MR11

MONTHLY REPORT • ECONOMIC AND FINANCIAL MARKET OUTLOOK

NUMBER 395 | NOVEMBER 2015

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CaixaBank Research

MONTHLY REPORT - ECONOMIC AND FINANCIAL MARKET OUTLOOK
November 2015

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Date this issue was closed:
31 October 2015

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Diminishing expectations?

In the mid-1990s Paul Krugman wrote one of his first books for the general public with the evocative title of The Age of Diminished Expectations. In hindsight, the 1990s turned out to be good for the US while today, more than 20 years later, Krugman's «age of diminished expectations» is probably an accurate description of the mood in the developed world.

After the huge blow dealt by the scope and duration of the Great Recession and the difficulty encountered in returning to brilliant growth rates, a certain pessimism has taken over the advanced economies regarding the future. Many economists interpret the current rock-bottom real interest rates (and their continuation in the future, as discounted in the financial markets) as proof that we are witnessing a secular stagnation in developed countries. Expectations are certainly limited, even if they are not exactly diminishing.

Such expectations are partly a logical consequence of the maturity achieved by the planet's most advanced economies. The historical progress made by countries in the euro area, for instance, has been huge. Throughout their working lives, today's retired generation has seen the country's average income multiply by 3.3 while the adults retiring in the coming decade will have seen the country's standard of living double during their active period. As a country progresses and becomes wealthier, it is natural for the rate of growth to lessen as there are fewer opportunities for its productive processes to incorporate innovations and new technologies.

However, although this process may be logical, that does not mean it is without impact on our societies. At the current rate of potential growth expected over the coming years, the young generation recently joining the labour market can only hope for the country to multiply its standard of living by 1.5 throughout their working lives. This is, naturally, an average figure and, since it covers a much more complex business and labour situation, many people could certainly experience an age of limited expectations; a lot of young people have serious doubts about their chances of enjoying a higher standard of living than their parents.

In Spain this drop in the rate at which the country's standard of living has improved, generation after generation, is even faster if we take into account the fact that today's retired generation achieved huge improvements starting from a very low level. That generation saw the country's standard of living multiply almost sixfold and their children's standard of living more than double, while the most their grandchildren can expect (based on current trends) is to improve their standard of living 1.5 times, as in the euro area as a whole.

Such long-term growth prospects have serious social and political implications. On the one hand these underlying phenomena help to explain the social tensions and political radicalism observed in many developed countries. Economic stagnation leads to tension as it makes policies of redistribution and social assistance much more difficult to implement.

From the point of view of economic policy, on the other hand, the developed world and particularly Europe should not see such stagnation as inevitable. In fact, given the current trends, although Spain and the euro area expect to multiply their income by just 1.5 over the next generation, the US figure is 1.8; far from impressive but only 0.4 pps below the rate achieved by the previous generation, a sign of how the US still leads the world economy.

In order to avoid or at least ease this secular stagnation, the challenge is to take over the frontier of the new tech generation and achieve an efficient, flexible productive system that is capable of incorporating new products, new services and new industries, and for all this to result in greater well-being for the population. Only if Europe truly takes this challenge on board will it see an end to this age of limited and diminishing expectations which we seem to have been fated to live through.

Jordi Gual
Chief Economist
31 October 2015

CHRONOLOGY

OCTOBER 2015

2 **The ratings agency S&P raises Spain's credit rating** to BBB+ from BBB and keeps its outlook stable.
5 **The free trade agreement is signed between the US and several Pacific countries** including Japan, Mexico, Australia and Canada.

SEPTEMBER 2015

20 **Syriza wins the elections in Greece** and secures the necessary support to implement the programme agreed with the institutions.

AUGUST 2015

11 The People's Bank of China announces a new mechanism to determine the exchange rate of the yuan and **this depreciates by 3.0% against the US dollar in one week**.
19 The **third programme of financial aid for Greece** is approved, totalling 86 billion euros and without the initial participation of the IMF. The Greek Prime Minister, Alexis Tsipras, calls an **early general election**.

JULY 2015

5 **The Greek referendum rejects** the agreement plan proposed by the European institutions.
14 **Iran reaches an agreement** with the five members of the United Nations Security Council and Germany in which it undertakes to reduce its nuclear programme in exchange for lifting the sanctions imposed.
31 The Spanish government brings forward its presentation of the **State Budget** for 2016.

JUNE 2015

26 The **Greek government calls a referendum** on whether to accept the latest proposal offered by European institutions for 5 July.
30 Greece does not pay the 1.6 billion euro **due to the International Monetary Fund**.

MAY 2015

7 The Conservatives win an absolute majority in the **UK elections**, marked by the promise to hold a referendum on the country remaining in the European Union.

AGENDA

NOVEMBER 2015

3 Registration with Social Security and registered unemployment (October).
6 Industrial production index (September).
16 GDP Japan (Q3).
18 Loans, deposits and NPL ratio (September).
19 International trade (September).
24 Central government budget execution (October).
26 Quarterly national accounts (Q3).
27 Economic sentiment index of the euro area (November).
CPI flash estimate (September).

DECEMBER 2015

2 Registration with Social Security and registered unemployment (November).
3 Governing Council of the ECB.
4 GDP of the euro area (Q3).
14 Industrial production index (October).
15 Fed Open Market Committee.
17 Quarterly labour cost survey (Q3).
European Council.
18 Loans, deposits and NPL ratio (October).
21 International trade (October).
22 State budget execution (November).
29 Household savings rate (Q3).
30 Flash CPI (December).
Balance of payments (October).
Net international investment position (Q3).

Limited risk from the emerging economies

The IMF expresses concern for world growth but the data tone down this sentiment. In its biannual revision of economic and financial forecasts the IMF has corroborated the gradual improvement in advanced economies but warns of the worsening balance of risks for emerging countries (mainly macroeconomic imbalances, weak commodities, tougher financial conditions and the slowdown in the Chinese economy). In spite of this slightly pessimistic view, the IMF's quantitative revision of its macroeconomic scenario has been relatively modest as global growth forecasts (3.1% in 2015 and 3.6% in 2016) are only moderately lower than the previous figures. This is due to the growth predicted for China remaining the same, as well as the minimal downward revision for US growth which has offset the larger revision for some emerging countries (in particular Brazil and, to a lesser extent, Russia). The most recent economic trends endorse the IMF's analysis. Concern for the real state of China has been somewhat tempered by the latest indicators, in particular by GDP growth in Q3 which stands at 6.9%, just below the figure of 7.0% posted in Q2 and higher than the consensus and our own forecast. Meanwhile the United States continues to grow: although its GDP figure for Q3 has remained a little below our forecasts this does not appear to threaten the expansionary trend predicted. Unfortunately, the worrying outlook of the weak front identified by the IMF has also been confirmed; in October attention was particularly focused on the increase in political, economic and geopolitical risks in Brazil and Turkey.

In addition to better macroeconomic figures, the actions taken by central banks are also helping to reduce the perceived risk for emerging countries. First of all, as opposed to the chain of rather confused messages issued in August and September, since then communication has been considerably more precise. For example, the Federal Reserve is now giving out more specific messages, placing the expectations of an interest rate hike in a more plausible zone, in our opinion (our main scenario is that this hike will take place in December). The ECB has also been explicit, suggesting that monetary stimuli will be increased, also in December. Other cases are not limited to communication; for instance the People's Bank of China has carried out a further cut in its interest rates. These measures have had an effect on financial markets. Whereas August and September saw episodes of notable instability, volatility diminished in October with quite strong gains for risk assets.

Compared with global fluctuations, the euro area's recovery is continuing without too many variations. Supported by the now all-too familiar factors (cheaper oil, the euro's depreciation and accommodative monetary policy), activity is improving slowly but surely. Nevertheless some distinctions still need to be made depending on the country in question. Germany, in spite of its greater exposure to the emerging economies, and Spain continue to accumulate positive indicators and France is also improving although its rate of activity is still subdued. Italy is following a similar course but the best news is that its pace of reforms has speeded up. After adopting two key reforms before the summer (labour and education), it has now altered the Senate's role which, in addition to the new Electoral Act passed in May, will ensure more responsive governance of the country. Outside the euro area we should note that year-on-year growth in the United Kingdom is now comfortably above 2% although the rate has slowed down somewhat.

The Spanish economy has reduced its rate of growth slightly but its outlook is still clearly positive. The Spanish economy grew by 0.8% quarter-on-quarter in Q3, a little less than the 1.0% in Q2. This is a small slowdown resulting from the temporary support factors gradually coming to an end, a situation that was expected and does not essentially alter recent trends. Domestic demand is still the driving force behind the economy's expansion, supported by labour's positive performance (jobs are being created, albeit at a rather more gradual rate than in previous quarters, and this is helping households to regain their financial wealth). Moreover, thanks to the fall in energy prices, inflationary tension is still notable for its absence: although prices are expected to recover soon, for the present inflation has merely stopped falling. More recently the real estate market has also improved, simultaneously posting growth in housing sales, mortgages, prices and housing starts. As a result of the expansion in economic activity, tax revenue is also increasing appreciably, helping to reduce the public deficit both of the central government and the autonomous communities. Nevertheless, the rate of adjustment in the public accounts might not be enough to meet the deficit target for 2015 (4.2% of GDP), as the European Commission recently warned.

FORECASTS

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

International economy

	2013	2014	2015	2016	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2016 Q1	2016 Q2
GDP GROWTH										
Global [1]	3.3	3.3	3.1	3.6	3.1	3.1	3.1	3.1	3.5	3.5
Developed countries	*0.9*	*1.6*	*2.0*	*2.1*	*1.8*	*2.0*	*1.9*	*2.1*	*2.2*	*2.1*
United States	1.5	2.4	2.5	2.5	2.9	2.7	2.0	2.4	2.8	2.3
Euro area	–0.2	0.9	1.5	1.8	1.2	1.5	1.7	1.7	1.7	1.8
Germany	0.4	1.6	1.6	1.9	1.1	1.6	1.9	1.7	1.8	1.9
France	0.7	0.2	1.0	1.4	0.9	1.0	1.0	1.2	0.9	1.4
Italy	–1.7	–0.4	0.7	1.2	0.2	0.7	1.0	1.2	1.1	1.1
Spain	–1.7	1.4	3.1	2.7	2.7	3.1	3.4	3.3	3.2	2.8
Japan	1.6	–0.1	0.9	1.1	–0.8	0.9	1.8	1.9	1.1	1.6
United Kingdom	2.2	2.9	2.5	2.3	2.7	2.4	2.3	2.4	2.5	2.4
Emerging countries	*6.3*	*5.8*	*5.0*	*5.5*	*5.1*	*5.0*	*5.0*	*4.9*	*5.4*	*5.6*
China	7.7	7.3	6.8	6.5	7.0	7.0	6.9	6.3	6.6	6.5
India [2]	6.9	7.3	7.1	7.2	7.5	7.0	7.0	7.2	7.2	7.2
Indonesia	5.6	5.0	4.9	5.5	4.7	4.7	5.0	5.1	5.2	5.4
Brazil	2.7	0.1	–2.3	–0.6	–1.6	–2.6	–3.0	–2.2	–2.4	–0.5
Mexico	1.4	2.1	2.5	3.3	2.6	2.2	2.5	2.6	2.9	3.2
Chile	4.2	1.9	2.3	3.2	2.5	1.9	2.4	2.2	2.0	3.5
Russia	1.3	0.6	–3.7	–0.2	–2.2	–4.6	–4.2	–3.8	–1.5	–0.2
Turkey	4.2	3.0	3.1	3.3	2.5	3.8	3.2	3.0	2.7	3.2
Poland	1.7	3.5	3.5	3.7	3.4	3.6	3.5	3.6	3.7	3.6
South Africa	2.3	1.6	1.9	2.4	2.0	1.5	2.0	2.1	2.2	2.3
INFLATION										
Global [1]	3.6	3.3	3.2	3.6	2.7	3.2	3.2	3.5	3.7	3.7
Developed countries	*1.4*	*1.3*	*0.3*	*1.5*	*0.1*	*0.1*	*0.1*	*0.7*	*1.6*	*1.4*
United States	1.5	1.6	0.2	1.8	–0.1	0.0	0.1	0.6	1.9	1.7
Euro area	1.4	0.4	0.2	1.3	–0.3	0.2	0.1	0.8	1.4	1.2
Germany	1.6	0.8	0.2	1.3	–0.1	0.4	0.0	0.5	1.3	1.1
France	1.0	0.6	0.2	1.2	–0.2	0.3	0.1	0.6	1.2	1.0
Italy	1.3	0.2	0.2	1.2	–0.1	0.1	0.3	0.6	1.1	1.0
Spain	1.4	–0.2	–0.4	1.3	–1.0	–0.3	–0.4	0.1	1.3	0.9
Japan [3]	0.4	2.7	0.9	1.3	2.3	0.5	0.2	0.7	1.4	1.1
United Kingdom	2.6	1.5	0.2	1.4	0.1	0.0	0.0	0.5	0.9	1.3
Emerging countries	*4.4*	*3.8*	*4.1*	*4.1*	*3.0*	*4.5*	*4.5*	*4.6*	*4.2*	*0.0*
China	2.6	2.0	1.5	2.1	1.2	1.4	1.7	1.9	1.8	2.4
India	10.7	6.6	5.0	5.7	5.3	5.1	3.9	5.8	7.0	6.2
Indonesia	6.4	6.4	6.2	4.3	6.5	7.1	7.1	4.3	3.9	4.3
Brazil	6.2	6.3	8.7	6.2	7.7	8.5	9.5	9.2	7.0	6.5
Mexico	3.8	4.0	2.9	3.3	3.1	2.9	2.6	3.0	3.3	3.5
Chile	2.1	4.4	4.5	3.7	4.4	4.2	4.8	4.5	4.5	4.0
Russia	6.8	7.8	15.0	6.6	16.2	15.8	15.7	12.5	8.0	7.0
Turkey	7.5	8.9	7.3	6.5	7.5	7.7	7.3	6.8	6.5	6.2
Poland	1.2	0.2	–0.6	1.7	–1.2	–0.8	–0.8	0.6	1.4	1.5
South Africa	5.8	6.1	5.1	6.1	4.1	4.6	5.1	6.6	7.4	6.2

