds and eligible liabilities (MREL) which has yet to be specified and will force banks to issue new and relatively costly debt. Another example comes from the Basel Committee, which is reviewing both internal and standardized models to reduce the large, unwarranted differences in the weighting of risk assets (RWA) between different banks. Harmonising these models should not result in any significant increase in capital requirements but there is a great deal of uncertainty regarding the final impact. The Basel Committee is also reviewing the leverage ratio (a simple capital to assets ratio, without taking into account the risk of the assets), as well as the possibility of penalizing the treatment of sovereign debt, which is currently exempt from capital requirements. With a view to 2018, there is also the plan to introduce new rules for calculating accounting provisions regarding asset impairment (the Bank of Spain has just introduced some changes in the existing rules, a step in this direction). All this uncertainty harms banking and makes it even more difficult, if possible, for banks to bolster their eligible own funds and liabilities, as required by the new regulations.

Given this situation, several institutions, including those from several supervisory authorities in the Eurosystem, have demanded a period of relative regulatory stability to help both banks and supervisors to implement, effectively and coherently, the whole new regulatory and supervisory framework and to verify what effect this application may have in practice on financial stability. The European Commission initiative known as Better Regulation is aimed precisely at reviewing new regulations and simplifying them as far as possible, to ensure the cost of achieving their objectives is not too excessive. Ultimately this would lead to lower costs for financial intermediation.

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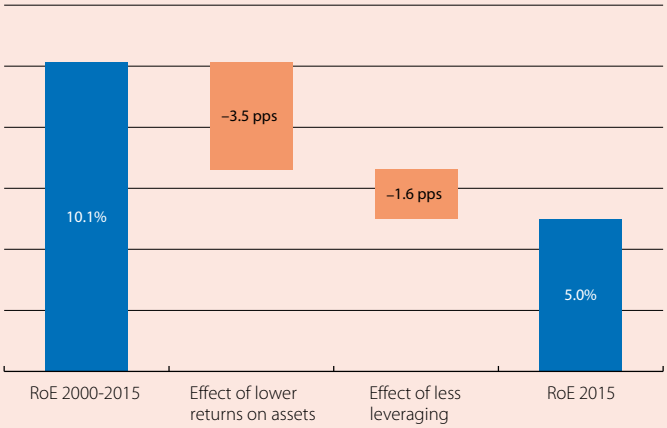
Profitability and risks for European banks: diverging trends

The macroeconomic environment and monetary policy are affecting the profitability of banks in the euro area. On the one hand the slow economic recovery and private sector deleveraging in some countries are limiting growth in the volume of loans and funds. On the other hand low interest rates (even negative in some cases) and continuing high costs as a result of the crisis (especially due to loan loss provisions) are also pushing down bank profits. Given this situation, the return on equity (RoE) for European banks stood at 5.0% on average in 2015, almost double 2014's figure (2.7%) but still far from the average since 2000 (10.1%).

Another factor that partly explains this low profitability is the increase in regulatory capital requirements. Since 2009 the common equity tier 1 ratio (CET1) has gone from 9% to almost 14% in 2015. This lower leveraging has helped to reduce the RoE by 1.6 pps.

In theory a larger share of equity in the structure of banks' balance sheets should reduce the risk perceived by shareholders. As these are the first to absorb losses, if a bank has a low capitalisation the risk of losing a large part of its equity is much higher than with a higher level of capitalisation. Moreover, a bank's management will tend to be more cautious if the shareholders have more capital at stake. Consequently, when investment in bank shares is perceived as less of a risk, the returns demanded by investors or the cost of equity (COE) should also be lower. But this has not been the case.

Breakdown of the fall in profitability of banks in the euro area



Source: *CaixaBank Research, based on Bloomberg data.*

Using the Capital Asset Pricing Model or CAPM,[1] we estimate a COE for European banks of 9.7% for 2015 and 10.0% for the historical period of 2000-2015. Although these figures are similar, a breakdown of the COE between the risk-free interest rate, the market risk premium and the banking sector risk premium reveal significant changes in the contribution made by each of these components. The risk-free interest rate is now approximately 3 pps below its historical average while the market risk premium has risen by almost 1 pp and the bank risk premium has increased by 1.7 pps.

Breakdown of the cost of equity for banks in the euro area

	2000-2015	2015
Risk-free interest rate	3.3%	0.5%
Market risk premium	5.0%	5.8%
Bank risk premium	1.7%	3.4%
COE	**10.0%**	**9.7%**

Note: *We have used the German 10-year sovereign bond as a risk-free asset and have calculated the market risk premium based on expected dividends (see box 5 of the «Financial Stability Review» by the European Central Bank, May 2015). The beta has been calculated using the Eurostoxx index for the euro area applying a timescale of five years with monthly data. Bank risk premium is (beta-1) x market risk premium.*
Source: *CaixaBank Research, based on data from Bloomberg and Thomson Reuters Datastream.*

Low risk-free interest rates are a result of the current expansionary monetary policy. Therefore, as monetary policy normalises, the cost of bank equity should rise if, in turn, the bank risk premium does not alter. So when might the bank risk premium fall? Why are banks still perceived as a risky investment when the aim of regulatory efforts is precisely the opposite?

As discovered in a recent survey carried out by the consultancy firm PWC[2] on the risks faced by banks, the macroeconomic environment represents one of the main concerns for banks around the world and especially in Europe. In this respect, investors may be discounting the fact that the current environment of low economic growth (accompanied by low interest rates and weak growth or stagnation in business volumes) is structural, which would permanently affect banks' business model. Another trend which, in addition to opportunities, also poses risks and uncertainty for traditional banks is digitalisation insofar as profits could be eroded with the emergence of new technological rivals and because it is not certain that all banks have enough innovative capacity to continue offering their customers competitive products and services (see the article «Online marketplace lending: an alternative to bank financing?» in this Dossier).

1. See the Dossier: «A lower cost of equity for banks» in MR10/2014.
2. See «Banking Banana Skins 2015» by the CSFI and the consultancy firm PWC.

The second risk highlighted in the survey is regulatory. The regulatory framework has yet to stabilise and measures and requirements still need to be defined that have an as-yet uncertain impact on the sector's bottom line. Logically investors will demand a higher expected return on equity until such sources of uncertainty are resolved. On the other hand the cost of equity may also have risen due to the practical disappearance of implicit public guarantees (the «no bail-out» principle). There are also fears that this very pressure on profits will lead some banks to take risks that cannot be accurately observed by supervisors or shareholders, resulting in a higher COE demanded for the sector as a whole.

In any case, even though such risks and uncertainties may be resolved favourably and this helps to lower the bank risk premium, there is no guarantee that such a reduction will offset the normalisation of risk-free interest rates and that the COE will fall to below its pre-crisis level. In fact most analysts place its medium-term rate at around 10%, its long-term average. The current levels of bank profitability will therefore have to increase considerably to pass this threshold. According to December's survey by the European Banking Authority (EBA), fewer than half the banks stated that their profits in 2015 were enough to cover the COE. Persistently low profits for banks in the euro area reduce the organic accumulation of capital and make it difficult to attract this externally, limiting the growth of bank financing, the main financing mechanism for the European economy (see the article «The banking sector and the capital markets: union creates strength», in this Dossier).

Improved profitability should be based on various levers. On the one hand, adapting the business model to low interest rates, which reduce income from interest, and an increasingly digital environment. There is no doubt that strict cost control will also be vital to bolster banks' bottom line. More fragmented and less efficient banking systems can also boost their profitability via national consolidation that reduces excess capacity. Crossborder acquisitions, within the banking union, of relatively weak banks or those with room for improvement in terms of efficiency may also serve to increase the profitability of the system as a whole (although, at present, pan-European economies of scale are not significant given the regulatory, institutional and cultural differences between countries). In summary, there are many different ways to improve profitability and be able to reward bank shareholders satisfactorily and sustainably. Only the banks that accomplish this will be able to say they have finally left the crisis behind them.