Notes: *1. In purchasing power parity. 2. Annual figures represent the fiscal year. 3. Takes into account the consumption tax hike introduced in April 2014.*

Forecasts

Spanish economy

	2013	2014	2015	2016	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2016 Q1	2016 Q2
Macroeconomic aggregates										
Household consumption	–3.1	1.2	3.0	2.5	2.5	3.0	3.3	3.1	3.1	2.6
General government consumption	–2.8	0.0	1.9	0.1	1.3	1.7	1.9	2.6	0.3	0.6
Gross fixed capital formation	–2.4	3.5	6.2	4.5	6.0	6.1	6.6	6.1	5.7	4.4
Capital goods	5.6	12.3	9.1	5.6	9.6	9.2	9.0	8.5	8.1	5.7
Construction	–8.9	–1.7	5.1	3.8	5.0	5.1	5.5	4.8	4.0	3.5
Domestic demand (contr. Δ GDP)	–2.8	1.3	3.3	2.4	2.8	3.2	3.5	3.5	3.0	2.5
Exports of goods and services	4.3	5.1	5.4	5.9	5.9	6.2	4.2	5.4	5.7	5.9
Imports of goods and services	–0.3	6.4	6.4	5.1	7.1	7.0	5.0	6.6	5.6	5.2
Gross domestic product	**–1.7**	**1.4**	**3.1**	**2.7**	**2.7**	**3.1**	**3.4**	**3.3**	**3.2**	**2.8**
Other variables										
Employment	–3.2	1.2	3.0	2.5	2.8	2.9	3.1	3.1	2.9	2.5
Unemployment rate (% labour force)	26.1	24.4	22.2	20.3	23.8	22.4	21.2	21.3	21.6	20.4
Consumer price index	1.4	–0.2	–0.4	1.3	–1.0	–0.3	–0.4	0.1	1.3	0.9
Unit labour costs	–0.4	–0.4	0.5	0.9	0.9	–0.1	0.0	1.0	–0.3	1.5
Current account balance (cum., % GDP)[1]	1.5	1.0	1.9	1.7	1.2	1.4	1.6	1.9	1.8	1.8
Net lending or borrowing rest of the world (cum., % GDP)[1]	2.1	1.4	2.5	2.3	1.5	1.8	2.2	2.5	2.4	2.4
Fiscal balance (cum., % GDP)[1]	–6.8	–5.8	–4.8	–3.3	–5.8	–5.3				

Financial markets

	2013	2014	2015	2016	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2016 Q1	2016 Q2
INTEREST RATES										
Dollar										
Fed Funds	0.25	0.25	0.25	0.79	0.25	0.25	0.25	0.25	0.50	0.75
3-month Libor	0.27	0.23	0.32	0.96	0.26	0.28	0.31	0.44	0.64	0.85
12-month Libor	0.68	0.56	0.81	1.48	0.66	0.73	0.82	1.02	1.22	1.39
2-year government bonds	0.30	0.44	0.71	1.57	0.58	0.59	0.67	1.01	1.30	1.48
10-year government bonds	2.33	2.53	2.23	3.06	1.97	2.16	2.22	2.58	2.87	3.00
Euro										
ECB Refi	0.54	0.16	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
3-month Euribor	0.22	0.21	–0.01	–0.04	0.05	–0.01	–0.03	–0.05	–0.05	–0.05
12-month Euribor	0.54	0.48	0.18	0.17	0.26	0.17	0.16	0.14	0.14	0.14
2-year government bonds (Germany)	0.13	0.05	–0.23	–0.19	–0.18	–0.22	–0.24	–0.26	–0.25	–0.25
10-year government bonds (Germany)	1.62	1.23	0.51	0.73	0.35	0.53	0.69	0.47	0.40	0.50
EXCHANGE RATES										
$/€	1.33	1.33	1.11	1.04	1.13	1.11	1.11	1.10	1.06	1.02
¥/€	129.65	140.42	134.72	129.69	134.30	134.25	135.82	134.53	133.58	128.79
£/€	0.85	0.81	0.73	0.71	0.74	0.72	0.72	0.73	0.73	0.71
OIL										
Brent ($/barrel)	108.47	99.45	56.16	63.59	55.19	63.43	51.10	54.89	61.16	63.20
Brent (€/barrel)	81.68	74.54	50.80	61.30	49.07	57.32	46.00	50.08	57.63	61.83

Note: *1. Four quarter cumulative.*

Forecasts

ECONOMIC OUTLOOK · Central banks take centre stage again

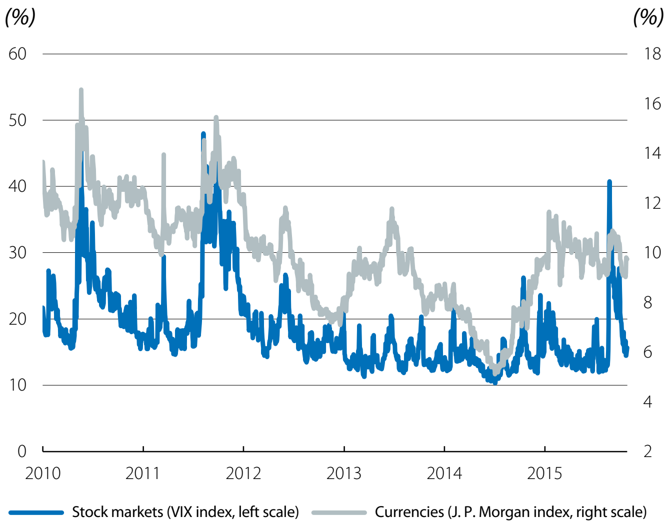
The uncertainty hovering over the global environment has eased, making way for a more favourable climate and the episodes of instability that had peppered the international financial scene between August and September were calmed by the messages and actions of central banks. On this occasion the European Central Bank (ECB) has taken the lead after forcefully stating that more monetary stimuli would very probably be adopted in December. At the same time, the more specific message given out by the Federal Reserve (Fed) regarding the path it plans to take with interest rates and the expansionary measures implemented by China's central bank (PBOC) have also had a positive effect. In this environment, risky assets and government bonds of the advanced bloc have benefitted the most although prices are still below the levels reached in June. The other side of the coin is represented by commodities, still immersed in their own particular adjustment, overlooked by the increase in risk appetite.

The steps taken by the Fed and the news coming from China will be the main factors modulating investor sentiment in the short and medium term and conditions are now more favourable for the upward trend in the different financial markets to continue until the end of the year. Evidence of China's transition towards a new model of growth should also help to support this positive scenario, as well as the seasonal factor of the period we are about to enter. However, the materialisation of this scenario is very likely to be accompanied by possible episodes of volatility that could be considerable in size.

The Fed clarifies the prospect of a possible interest rate hike in December. In the communication issued by the Federal Open Market Committee (FOMC) in October, Janet Yellen shifted the focus back onto the domestic economy, eliminating the previous mention of «global economic and financial developments» but maintaining comments regarding the monitoring of domestic factors. Moreover, for the first time reference was made to the next FOMC meeting in December to decide whether it was the right time to start raising interest rates. The probability assigned by the markets that the start of monetary normalisation will be announced then (our main scenario) has increased notably (currently 48%) compared with a hike in 2016. All this is supported by a positive macroeconomic environment, with private consumption and investment remaining firm in spite of lower GDP growth in 2015 Q3 due to a reduction in stocking.

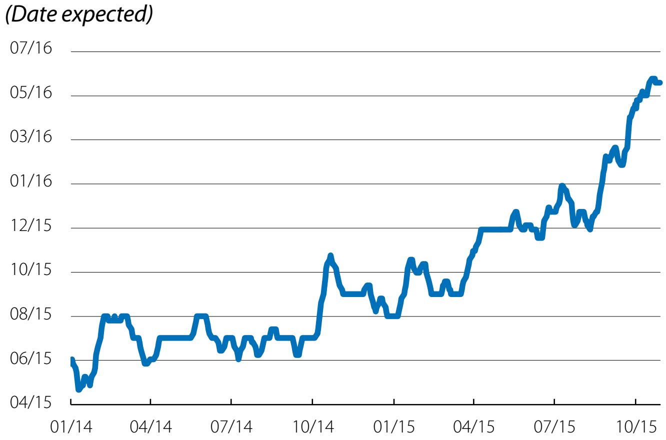
China is still an important focus of attention but the perceived risk regarding this area has improved. Investors welcomed the GDP growth figure for 2015 (6.9% year-on-year),

Implied volatility in financial markets



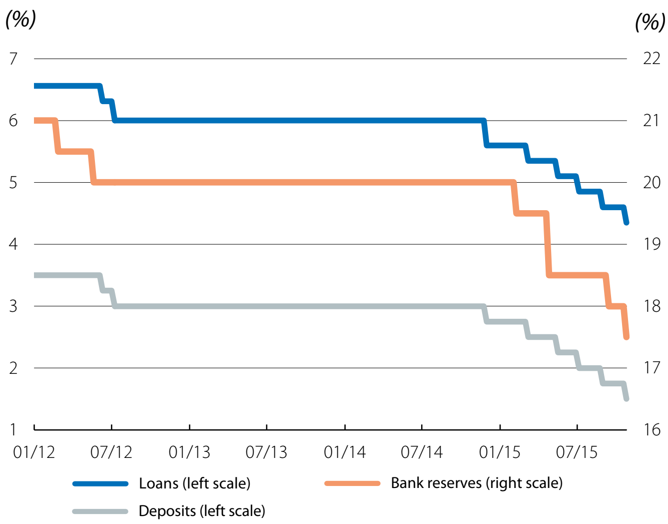
Source: *CaixaBank Research, based on Bloomberg data.*

US: expectations of the first official interest rate hike *



Note: ** Expectation implicit in federal funds rate futures.*
Source: *CaixaBank Research, based on Bloomberg data.*

China: official central bank interest rates



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

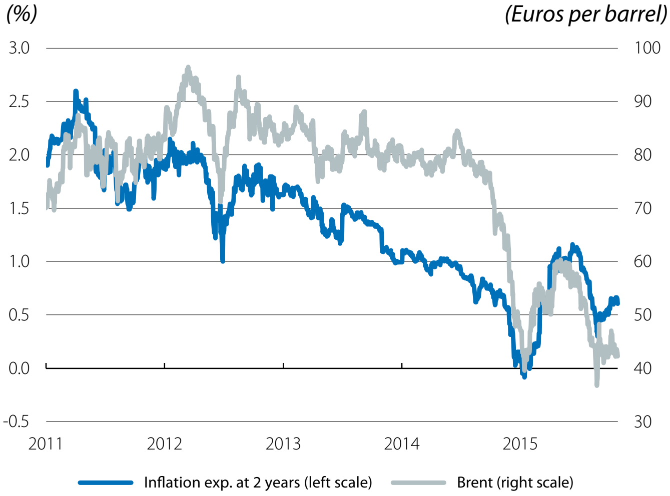
higher than expected by the consensus of analysts and tempering the weak pulse suggested by some recent activity indicators. The decision of the PBOC to cut official interest rates on loans, deposits and bank reserves also had a positive effect on investor sentiment. The response and scope of the measures adopted by the PBOC confirm its willingness to act quickly to limit any tail risks, helping to dilute fears regarding a possible abrupt slowdown in the Chinese economy. The PBOC's decision to eliminate the current restrictions on returns for bank deposits is also a remarkable step and shows that the Asian giant has made notable progress towards liberalising interest rates. In the short and medium term the Chinese government's communication policy will be key to ensuring the measures announced do not result in high levels of volatility.

The ECB increases the accommodative tone of its messages and suggests more monetary stimuli in December. After its October meeting, the Governing Council of the ECB showed a clear readiness to implement additional expansionary measures and stated that these might be announced at its next meeting on 3 December. Mario Draghi once again placed particular emphasis on the continuation of downside risks for growth and particularly inflation. In spite of an improvement in monetary and credit aggregates, the ECB wants to cut short the counterproductive effects of tougher financial conditions. Specifically, the ECB President repeated the possibility of adjusting the bond acquisition programme (QE). This time, however, he also added that the option of cutting the deposit rate is also being considered by the ECB. This willingness to lower the official rate is one aspect that helps to strengthen the institution's commitment to achieve its inflation target. In any case, the decision to revise the accommodative degree of monetary policy will depend on the macroeconomic forecast presented by the authority in December. Nevertheless, the ECB may still opt to wait until January 2016, particularly given that the ECB's meeting in December comes before the Fed's meeting.

Sovereign debt is following the lead taken by the central banks. Yields on 10-year US and German bonds have fluctuated again with the messages issued by the monetary authorities which, in turn, have been influenced by growing concern for weak inflation. The latest version of Mario Draghi's «whatever it takes», promising to revise the monetary expansion programme in December, has widened the spread between yields on US and German bonds with the latter falling although we expect this trend to reverse in the first half of 2016 as global deflationary pressure eases.

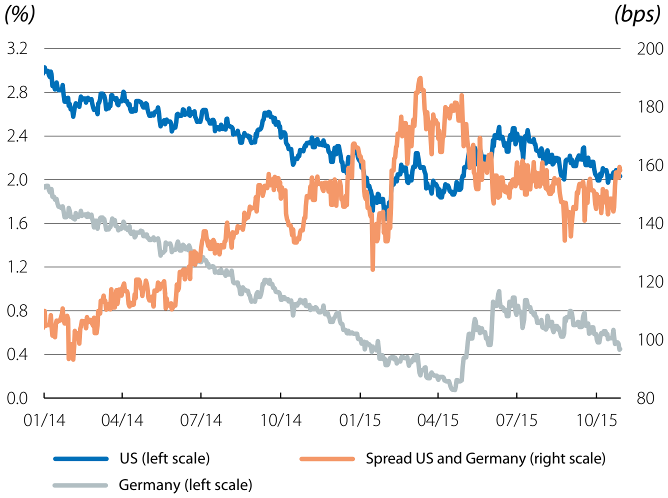
Meanwhile periphery sovereign debt has remained firm in spite of several impending elections. In October, yields on periphery public debt continued the downward trend started the previous month with the accommodative messages of central banks as a backdrop. The gradual improvement in the macroeconomic situation of countries such as Spain, Italy and Portugal, together with the irrefutable safety net provided by

Inflation expectations in the euro area and oil prices



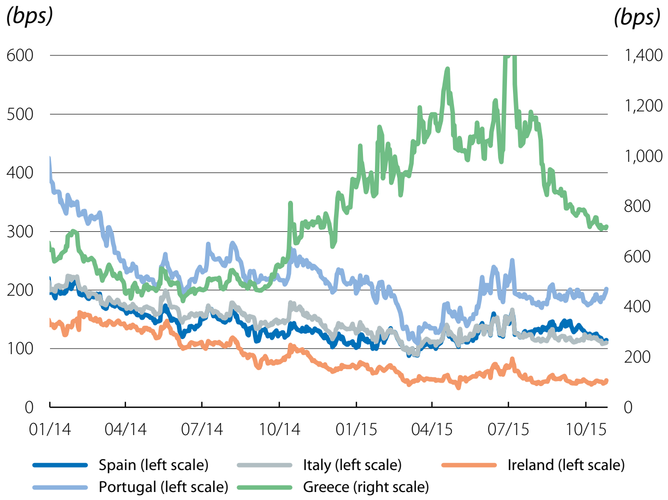
Source: CaixaBank Research, based on Bloomberg data.

Yields and spread on 10-year public debt



Source: CaixaBank Research, based on Bloomberg data.

Euro area: 10-year public debt risk premia



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

the ECB, have strengthened the stability of the sovereign debt of these countries in a period with several general elections being held. Spain's 10-year risk premium has fallen to levels close to those of Italy (around 110 bps), helped also by the sovereign rating upgrade (from BBB to BBB+) by the S&P agency.

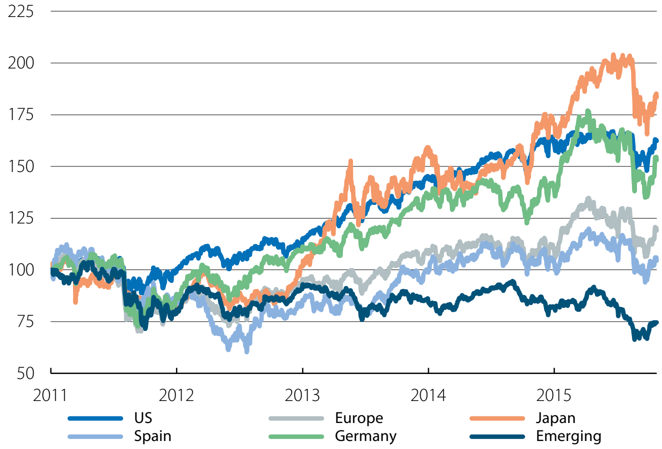
International stock markets advance in unison after the ups and downs of August and September. The general tone of equity markets was firm in October although share prices are still a considerable distance from the levels reached in spring. Although not definitive, this shift in the sources of uncertainty resulting from the summer correction has supported the upward trend. This has had a greater effect on investor mood than the lacklustre corporate earnings campaign in the US although it is true that, out of the 230 companies in the S&P 500 that have published their accounts, 75% have reported higher profits than expected. The weak tone in revenue and turnover has not gone unnoticed, however. In this case the ratio of positive surprises is 43% while negative surprises reached 56%. Nonetheless the stock market rally in advanced markets is very likely to continue until the end of the year. The flow of positive news from China, the more specific information provided by the Fed and the reinforcement of accommodative monetary conditions in the euro area should provide the main leverage. In the emerging area stock markets will continue to deal with the now-familiar obstacles although flows of portfolios towards these countries posted a positive trend in October.

The private bond market is following in the wake of the stock markets. Over the last few months there have been widespread and significant increases in corporate bond spreads (particularly in sub-investment grade bonds). Of note is the leading role played by bonds issued to finance the growing activity in mergers and acquisitions. The number of mega-operations (above 10 billion dollars) since the beginning of 2015 is now higher than the figure recorded for the whole of 2007.

The commodity crisis continues to keep world growth on tenterhooks. After the slight appreciation of the euro in the first half of October, the ECB's meeting resulted in the currency falling by more than 3%, pushing down the dollar/euro exchange rate from 1.14 to 1.10 in just two days. Attention has turned particularly to the currencies of emerging economies such as Brazil and Turkey which have once again suffered from domestic tensions and weak commodities. In this area, after a notable rally at the beginning of October thanks to subsiding fears regarding global growth, crude oil returned to its downward path, losing 2.4% in October and 17% since the beginning of the year. One positive note was provided by copper, a leading indicator of industrial activity, which had lost 16% for the year to date but picked up by 2.4% in October.

Main international stock markets

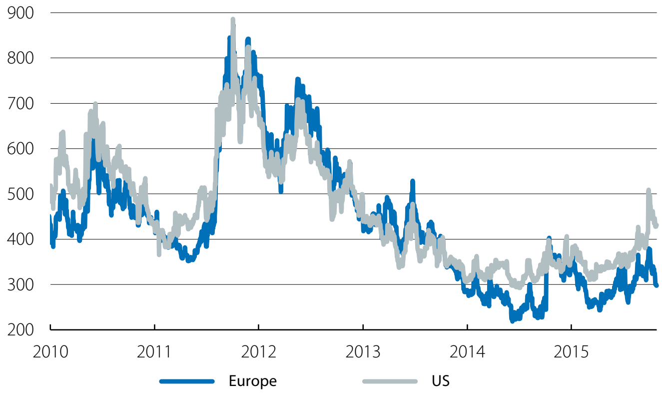
Index (100 = January 2011)



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

Risk premia of sub-investment grade corporate bonds *

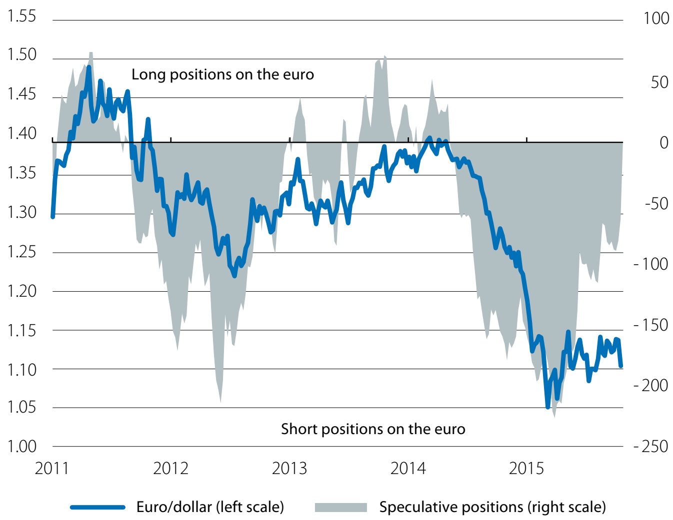
(bps)



Note: ** Spread compared with a basket of sovereign bonds.*
Source: *CaixaBank Research, based on Bloomberg data.*

Currencies: speculative positions on the euro/dollar

(Dollars per euro) *(Thousands of contracts)*



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

FOCUS · The implied equity risk premium: a clearly imperfect indicator that needs to be taken into account

It is no easy task to estimate just how much the stock market may be over- or undervalued. All indicators have their advantages and disadvantages and it is therefore advisable to take a wide range of measurements into account. An overall evaluation of a number of indicators can provide a more confident assessment of the market in question and among the many different measurements that can be used is the implied equity risk premium (IERP).

Before looking at the IERP it is useful to explain what we mean by the equity risk premium. This measurement is merely the recompense demanded by investors in terms of yield for investing in higher risk assets (stocks) instead of securities with a lower level of risk (public debt). An asset's level of risk is related to its dispersion or volatility or its historical yield. For instance, the standard deviation of the historical annual yields (from the end of the 19th century up to the beginning of the second decade of the present century) for shares listed on the US stock market is 20% while, in the case of 3-month US Treasury bills, this standard deviation is 4%. Naturally the reward for the higher risk entailed by the stock market is the much higher returns it provides compared with bonds. Historically the average annual real yield (inflation-adjusted) for the US stock market is 6.5% whereas, historically, the average yield for 10-year US bonds has been around 3% in real terms. The difference between both figures provides a historical equity premium of 3.5%. If we take into account the historical yield for US Treasury bills (1.6%), the equity premium rises to 4.9%, representing a considerable difference in yield demanded by investors to invest in stocks instead of public debt. In fact the difficulty encountered by economic theory in explaining such a large equity risk premium as the one observed in the data is still a conundrum today (known as the equity premium puzzle).