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The banking sector and the capital markets: union creates strength

During the 1990s, the role played by banks and capital markets as mechanisms that channel savings towards investment opportunities gave rise to an intense and animated debate in academic circles, focused on the pros and cons associated with both alternatives. In the years following the outbreak of the Great Recession, this debate has once again raised its head, particularly in Europe where some consensus can be found regarding the advantages of encouraging the development of capital markets and reducing the euro area's excessive dependence on bank financing. The initiative promoted by the European Commission to create a capital market union in Europe is along these lines. However, we should not reduce this debate to merely a question of «banks versus capital markets» as these two spheres of the financial system are not so much opposing alternatives but rather complementary to each other.

Traditionally the euro area and Japan have provided clear examples of highly bank-oriented economies: between 70% and 80% of external financing for the corporate sector comes from banks and this percentage rises to 85% in the case of small and medium-sized firms on the European continent. In fact capital markets play a very modest role in the financing pattern of Europe's businesses, either by issuing bonds or by raising capital (equity). On the other hand obtaining funds from capital markets and particularly the corporate bond market is the predominant financing method in the US while bank financing only accounts for between 10% and 15% of all external financial resources for the US business sector. However, it should be noted that the role played by banks in the US in terms of providing funds to the private sector is rather underestimated due to the fact that the large amount of debt securitised by banks is not taken into account. Nonetheless there are considerable differences to the European situation given the little use of banks made by US small and medium-sized firms, accounting for just 35% compared with 85% in Europe's case. With these data in mind, many people from different spheres have suggested recently that the role played by the banking sector in the euro area should be considerably reduced, delegating to capital markets most of the responsibility for mobilising capital to meet companies' financing needs.

Nevertheless, such proposals do not always take into account the positive effects of bank financing in general and companies' ability to access capital markets. Firstly, bank lending is associated with an important process of checking and analysing companies' credit capacity and quality, both *ex ante* and also throughout the relationship between the bank and its customer. As a result of this, and of the long-term relationship established in many cases between both parties, information regarding debtor solvency is less asymmetric, consequently reducing financing costs.[1] Secondly, monitoring and selecting projects and the destination of the funds received fosters stronger corporate governance policies and this, in turn, tends to improve the credit capacity of the private sector as a whole and, as in the previous case, to push down its financing costs. At the same time, the indication and reduction of asymmetric information resulting from the granting of bank loans also have a favourable effect on those companies deciding to look to the capital market for their funds. Specifically, companies with some association with banks enjoy lower costs for debt and equity issuances compared with those firms with less degree of association.[2] So the effects of traditional bank activities go beyond the sphere of banking *per se* and even extend to the capital market.

For their part, the markets fundamentally have two strengths as a financing mechanism. On the one hand they help to share risk between players according to their preferences and especially their risk tolerance. On the other hand, when the markets in which debt securities or equity are traded are sufficiently liquid and the investor base is broad, corporate financing costs tend to fall. A minimal size of firm and issuance is normally required, however. The possibility of trading securities on the secondary market enhances price formation as prices reflect, approximately and in the absence of any significant distortions, the aggregate expectations of investors regarding the viability of the business project.