The IERP is merely the forward-looking version of this indicator. A comparison of its value with that of the historical equity risk premium can point to a market possibly being overvalued. This measurement is based on the estimated cashflows, fundamentally dividends, that will be generated by the equity portfolio in question (for example, members of the S&P 500). First we calculate the internal rate of return (IRR) implied in this path for dividends, taking into account the price at which the shares are sold, and then we deduct the risk-free interest rate (generally the yield on 10-year US bonds). A low IERP points to possible overvaluation.

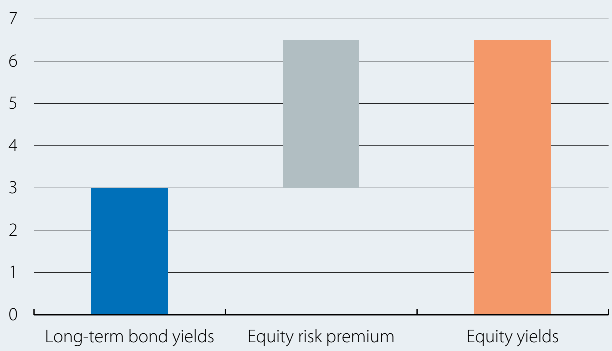
So what can we say about the current IERP for the US stock market? Firstly, that it is close to 7%, above the historical risk premium observed. Consequently, in principle, this measurement does not appear to be at a level that suggests the market is severely overvalued, in clear contrast with what has been suggested by other indicators such as the CAPE (a ratio of the current price compared with the average earnings over the last 10 years).

Nevertheless we should remember that low risk-free interest rates justify a high IERP as it is logical for investors to expect these interest rates to normalise in the future. In fact, in the last few years the drop in interest rates has been almost offset by a rise in the IERP. On the other hand, and this is a fundamental problem for the indicator, a relatively high IERP is not necessarily incompatible with an overvalued stock market as the dividends used to estimate it may be too optimistic, something that occurs relatively frequently.

In summary, although the IERP does not currently suggest the US stock market is overvalued, it is important to remember its weaknesses as an indicator. In any case we should continue to keep a close eye on this indicator, together with many others.

US: historical equity risk premium (1872-2012) *

(%)



***Note** * Annualised historical yields.*
***Source:** CaixaBank Research, based on data from J. J. Siegel.*

FOCUS · Brazil awakens the spectre of financial contagion in Latin America

Brazil has been in the firing line in the last few months due to its delicate situation, both political and financial. The recent uncertainty generated by China and unstable commodity markets, accompanied by Brazil's credit rating downgrade, has increased the downward pressure on the country's assets. With Latin America's turbulent financial episodes still fresh in the memory (the debt crisis in the 1980s, the «Tequila Effect» in 1994, the crisis of the Brazilian real at the end of the 1990s, etc.), the problems currently faced by the region's biggest economy are leading to fears of potential financial contagion to the rest of Latin America.

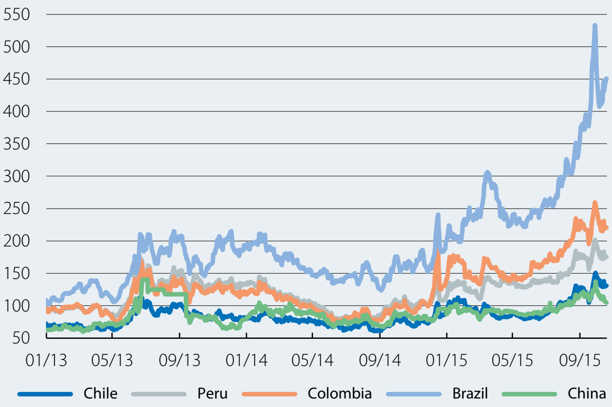
One difficulty in evaluating how easily Brazil's financial crisis could be passed on to the rest of Latin America via banking or capital markets is the lack of information on countries' relative exposure to each other that reflects the region's degree of integration. Taking this restriction into account, one indirect way of analysing the degree of financial interconnection is based on the trend in correlations between Brazil's financial markets and those of the region. Specifically, an increase in correlation coefficients during a crisis period suggests possible contagion, this normally being a necessary condition but not enough on its own. Recent evidence, however, shows how the correlation between Brazil and Latin America's equity and bond markets has tended to decrease, pointing to a relatively limited potential contagion (via purely financial channels) to other countries in the region (the effects via real channels and financial channels more closely linked to the economy, analysed in the Focus «Brazil in recession, contagion to Latin America?», also seem to be modest in scope). This conclusion becomes even stronger when we realise that, over the last few months, there have been other factors such as doubts regarding China and falling commodity prices that may have affected Latin American economies as a whole as well as their financial markets, increasing the correlations between these markets.

One additional exercise that could help to isolate the effect of Brazil's financial contagion to its neighbouring countries analyses the performance of markets on specific days when events have occurred with a high impact on Brazil's markets (so-called event studies). For example: on 9 September 2015, the day when Brazil's government bonds lost their investment grade status, and on 17 September 2015, when opposition parties filed a request to impeach President Rousseff. On these two days yields on the debt of the region's countries moved in a different direction to that of Brazilian sovereign bonds and actually fluctuated more in line with other emerging debt. This situation also suggests that financial contagion is weak.

In short, the evidence available is not indicative, in principle, of a high risk of contagion from Brazil to other countries in the region via the financial channel. However, it is important to remember just how unpredictable financial markets can sometimes be and to take into account the existence of tipping points or non-linear effects: there is no need to repeat the past.

5-year sovereign CDS *

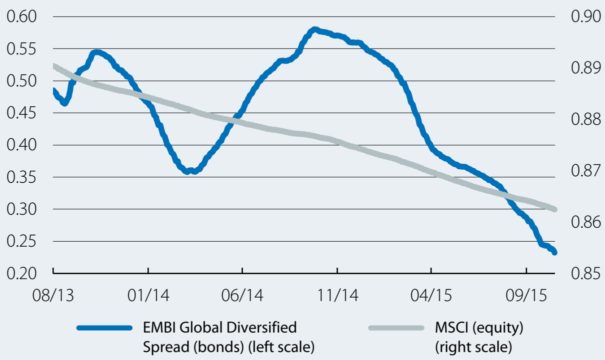
(bps)



Note: ** CDS (credit default swap).*
Source: *CaixaBank Research, based on Bloomberg data.*

Correlations between Brazil and the rest of Latin America * in equity and bond markets

(Correlation coefficient) *(Correlation coefficient)*



Note: ** Average of correlations between Brazil and Bolivia, Chile, Colombia, Paraguay, Peru, Uruguay and Venezuela for the EMBI Global Diversified Spread by J. P. Morgan and between Brazil and Chile, Peru and Colombia for the MSCI by J. P. Morgan.*
Source: *CaixaBank Research, based on Bloomberg data.*

KEY INDICATORS

Interest rates (%)

	30-Oct	30-Sep	Monthly change (bps)	Year-to-date (bps)	Year-on-year change (bps)
Euro area					
ECB Refi	**0.05**	0.05	0	0.0	0.0
3-month Euribor	**–0.07**	–0.04	–3	–14.6	–15.4
1-year Euribor	**0.11**	0.14	–3	–21.5	–23.0
1-year government bonds (Germany)	**–0.35**	–0.27	–8	–28.6	–28.9
2-year government bonds (Germany)	**–0.32**	–0.25	–7	–22.2	–26.4
10-year government bonds (Germany)	**0.52**	0.59	–7	–2.1	–32.1
10-year government bonds (Spain)	**1.67**	1.89	–22	5.9	–40.6
10-year spread (bps) [1]	**115**	131	–15	8.4	–8.1
US					
Fed funds	**0.25**	0.25	0	0.0	0.0
3-month Libor	**0.33**	0.33	0	7.4	9.8
12-month Libor	**0.87**	0.85	2	24.1	31.6
1-year government bonds	**0.32**	0.31	1	10.7	22.9
2-year government bonds	**0.72**	0.63	9	5.6	22.9
10-year government bonds	**2.14**	2.04	10	–3.1	–19.5

Spreads corporate bonds (bps)

	30-Oct	30-Sep	Monthly change (bps)	Year-to-date (bps)	Year-on-year change (bps)
Itraxx Corporate	**71**	91	–20	8.1	5.9
Itraxx Financials Senior	**69**	96	–26	2.0	2.1
Itraxx Subordinated Financials	**148**	194	–46	–1.2	–6.9

Exchange rates

	30-Oct	30-Sep	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
$/€	**1.101**	1.118	–1.5	–9.0	–12.1
¥/€	**132.750**	133.990	–0.9	–8.4	–5.6
£/€	**0.713**	0.739	–3.5	–8.1	–8.9
¥/$	**120.620**	119.880	0.6	0.7	7.4

Commodities

	30-Oct	30-Sep	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
CRB Commodity Index	**395.2**	403.1	–2.0	–9.7	–13.9
Brent ($/barrel)	**47.6**	47.1	1.0	–14.6	–43.8
Gold ($/ounce)	**1,142.2**	1,115.1	2.4	–3.6	–2.7

Equity

	30-Oct	30-Sep	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
S&P 500 (US)	**2,079.4**	1,920.0	8.3	1.0	3.0
Eurostoxx 50 (euro area)	**3,418.2**	3,100.7	10.2	8.6	9.8
Ibex 35 (Spain)	**10,360.7**	9,559.9	8.4	0.8	–1.1
Nikkei 225 (Japan)	**19,083.1**	17,388.2	9.7	17.1	16.3
MSCI Emerging	**847.8**	792.1	7.0	–11.3	–16.6
Nasdaq (US)	**5,053.7**	4,620.2	9.4	6.7	9.1

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

ECONOMIC OUTLOOK · The US is on pause while China holds firm

According to the IMF, the world economy will grow by 3.1% in 2015 and by 3.6% in 2016, slightly below its forecast in July. Growth will be supported by a moderate recovery in the advanced economies while there is a slowdown in the emerging economies and increased downside risks due to doubts regarding China and the weakness of commodity exporters. The US has the strongest recovery among the advanced economies with expected growth of 2.6% and 2.8% in 2015 and 2016, respectively. Forecasts have been revised downwards for Japan, however, growing by 0.6% and 1.0%. Brazil has once again suffered one of the largest downgrades among the emerging economies and is expected to shrink by 3.0% and 1.0% in 2015 and 2016, respectively, while Russia is predicted to decline by 3.8% and 0.6%. China's growth forecast (6.8% and 6.3%) has remained the same, however, while India's forecast has only been reduced very slightly (7.3% and 7.5%).

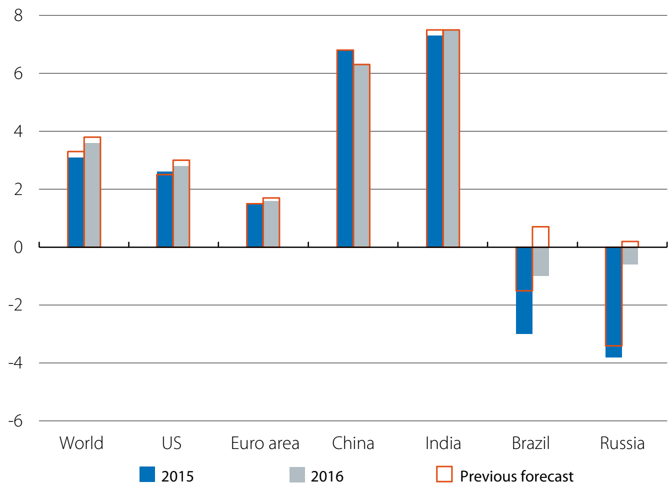
UNITED STATES

Growth in US GDP slows down in 2015 Q3, but only temporarily. According to the first estimate by the Bureau of Economic Analysis, the US economy grew by a moderate 0.4% quarter-on-quarter in 2015 Q3 (2.0% year-on-year) compared with 0.6% in Q2. This is a weak figure due particularly to a non-recurrent adjustment in inventories, deducting 0.4 pps from the quarter-on-quarter growth in GDP. The picture painted for the rest of the components, which indicates the medium-term trend, is more favourable, however. Private consumption increased by a significant 0.8% quarter-on-quarter, as had been suggested by indicators of consumer confidence, while non-residential investment grew by a more moderate 0.5% quarter-on-quarter. The drop in defence spending was offset by an increase in other items in the component of public consumption. The weakness of this growth, greater than expected, has led us to revise downwards our growth forecast for 2015, to 2.5% (previously 2.7%). With a view to 2016 we have also revised slightly downwards our main scenario, which now predicts growth of 2.5% (previously 2.7%) as we expect a stronger dollar given the ECB's extension of quantitative easing. Nonetheless we remain positive about the US expansion, supported by consumption, investment (both corporate and residential) and less fiscal consolidation. The Fed's message in October was framed within this expansionary situation, reinforcing the possibility of interest rate hikes beginning in December (coinciding with our main scenario).

Consumption and housing indicators suggest the expansionary phase will continue in the US. In October the Conference Board consumer confidence index (97.6 points) lost some of its strong upswing from September (102.6) but,

IMF: GDP forecasts for 2015 and 2016

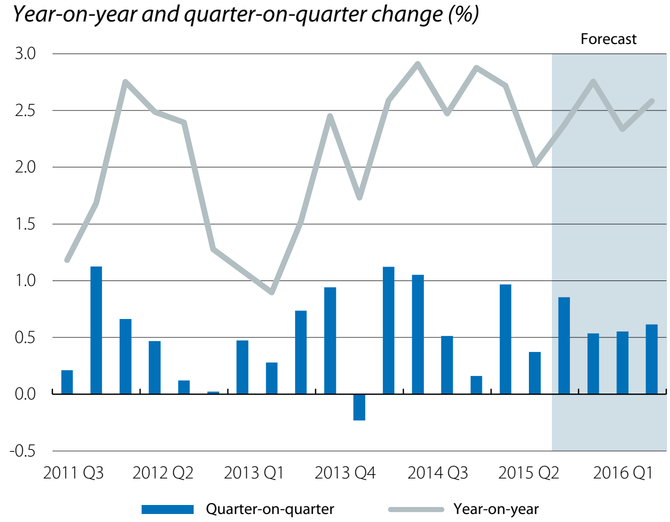
Annual change (%)



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

US: GDP

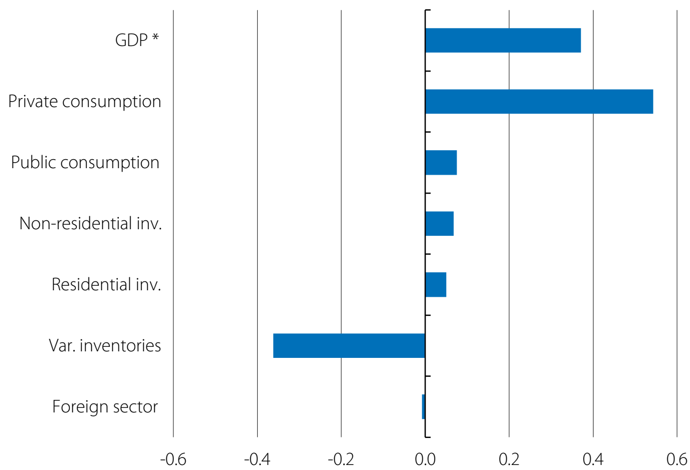
Year-on-year and quarter-on-quarter change (%)



Source: *CaixaBank Research, based on data from the Bureau of Economic Analysis.*

US: GDP

Contribution to quarter-on-quarter growth in GDP in 2015 Q3 (pps)



Note: * *Quarter-on-quarter change.*
Source: *CaixaBank Research, based on data from the Bureau of Economic Analysis.*

supported by a very positive perception of the current situation, is still 5 points above its historical average. The real estate sector is also performing well with sales of second-hand properties increasing and the NAHB index for developer sentiment (which takes prices and sales into account) reaching 64 points in September, its highest level since October 2005. The ISM business sentiment indices were more ambiguous in September, however, recording a second month of decline although still at levels in line with economic expansion.

The labour market will continue to boost consumption, the mainstay of the US expansion. In spite of the slowdown in the rate of job creation over the last two months, the labour market is still recovering. 142,000 jobs were created in September and although this figure was below the threshold of 200,000, the monthly average for the year to date (198,000) continues to point to a dynamic labour market. Unemployment also remained at a low 5.1%. However, wages, benefitting from the still considerable level of under-employment, once again rose by a contained 2.2% year-on-year, far below the zone of normality of 3%-4% set by Janet Yellen a few months ago. Meanwhile prices provided a positive surprise in September, in particular September's core inflation figure, which excludes the prices of food and energy, standing at 1.9%, its highest since February 2013. The general CPI posted a zero year-on-year change, kept down by energy prices which accumulated a year-on-year drop of 18.4%.

JAPAN

We expect the second half of the year will be stronger for Japan. The acceleration we predict over the coming months is based on more dynamic consumption boosted by oil remaining cheap and low inflation, helping to support the purchasing power of households. Given this situation, GDP growth for 2015 Q2 was revised slightly upwards.

In spite of the expected acceleration, China represents a downside risk. The weak demand in China and US for Japanese goods is preventing the cheap yen from benefitting exporters (mostly large firms) as much as it has in the past. The yen's depreciation has also made imports more expensive for consumers and small and medium-sized firms, which import intermediate goods. Industrial production, closely linked to the economy's growth in general, has remained flat in spite of the monetary stimuli which started to be implemented in 2013. Nonetheless, in October the country's central bank decided not to intensify its asset purchase programme (currently totalling 80 trillion yen a year, 16% of GDP).

EMERGING ECONOMIES

China's GDP growth in Q3 was surprisingly high, up by 6.9% year-on-year, only slightly below the 7.0% posted in Q2. This rise, higher than our forecasts, has led us to carry out a technical upward revision of our GDP growth forecasts for

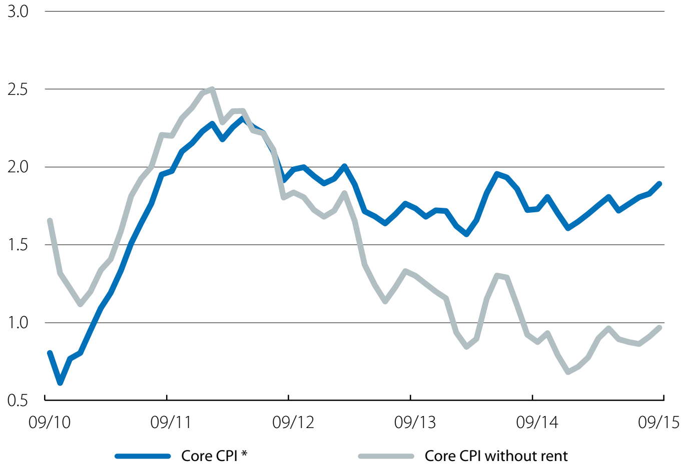
US: unemployment and nominal wages

Year-on-year change (%) *(% of the labour force)*

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

US: CPI

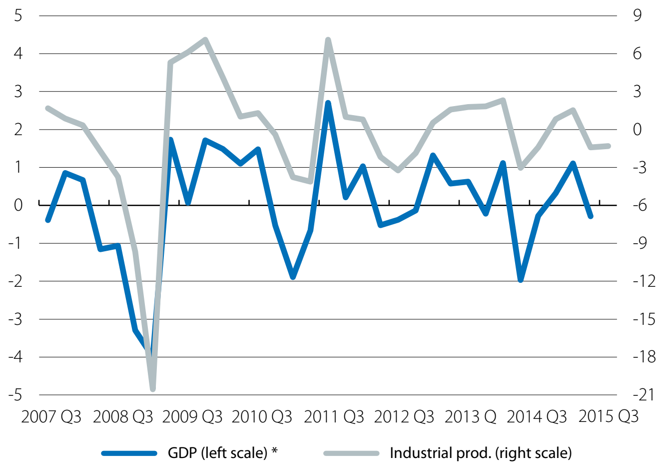
Year-on-year change (%)



Note: ** Core: general index without energy or food.*
Source: *CaixaBank Research, based on data from the Bureau of Labor Statistics.*

Japan: GDP and industrial production

Quarter-on-quarter change (%) *Quarter-on-quarter change (%)*



Note: ** In real terms.*
Source: *CaixaBank Research, based on data from the Ministry of the Interior and Ministry of Industry.*

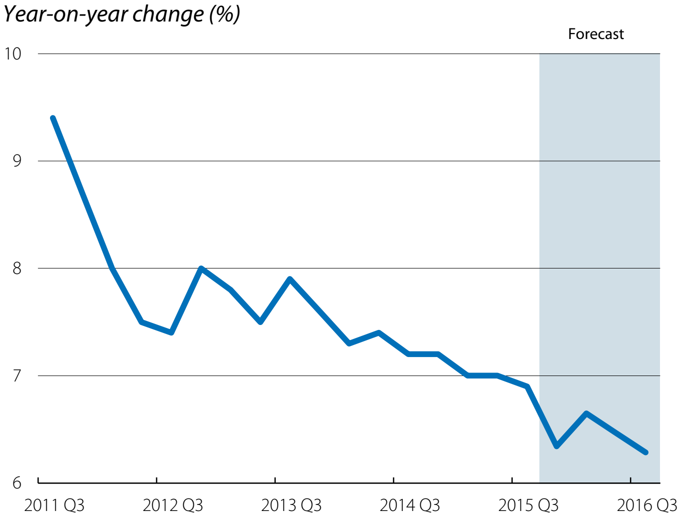
2015 to 6.8% (previously 6.7%). Nonetheless, the downside risks are still high. Proof of this are the measures which the Executive continues to implement to boost growth, most recently the central bank's further cut in the official interest rate (of 25 bps to 4.35%), the fifth reduction of the year so far. It also reduced the cash reserve ratio by 50 bps (to 17.5% for most large banks). At the same time the monetary authority also announced it would suspend the limit on bank deposit interest rates, representing another step towards liberalising and modernising the financial system. In fact, the need to reform the country's financial system was once again mentioned at the 5th Plenary Session of the Central Committee of the Communist Party of China, which took place at the end of October, drafting the lines of action to be followed by the country over the next five years (2016-2020). It was also decided to suspend the one-child policy, allowing couples to have two children, and emphasis was also placed on the Executive's desire to maintain medium growth (6.5% for 2016) that also respects the environment and is compatible with a shift towards a more consumption and services-based economic model.

Brazil has yet to redress its problems. The latest indicators confirm that activity has continued to fall without the most pressing imbalances improving to any noticeable extent (in particular inflation, which climbed to 9.5% in September). Political uncertainty is also increasing. 80% of the measures contained in the fiscal adjustment programme proposed for 2016 by Dilma Rousseff's government require parliamentary approval which, at present, is difficult to guarantee. Moreover, the Court of Auditors has yet to validate the 2014 accounts and Rousseff may even be impeached (a scenario we believe to be highly unlikely). Given this situation, the President has reshuffled the Executive to reinforce her support in Congress. The combined effect of sluggish activity, political uncertainty and the impact of the fiscal adjustment in 2016 (valued at 1.2% of GDP) have warranted a downward revision of our main scenario for GDP growth: from –1.8% to –2.3% in 2015 and from +0.4% to –0.6% in 2016.

Turkey's growth in Q2 was surprisingly high but downside risks have increased. GDP grew by 3.8% year-on-year in Q2, notably above the forecasts and the figure posted in the previous quarter (2.5%). The strength of domestic demand, in particular the acceleration observed in investment and public consumption, is the main factor behind this spurt from activity. However, the economic outlook for Q3 is more subdued due to the increase in political risks both internally (political conflicts) and externally (Syria), as well as the worsening of the exchange rate crisis. Although the incumbent party, the AKP (moderate Islamists), are likely to win an absolute majority in the elections on 1 November, thereby reducing the internal political instability, there is no guarantee the country's huge macroeconomic imbalances will be redressed or its external geopolitical risks reduced. We have therefore revised downwards our growth figures: from 4.0% to 3.3% in 2016.