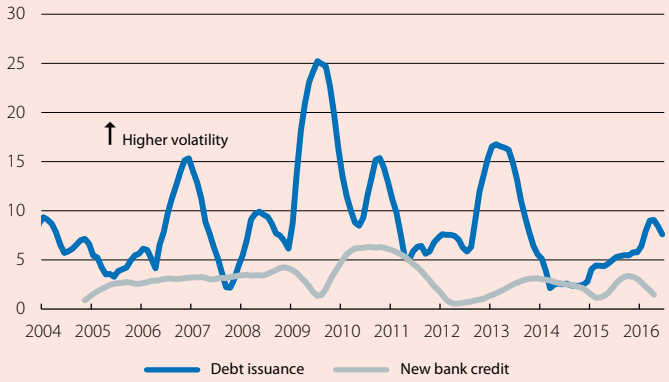
So banks and markets are far from being separate, sealed compartments as, in practice, both alternatives are closely related and complement each other.[3] Even more so when we add securitisation into the mix, a natural link between banks and markets. Moreover, in the short or medium term capital markets are unlikely to replace bank financing because companies in the euro area currently have very limited access to corporate bond and equity markets (and particularly to the latter). This is due both to the

1. The literature on the role played by banks in reducing information asymmetry is very extensive but readers can find a particularly interesting reference in Song, F. and Thakor, A. (2010), «Financial System Architecture and the Co-evolution of Banks and Capital Markets», Economic Journal.
2. On this issue, see Drucker, S. and Puri, M. (2005), «On the benefits of concurrent lending and underwriting», Journal of Finance, and «Banks in capital markets», Handbook of Corporate Finance, Vol. I (2007).
3. In line with the theory supported by various studies, especially Levine, R. (2002), «Bank-Based or Market-Based Financial Systems: Which is better?», Journal of Financial Intermediation.

absence of a common operational, regulatory and insolvency framework and also to aspects related to the euro area's predominance of small firms. A recent study by the World Bank highlights this situation, revealing that those companies issuing debt or capital are much larger than those that do not.[4] Specifically, the authors analysed a sample of 45,000 enterprises and 51 countries in the period 2003-2011 and found that the median company issuing capital is twice the size (in terms of total assets) of the median non-issuer. This contrast is even greater between firms that issue bonds and non-issuers as the vast majority of funds obtained by issuing debt are concentrated in just a few very large companies.

Euro area: volatility of financing flows in the non-financial corporate sector *

Coefficient of variation (%)



***Note:** * New bank credit: flows corresponding to new bank credit operations in the euro area in the non-financial corporate sector, cumulative over 12 months. **Debt issuance:** flows corresponding to bonds issued by the non-financial corporate sector in the euro area, cumulative over 12 months.*
***Source:** CaixaBank Research, based on data from the ECB and Bloomberg.*

On the other hand a larger role played by capital markets does not ensure the financing available to companies is more stable. Banks and capital markets have a disparate effect on the nature and volatility of the economic and financial cycle.[5] The severity of the economic crisis in Europe after the outbreak of the financial crisis is put forward as the main argument by those claiming the advantages of a market-oriented system above the dangers of a bank-oriented system. However, unlike markets, if banks are well capitalised they have the capacity to withstand shocks, helping to stabilise the provision of credit and to soften the impact of such shocks on the economy as a whole. Moreover the costs and volumes of issuances of bonds and capital are often highly volatile and the liquidity of these markets tends to be drained off during episodes of financial instability. Such circumstances could end up having an opposite effect to the one desired: accentuating the procyclicality of the financial system and impinging upon financial and economic stability. In fact, an analysis carried out by BIS economists shows that the depth of normal recessions (in terms of GDP lost) in bank-oriented economies is less than in economies more based on capital markets.[6]

In conclusion, far from being purely rival alternatives, banks and markets make up a duo in which the development of one has a positive effect on the other. Initiatives such as capital market union are beneficial insofar as they will complement the bank financing channel in the long term; even more so after all the efforts invested in making the euro area's banking system more robust.

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4. Didier, T., Levine, R. and Schmukler, S. (2015), «Capital Market Financing, Firm Growth and Firm Size Distribution», Policy Research Working Paper 7353, The World Bank.
5. On the procyclicality of the financial system, see Jódar-Rosell, S. and Gual, J. (2014), «La prociclicidad del sistema financiero tras las reformas», Documentos de Economía de CaixaBank.
6. Gambacorta, L., Yang, J. and Tsatsaronis, K. (2014), «Financial Structure and Growth» BIS Quarterly Review, March 2014.