China: GDP

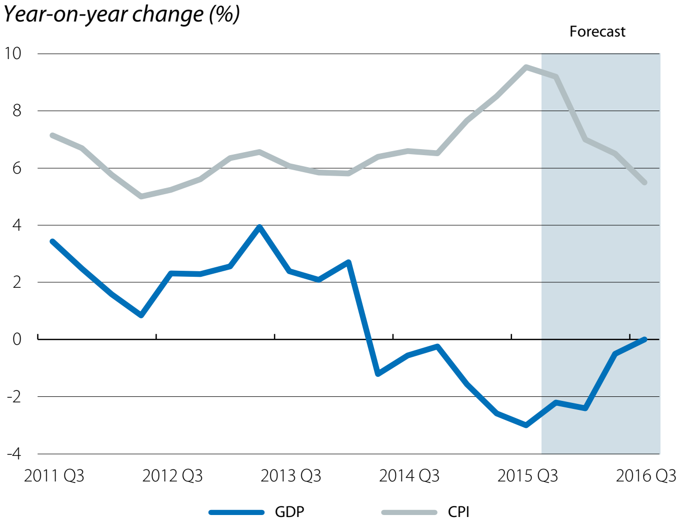
Year-on-year change (%)



Source: *CaixaBank Research, based on data from the Bureau of Economic Analysis.*

Brazil: GDP

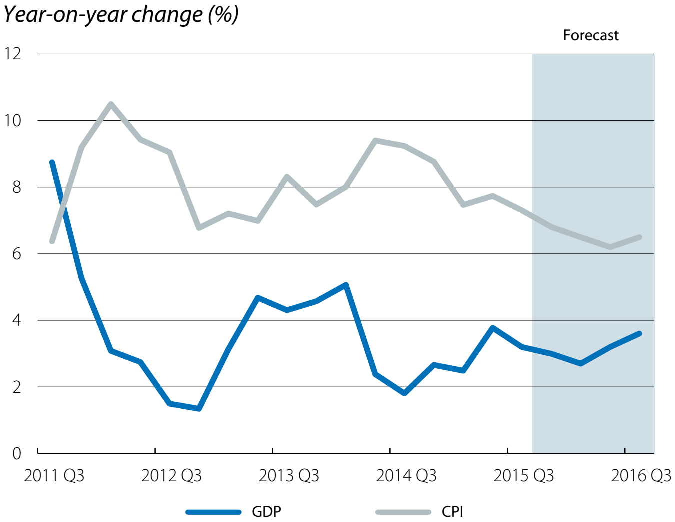
Year-on-year change (%)



Source: *CaixaBank Research, based on data from the Brazilian Institute of Geography and Statistics (IPEA).*

Turkey: GDP

Year-on-year change (%)



Source: *CaixaBank Research, based on data from the Turkish Statistics Office.*

FOCUS · Brazil in recession, contagion to Latin America?

The seriousness of Brazil's recession has taken Brazilians and foreigners by surprise: after falling by 0.7% quarter-on-quarter in Q1, the country's GDP plummeted by a notable 1.9% in Q2. The reasons for this bad performance are explored in a recent Focus:[1] Brazil is facing the challenge of correcting significant macroeconomic imbalances in a context of falling activity and difficulties in implementing economic policy. Here we focus on analysing the possible economic impact on Latin America of a shock in its largest economy, equivalent to 37% of the region's GDP.

One fundamental channel for contagion is trade. The most exposed countries are those which export most goods to Brazil: Paraguay, Bolivia, Argentina and Uruguay, which send between a fifth and a third of all their exports to the South American giant. However, to examine the economic impact more accurately we need to relate these countries' exports with their economic size, differentiating between the more vulnerable situation of Bolivia and Paraguay (whose exports account for 11.7% and 9.7% of their national GDP, respectively) and that of Uruguay (3.3% of GDP) and Argentina (2.6% of GDP).

Bolivia and Paraguay are therefore the most exposed to a shock from Brazil. Nevertheless, the extent of this risk also depends on the kind of goods traded and these two countries are in very different situations: while Bolivia exports natural gas and oil, products whose demand, although partially inelastic, will fall given Brazil's decrease in consumption and investment, Paraguay exports agricultural commodities which, in principle, are staple goods and can also be relocated much more easily internationally (although this last factor has diminished slightly due to the current context of a drop in global demand for commodities). In summary, the balance of commercial risks is more worrying in the case of Bolivia (due to its extensive trade and the composition of the goods traded) but somewhat less in Paraguay (the degree of trade is partly offset by the composition of the goods).

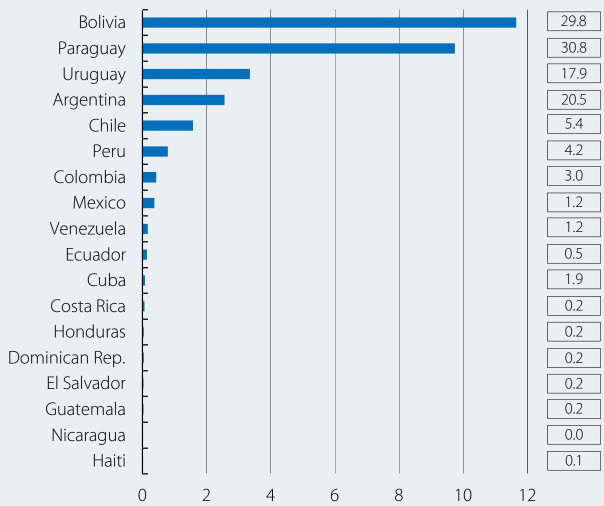
A second potential channel of contagion is financial. With regard to Latin America's investments in Brazil, the stock of foreign direct investment from Uruguay is equivalent to 7.9% of the country's GDP, that of Chile represents 3.5% of its national GDP and Mexico's investment is equivalent to 1.1% of its GDP. On the other hand, investments by Brazilian firms in 2013 represented a stock equivalent to 5.2% of GDP in Uruguay, to 2.2% of GDP in Paraguay and to 1.6% in Peru, while the region's remaining countries are much less exposed.[2] We can therefore conclude that the effect Brazil's recession might have on Latin America as a whole could be classified as small to medium, as Latin America is not particularly integrated and its two main engines (Brazil and Mexico) are not closely related at all.

Nonetheless this assessment must necessarily be cautious given the fact that Brazil's recession is occurring at the same time as a second shock (in commodities) and tougher financing conditions. We should also remember that, although the economic channels (and those financial channels most closely linked to economic performance) are relatively small and limited to just a few countries, contagion via other means could entail a greater risk. In particular, if international investors got rid of their investment positions in Brazil (a reasonable reaction in response to the country's worsened outlook), a similar, albeit partly irrational response could occur in other economies.[3]

Can we quantify the possible total effect of these different channels? According to a recent study by the IMF[4] that evaluates how much Brazil's shocks are passed on to the rest of the region, the overall impact would be particularly strong in Paraguay (every 1 pp drop in Brazil's GDP reduces Paraguay's GDP by 0.9 pps) and have markedly less of an effect, although still appreciable, on Argentina, Bolivia and Uruguay (in the order of 0.25 pps).

Exports of goods to Brazil in 2014

(% of GDP) *(% of the country's total exports)*



Source: *CaixaBank Research, based on data from the International Monetary Fund-DOTS and Oxford Economics.*

1. See «The deterioration in Brazil's outlook: a bad patch or something more deep-rooted?», published in MR05/2015.
2. Portfolio investments are not taken into account because no information is available on their countries of origin and destination. Nonetheless it should be noted that flows of foreign direct investment account for 90% of capital outflows and 60% of capital inflows.
3. This channel is explored in more detail in the Focus «Brazil awakens the spectre of financial contagion in Latin America» in this Report.
4. Adler, G. and Sosa, S. (2012), «Intra-Regional Spillovers in South America: Is Brazil Systemic after All?», IMF Working Paper WP/12/145.

FOCUS · Exchange rate movements and exports: sense and sensitivity

One of the best channels via which accommodative monetary policy can boost economic growth is by depreciating the currency. Depreciation of the local currency stimulates a country's exports as these become cheaper for foreign buyers. Nonetheless, some recent studies suggest that this relationship between the exchange rate and exports has weakened over the last few years.

Various elements have been proposed as the causes of this reduction in sensitivity but the most important is undoubtedly the proliferation of global value chains (GVC). Specifically, a country is considered to form part of a GVC when its exports, in addition to being made up of value added generated in the country itself, also contain a relevant proportion of intermediate goods and services from other economies. In this case the price of such exports will depend both on local costs and also on the cost of the intermediate goods and services that have been imported. If the country's currency depreciates, from a foreign point of view the cost of the locally-produced share of the exports falls as the local currency has become cheaper in comparison with the foreign currency. However, the cost of the inputs imported remains constant in foreign currency terms and becomes more expensive in local currency terms. This means that, when the local currency depreciates, the price of exports produced within GVCs falls less (once again, for foreign countries) than if the exported goods had been produced locally in their entirety, and the stimulus provided by this depreciation for exports is therefore smaller.

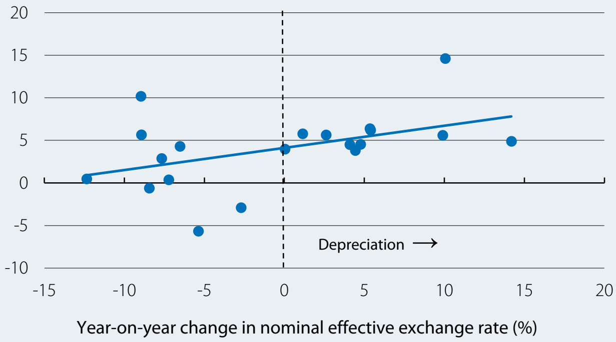
Conversely, other global phenomena might have strengthened the relationship between the exchange rate and exports; in particular, new countries entering the arena of world trade and the liberalisation of some markets. Both elements increase competition with the result that exchange rate movements cannot be absorbed as easily via company mark-ups and therefore have a greater effect on prices. And as prices directly affect the demand for exports, when prices are more sensitive to a currency's exchange rate, the volume of exports is also more sensitive to such exchange rate movements.

Given the co-existence of elements that may have weakened and also strengthened the exchange rate elasticity of exports, various empirical studies have attempted to quantify this and track its evolution over time. The conclusion is controversial. While one recent report by the World Bank states that this link has indeed weakened and that GVCs are responsible for a considerable part of the change, the IMF finds no evidence to support such a conclusion in its «World Economic Outlook» for October 2015 (WEO).[1] Along the same lines as the World Bank study, the ECB mentions a certain weakening of the relationship in the case of exports of manufactured goods from European countries, and the Fed for the same case in the US.[2]

Using the findings from these studies to assess the euro area's current situation, the euro's recent depreciation of close to 5% in real terms against its trading partners would have increased the volume of exports by between 3% and 3.8%; an improvement which, although clearly below the figure of 5.5% that would have been recorded a few years ago in a less integrated world, is nevertheless significant. Consequently, although there is perhaps less sensitivity between exchange rate movements and exports, their relationship is far from over.

Main advanced and emerging economies: exports and exchange rate

Year-on-year change in nominal exports (%)



Note: *Year-on-year change in nominal exports of goods and services in local currency between 2014 Q1 and 2015 Q2 (cumulative over four quarters). Not including major commodity exporters.*
Source: *CaixaBank Research, based on data from the BIS and Thomson Reuters Datastream.*

1. See Ahmed, S., Appendino, M. A. and Ruta, M. «Depreciations without exports? Global value chains and the exchange rate elasticity of exports.» World Bank Policy Research Working Paper (August 11, 2015). In this article the authors find that the effect of the real exchange rate on exports decreased by almost half between 1996 and 2012 and that GVCs lie behind 40% of this reduction. See also IMF, World Economic Outlook (October 2015), chapter 3.
2. See Di Mauro, F., Rüffer, R. and Bunda, I. (2008), «The changing role of the exchange rate in a globalised economy». ECB Occasional Paper 94.