Online marketplace lending: an alternative to bank financing?

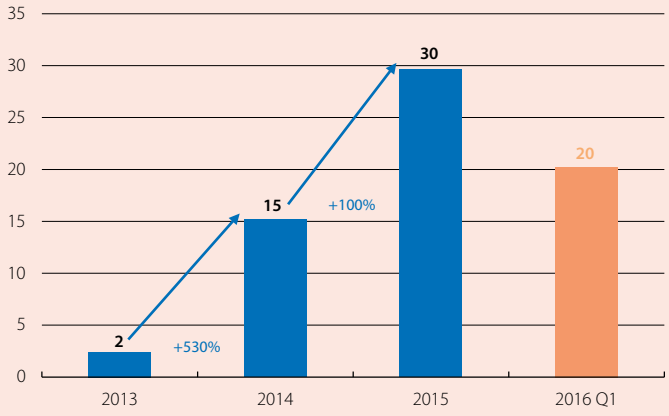
Online marketplace lending[1] is a new form of intermediation with the potential to replace or complement the traditional financial system. These 100% online platforms provide direct contact between lenders and borrowers and offer services to screen loans, assess creditworthiness, manage servicing and collection, and recover non-performing loans. This is partly a kind of fintech whose aim is to use technology to offer financial services with a particular, although not exclusive, focus on market segments that may not be profitable for traditional banks,[2] especially consumer credit niches and financing for micro and small firms.

These fintechs are developing very quickly in China, the USA and the United Kingdom, as shown by the fact that, in 2015, platforms financed by venture capital attracted more than 3.5 billion dollars in capital in these three countries.[3] Such investments, associated with high interest on the part of individual and institutional investors looking for higher returns, are expected to provide a strong boost for growth in these markets. Some analysts, for instance, estimate that the volume of loans in these three countries could increase by almost 75% annually in the coming years and go from 89 billion dollars in 2015 to 467 billion dollars in 2018.[4] Should these predictions come about, online marketplace lenders will have demonstrated its potential to become a significant alternative to bank financing.

That said, the market is still in its infancy in Spain. It is estimated that the volume of online marketplace lending totalled approximately 30 million euros in 2015,[5] still representing a very small proportion of the sector's total credit.

Spain: estimated online marketplace lending

(Million euros)



Source: *CaixaBank Research, based on data from Indexa Lending, Arboribus, Circulantis, Comunitae, Funding Circle, Growly, LoanBook, MytripleA and Zank.*

The most innovative fintechs aim to differentiate themselves from traditional banks by reducing operational costs, developing new risk models and improving the customer experience. The advantage of operational costs comes from a business model based on granting credit (which is not held on balance sheet), distribution exclusively via digital channels and automated processes. Moreover, as these institutions do not hold deposits, they do not have to meet the same regulatory costs as banks (see the article «The (r)evolution in the regulatory and supervisory framework resulting from the crisis» in this Dossier). The second strategic pillar for such platforms consists of developing new credit risk models based on exploiting a large amount of data,[6] including non-traditional sources such as social media and information on the speed with which a credit application is made. This innovation may help to reduce fraud and refine solvency assessments insofar as these new sources of data could improve the predictive ability of these models. Lastly, such differentials help to speed up the process of evaluating loan applications, a key aspect of the customer experience.