KEY INDICATORS

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

UNITED STATES

	2013	2014	2014 Q3	2014 Q4	2015 Q1	2015 Q2	07/15	08/15	09/15
Activity									
Real GDP	1.5	2.4	2.9	2.5	2.9	2.7	–	2.0	–
Retail sales (excluding cars and petrol)	3.4	3.9	4.4	4.8	4.8	3.7	4.3	3.9	3.8
Consumer confidence *(value)*	73.2	86.9	90.9	92.7	101.3	96.2	91.0	101.3	102.6
Industrial production	1.9	3.7	4.2	4.5	3.5	1.4	1.3	1.1	0.4
Manufacturing activity index (ISM) *(value)*	53.8	55.7	56.9	56.9	52.6	52.6	52.7	51.1	50.2
Housing starts *(thousands)*	928	1.001	1.029	1.055	978	1.158	1.152	1.132	1.206
Case-Shiller home price index *(value)*	158	171	170	173	177	179	178	179	...
Unemployment rate *(% lab. force)*	7.4	6.2	6.1	5.7	5.6	5.4	5.3	5.1	5.1
Employment-population ratio *(% pop. > 16 years)*	58.6	59.0	59.0	59.2	59.3	59.3	59.3	59.4	59.2
Trade balance [1] *(% GDP)*	–2.9	–2.9	–2.9	–2.9	–3.0	–2.9	–2.9	–3.0	...
Prices									
Consumer prices	1.5	1.6	1.8	1.2	–0.1	0.0	0.2	0.2	0.0
Core consumer prices	1.8	1.7	1.8	1.7	1.7	1.8	1.8	1.8	1.9

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

	2013	2014	2014 Q3	2014 Q4	2015 Q1	2015 Q2	07/15	08/15	09/15
Activity									
Real GDP	1.6	–0.1	–1.4	–0.8	–0.8	0.9	–	...	–
Consumer confidence *(value)*	43.6	39.3	40.5	38.9	40.7	41.5	40.3	41.7	40.6
Industrial production	–0.6	2.1	–0.3	–1.4	–2.2	–0.5	0.0	–0.4	–0.8
Business activity index (Tankan) *(value)*	6.0	13.5	13.0	12.0	12.0	15.0	–	12.0	–
Unemployment rate *(% lab. force)*	4.0	3.6	3.6	3.5	3.5	3.3	3.3	3.4	3.4
Trade balance [1] *(% GDP)*	–2.4	–2.6	–2.9	–2.6	–1.8	–1.4	–1.2	–1.1	–1.0
Prices									
Consumer prices	0.4	2.7	3.4	2.5	2.3	0.5	0.3	0.2	0.0
Core consumer prices	–0.2	1.8	2.3	2.1	2.1	0.4	0.6	0.8	0.9

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

	2013	2014	2014 Q3	2014 Q4	2015 Q1	2015 Q2	07/15	08/15	09/15
Activity									
Real GDP	7.7	7.3	7.2	7.2	7.0	7.0	–	6.9	–
Retail sales	13.1	14.3	15.9	11.7	10.5	10.2	10.5	10.8	10.9
Industrial production	9.7	8.3	8.0	7.6	6.4	6.3	6.0	6.1	5.7
PMI manufacturing *(value)*	50.8	50.7	51.3	50.4	49.9	50.2	50.0	49.7	49.8
Foreign sector									
Trade balance [1] *(value)*	258	382	322	382	488	541	537	547	576
Exports	7.8	6.0	12.9	8.6	4.6	–2.2	–8.3	–5.5	–3.7
Imports	7.3	0.5	1.0	–1.7	–17.6	–13.5	–8.1	–13.8	–20.4
Prices									
Consumer prices	2.6	2.0	2.0	1.5	1.2	1.4	1.6	2.0	1.6
Official interest rate [2] *(value)*	6.00	5.60	6.00	5.60	5.35	4.85	4.85	4.60	4.60
Renminbi per dollar *(value)*	6.1	6.2	6.2	6.1	6.2	6.2	6.2	6.3	6.4

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 · **The euro area's recovery is not slowing down**

The recovery is continuing in the euro area without any great changes. Judging by the trend in business indicators, the rate of growth is remaining steady in the second half of 2015. One sign of this is that the IMF has kept almost all its growth forecasts intact for the region (1.5% in 2015 and 1.6% in 2016). The recovery is therefore continuing, supported by low oil prices, the euro's depreciation and accommodative monetary policy. In the short term the euro area's growth rate might be affected by a greater slowdown in the emerging economies than expected although, if this did occur, it could be offset with expansionary monetary policy. Nevertheless this should not be a medium or long-term solution: structural reforms still need to be implemented (economic, fiscal, bank and political union) which will help to improve productivity.

Economic activity holds firm in Q3 in spite of the slowdown in the emerging economies. As a whole the figures indicate a gradual recovery in industry although this varies between countries. In August, while industrial production grew in year-on-year terms at a similar rate to the previous month in Germany and Spain, the figures recorded in Italy and in France were slightly lower. With a view to Q4, one positive note is the trend in the euro area's composite PMI in October, standing at 54.0 points, slightly above the figure posted for Q3 (53.9) and comfortably within the expansionary zone. By country, the French index recorded an increase this month that would be compatible with a slight acceleration in activity although this is still at a contained level. For its part the German PMI showed a slight improvement in October compared with Q3. Another of the German benchmark business indicators, the IFO, remained at a very high level (108.3 points compared with 108.2 in Q3). These indicators therefore suggest that the German economy is holding up well to the slowdown in the emerging economies.

Consumption advances at a considerable rate. Consumption indicators for Q3 point to this component having considerable weight in the euro area's economic growth. Although the consumer confidence index fell slightly in October it is still at a much higher level than its historical average. The same situation is suggested by the rate of change in retail and consumer goods which remained high although there was some decline in August, to 2.3% year-on-year. Another indicator for consumption, vehicle registrations, also recorded significant growth in September of 10.2% year-on-year. Investment is also remaining firm. In fact, the strong increase in the industrial production of capital goods in August, namely 4.1% year-on-year, indicates that investment might have speeded up in Q3.

Euro area: GDP forecasts of the IMF

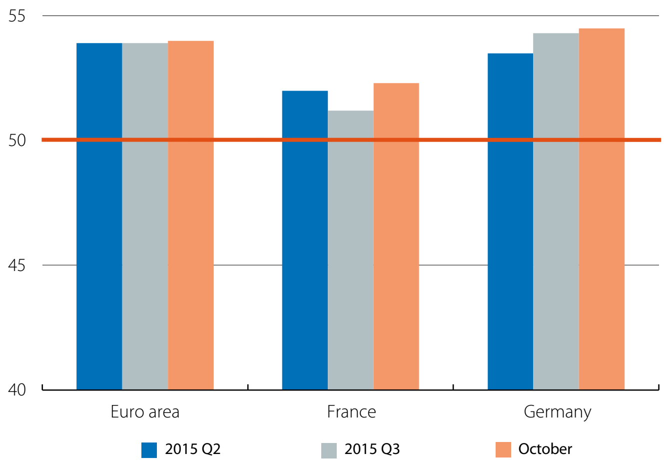
Annual change (%)

		Forecast		Change compared with July 2015 forecast	
	2014	2015	2016	2015	2016
Euro area	0.9	1.5	1.6	=	▼ 0.1
Germany	1.6	1.5	1.6	▼ 0.1	▼ 0.1
France	0.2	1.2	1.5	=	=
Italy	–0.4	0.8	1.3	▲ 0.1	▲ 0.1
Spain	1.4	3.1	2.5	=	=

Source: *CaixaBank Research, based on IMF data (WEO).*

Euro area: composite PMI activity indicator

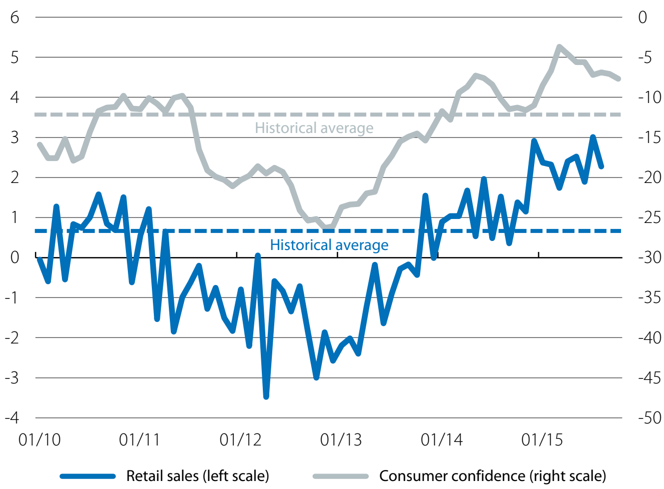
Level



Source: *CaixaBank Research, based on data from Markit.*

Euro area: consumption indicators

Year-on-year change (%) *Level*



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

The gradual recovery in the labour market is supporting consumption. In September unemployment in the euro area stood at 10.8%, 0.7 pps below its level one year ago. The peripheral countries, especially Spain, have contributed significantly to this drop. With a view to Q4, the data on employment expectations provided by the European Commission suggest that the labour market will continue to improve. Specifically, industry is still at a high level compatible with increased employment although October's figure suggests a slight slowdown (–3.0 points compared with –2.8 points for Q3) and the same pattern can be seen in the services sector. Germany posted particularly good figures for its labour market with unemployment at a minimal level, namely 4.5%. This boom in the labour market has contributed to the country's strong support for refugees as the government believes they could be a useful asset in the medium term to offset shortages in labour supply.

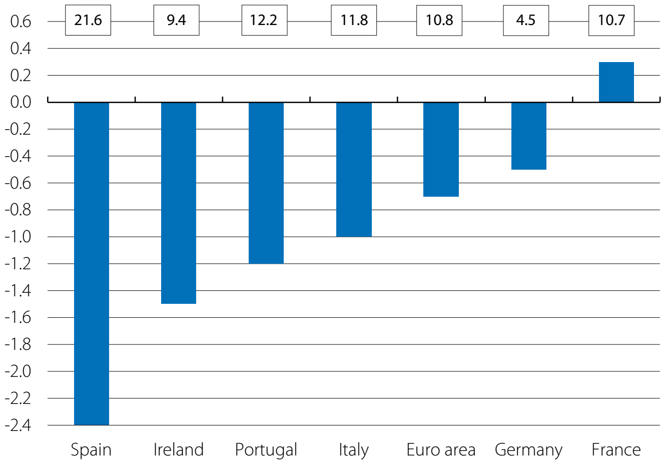
Continued low inflation is pressurising the ECB to announce possible additional measures in December. According to the institution, the prolonged and widespread weakness of inflation, signs of a slowdown for activity in China and volatile international markets over the last few months warrant a re-examination of the degree of monetary policy accommodation. Specifically, the ECB President, Mario Draghi, confirmed the possibility of adjusting the size, composition and duration of the asset purchase programme and added possible cuts in the deposit facility interest rate. The ECB's main aim was to signal to the markets its willingness to use all the instruments available within its mandate in order to anchor interest rates at a low level and ensure a favourable exchange rate. Given that, according to the activity figures, the recovery is firmly on track, we do not expect any measures the ECB ends up taking will be very broad, mostly aimed at strengthening the commitment to meet its mandate. A similar picture is painted by the trend in inflation expectations, remaining at levels similar to those when monetary expansion began. It should also be noted that inflation increased by 0.1 pps in October to 0.0% and we expect it to rise further as the recovery consolidates and the effects of falling oil prices disappear. Core inflation also rose by 0.1 pps to 0.9%, a value which it has maintained throughout most of the second half of year.

Expansion of the quantitative easing programme, should it be carried out, would make the euro depreciate further and thereby boost exports. In August exports of goods from the euro area to the rest of the world rose by 5.6% year-on-year, a level similar to July. The rise in imports was lower, namely 3.0% year-on-year, thanks partly to low oil prices which helped to reduce the energy bill. As a result the euro area's trade balance considerably increased its surplus, from 7.4 billion euros in August 2014 to 11.2 billion in the same month of 2015. In fact one of the possible aims of the ECB in announcing potentially greater monetary expansion would be to maintain the euro's depreciation,

Unemployment rate

Change Sept. 2015 – Sept. 2014 (pps)

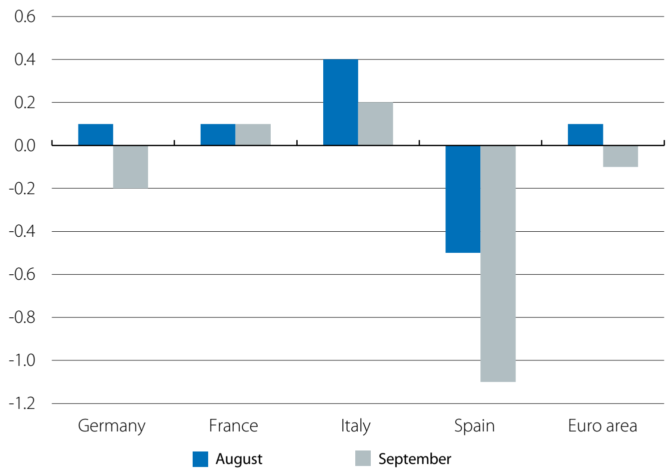
Rate (% of the labour force)



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

*Euro area: HCPI **

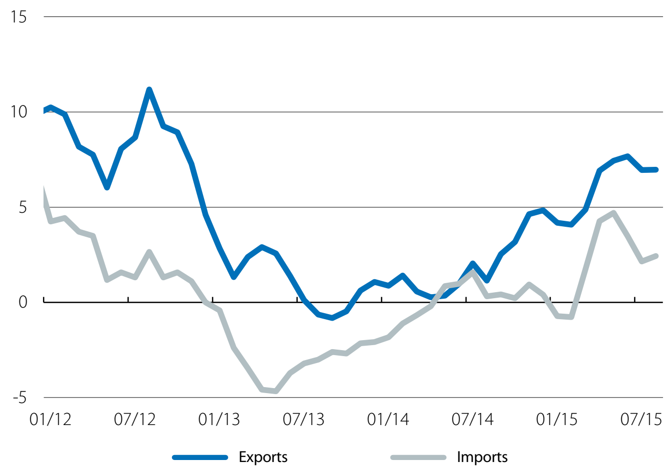
Year-on-year change in 2015 (%)



Note: ** Inflation for Spain is the national figure, not the harmonised rate.*
Source: *CaixaBank Research, based on Eurostat data.*

*Euro area: international trade of goods **

Year-on-year change in 3-month cumulative figure (%)



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

a circumstance that would help to boost the foreign sector's good performance.