Nevertheless, there are also a number of considerations that represent serious challenges to the marketplace lending business model. On the one hand, the predictive ability and accuracy of some of the new risk models cannot be validated until different stages in the credit cycle have occurred.[6] Another aspect to bear in mind is volatility in fintech financing. In a downward phase of the cycle; i.e. in an environment with high levels of non-performing loans or higher interest rates, these platforms could see their financing flows reduced as a result of less investor interest.[7] Similarly, unlike banks which fund loans with deposits, fintechs depend on an investor base that demands much higher returns than the average cost of funds for a bank. It is estimated that the lower operational costs incurred by online marketplace platforms are actually offset by a higher financing cost, so that the

1. Also known as peer-to-peer (P2P) lending or crowdlending.
2. Due to certain regulatory requirements (such as to prevent money laundering and the financing of terrorism) or credit policies.
3. See KPMG, CB Insights (2016), «The Pulse of Fintech, 2015 in Review».
4. See Citi (2016), «Digital Disruption, How FinTech is Forcing Banking to a Tipping Point».
5. For estimates of the market in 2013 and 2014 see AltFi or University of Cambridge, EY (2015), «Moving Mainstream, The European Alternative Finance Benchmarking Report».
6. See U.S. Department of the Treasury (2016), «Opportunities and Challenges in Online Marketplace Lending».
7. See McKinsey & Co (2015), «The Fight for the Customer. McKinsey Global Banking Annual Review 2015».

total costs of banks and these platforms are not so dissimilar.[8] Lastly, in a relatively small market such as Spain it may also be difficult for online marketplace lending to attract investors.

In addition to these considerations regarding the business model, fintechs must also operate in a complex and highly competitive environment. In Spain, with the aim of protecting small savers, legislation governing platforms limits the volume of individual loans, the maximum investment a non-accredited investor can make and the investment a platform can keep on its balance sheet.[9] Moreover, the proliferation of fintechs, in addition to the advances in digitalisation made by traditional financial institutions, increases the competition in a sector in which achieving economies of scale is crucial insofar as this helps to add more information on borrower behaviour in order to develop models and invest in innovation and security. Many fintechs may also find it difficult to keep up the high growth rates observed to date, as shown by the slowdown that is starting to be recorded by investment in online marketplace lending in Europe, especially that of limited scale.[10]

In this respect, traditional banks also possess a number of advantages over fintechs (economies of scope and scale, more stable sources of funding and integrated multi-channel distribution networks) which allow them to bear both the regulatory costs and also investments required in technology and security. Given this situation, the theory of disruptive innovation[11] suggests that the incumbent organisations will accelerate their innovation to face new rivals, which can initially offer better products or services to their current clients. In short, the risk is high for those institutions that are slower to respond in terms of innovation.

Ultimately, the major challenge for any company, whether it is a fintech or a traditional financial institution, is to offer a good value proposition and to gain the trust of clients and investors. It is too soon to know how the online marketplace lending business model will develop over the next few years but we can predict that not all institutions will successfully overcome this challenge, be they incumbents or fintechs.

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8. See Deloitte (2016), «Marketplace Lending: A Temporary Phenomenon?».
9. Online marketplace lending in Spain is supervised by the Bank of Spain (collection and payment) and the Securities and Investments Board (CNMV) (marketplace lending). Each project can attract up to 2 million euros, except for those aimed exclusively at accredited investors (5 million euros). Non-accredited investors can invest up to 3,000 euros in the same project and up to 10,000 euros in all the different marketplace platforms within a period of 12 months. A platform can use its balance sheet and invest up to 10% of the target funding for each project.
10. See KPMG, CB Insights (2016), «The Pulse of Fintech, Q1 2016».
11. See Christensen, C., Raynor, M. and McDonald, R. (2015), «What Is Disruptive Innovation?», Harvard Business Review.

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As of December 31, 2015

	MILLION €
Customer funds	296,599
Receivable from customers	206,437
Profit atributable to Group	814
Market capitalisation	18,702
Customers (million)	13.8
Staff	32,242
Branches in Spain	5,211
Self-service terminals	9,631

"la Caixa" BANKING FOUNDATION COMMUNITY PROJECTS: BUDGET 2016

	MILLION €
Social	308.8
Research and education	61.3
Spreading culture and knowledge	129.9
TOTAL BUDGET	**500**

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