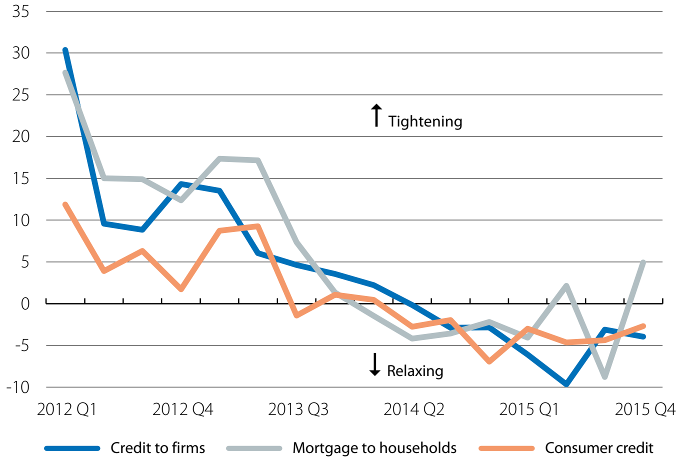
The rise in credit suggests that monetary stimuli are being effective. According to October's bank lending survey, in 2015 Q3 banks relaxed their conditions for granting loans to firms and to households for consumption, segments in which strong demand can be found, encouraged by low interest rates. However, banks tightened up their criteria slightly for mortgage loans, mainly because of regulatory reasons in spite of demand growing strongly in some countries such as the Netherlands. The survey therefore shows that banks are using the liquidity injected by the ECB to grant more loans.

The drop in interest rates on sovereign bonds makes it easier to adjust the public deficit. In Q3 the euro area's public deficit stood at 2.0% of GDP, 0.6 pps below the figure posted for 2014 Q2. The euro area's fiscal consolidation is therefore still on track, helped by the fall in risk premia and interest rates as a consequence of the ECB's expansionary monetary policy, and the institution extending the programme would further help this process. On the other hand the figures for public debt indicate that a downward slide may have started (being 92.2% of GDP in Q2 compared with 92.7% in 2014 Q2). Nevertheless, the trend in the deficit of the euro area as a whole is the result of highly disparate situations between the different countries. While Germany, for instance, had a surplus of 0.3% of GDP in 2014 (and a public debt of 74.9%), France had a deficit of 3.9% in 2014 and a debt of 95.6%. In general, the peripheral countries saw considerable reductions in their public deficit throughout 2014.

The rate of growth in the United Kingdom is slowing down but it is still strong. British GDP increased by 0.5% quarter-on-quarter in 2015 Q3 (0.7% in Q2). It is therefore continuing the slight slowdown beginning at the end of 2014: the year-on-year rate of change stood at 2.3% in Q3 (compared with 2.9% for 2014 Q3). This lower growth in activity is probably due to the stabilisation of domestic demand (the breakdown in GDP for Q3 has yet to be released), the main engine for growth since the start of the recovery but which, in the last few months, had already been showing signs of a slowdown. This moderation in GDP growth, the inflation rate being close to zero and responses by the rest of the central banks of developed countries to the slowdown in the emerging economies, could persuade the Bank of England (BoE) to delay its first interest rate hike. If the BoE is forced to maintain its current accommodative stance, attention will be centred on whether it is possible, in this context, to curb the pressure on prices of risky assets, especially real estate.

Euro area: bank lending survey

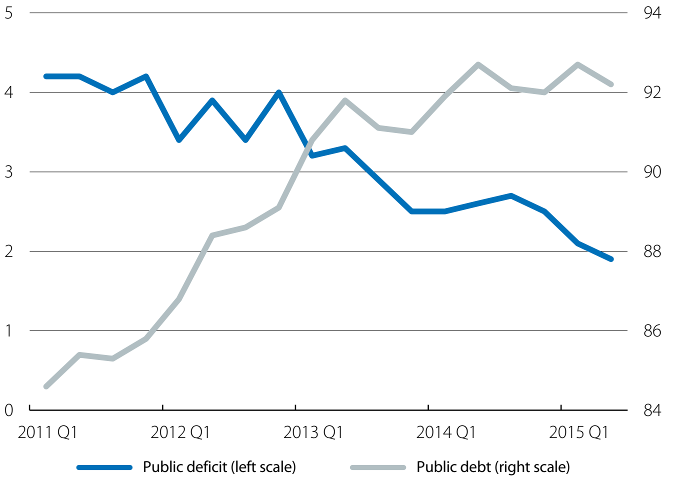
Banks tightening (+) or relaxing (-) conditions for granting loans (net %)



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

Euro area: public deficit and debt

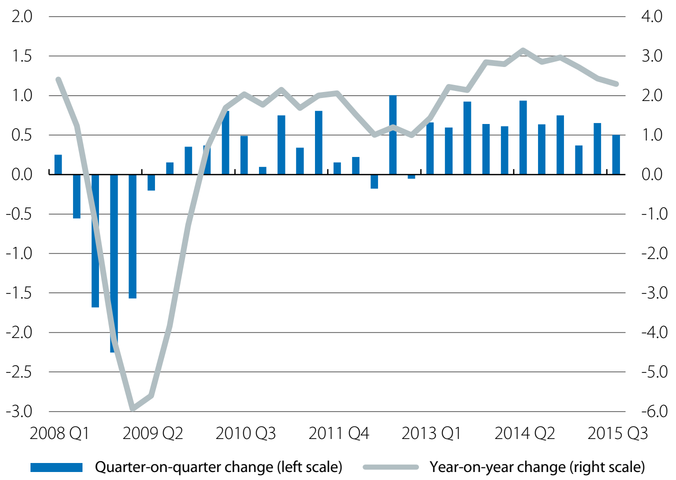
(% of GDP) *(% of GDP)*



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

United Kingdom: GDP

Quarter-on-quarter change (%) *Year-on-year change (%)*



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

FOCUS · The Beveridge curve and the mismatching of professional skills in the euro area

The Beveridge curve shows the relationship between the unemployment and the job vacancy rates. Movements throughout the curve, when job vacancies and unemployment move in opposite directions, show the impact of cyclical fluctuations in economic activity on these variables. An expansionary phase is therefore characterised by low unemployment and a high job vacancy rate while a recessionary phase is the opposite situation. On the other hand outward movement by the whole curve; i.e. when there is a higher unemployment rate for the same job vacancy rate, points to a possible deterioration in the matching process. This phenomenon, when it is much more difficult to fill a vacancy and therefore a lot of companies believe a labour shortage is limiting their production, is associated with a larger mismatch between the skills required by firms and those available in the labour force.[1]

The Beveridge curve for the euro area moved outwards during the crisis (see the first graph) and, except for Germany, all countries saw a deterioration in the matching of the labour market to a greater or lesser extent. It is significant that the influence of the improved economic cycle can already be seen on the curve although there has not been, for the moment, any shift inwards or, in other words, more efficient matching.

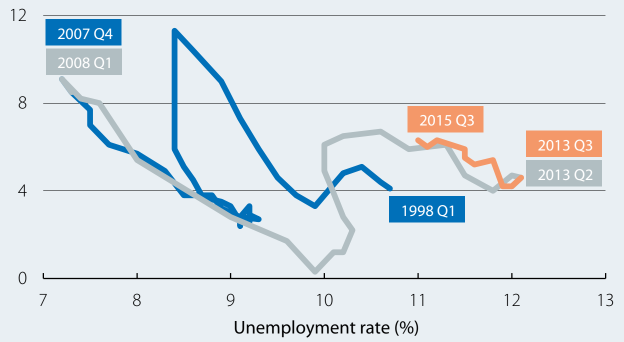
One way of assessing the effect of skills mismatch on the matching process is provided by the skills mismatch index (SMI) which compares the level of education of the working age population (which would represent the labour supply) with those in employment (similar to the demand).[2] This index increases as the gap between the qualifications of these two groups widens, something which occurred in the euro area during the recession when the SMI tripled. Spain was mainly responsible for this growth (see the second graph), which comes as no surprise given the nature of its crisis, closely linked to real estate whose labour force is typically less highly qualified. The case of Ireland is similar because it also experienced a shock in the construction industry, albeit less severe. This index appears to be improving in both countries as the economic environment recovers but it is falling very slowly since a large part of the rise in the SMI was due not only to cyclical factors but also to structural.

In the rest of the countries the crisis was concentrated less in one specific sector so the trend in their SMI should be less dependent on the economic cycle. In fact, the increase observed in France, for example, is gradual, suggesting that the mismatch in the French labour market is gradually increasing and is structural in nature. Once again the notable exception was the German SMI, following a downward trend and helping its labour market to perform well. Lastly other economies such as the Netherlands have a very low level of skills mismatch, something which undoubtedly makes their matching process much more efficient.

To sum up, in most euro area countries the increase in skills mismatch is making the labour market's matching process more difficult. Although part of this change has been cyclical and will therefore reverse with the economic recovery, another significant portion is structural. Hence the need for greater coordination between passive and active policies and to promote training programmes that help to match the human capital of the unemployed with companies' needs.

The Beveridge curve in the euro area

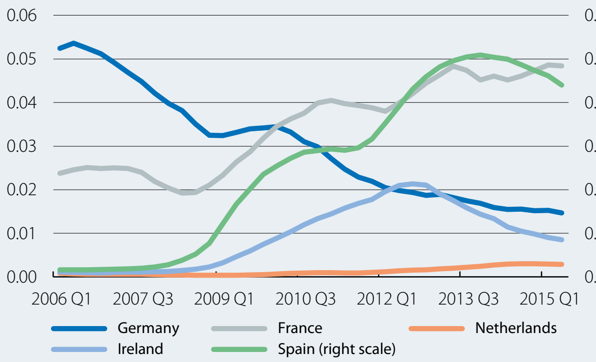
*Companies where the labour factor limits production * (% of total)*



Note: ** Quarterly survey on industries carried out by the European Commission. Provides details on the percentage of respondents mentioning that a labour shortage has been one of the factors limiting their production over the previous three months.*
Source: *CaixaBank Research, based on data from Eurostat and the European Commission.*

Skills mismatch in the labour market of euro area countries

*Index **



Note: ** Average of four quarters.*
Source: *CaixaBank Research, based on Eurostat data.*

1. Changes in how labour market institutions operate can also move the Beveridge curve.
2. $SMI_{it} = \sum_{j=1}^{3}(A_{ijt} - E_{ijt})^2$ where A_{it} is the % labour force (and E_{it} is the % employed) with educational level *j* and in country *i* during the period *t*. An increase in the index indicates a growing gap between the qualifications of employed people and of the working age population. A more detailed discussion of the reliability of this index can be found in «Euro Area Labour Markets and the Crisis», Occasional Paper Series 138 – 2012, ECB.

FOCUS · The French government's commitment to reforming the French economy: one for all and all for one?

The French government presented its Budget for 2016 at the end of September, continuing the relative fiscal consolidation underway for several years now and predicting a gradual recovery for the French economy which should achieve GDP growth of 1.5% in 2016 (a realistic forecast but not without risk according to the *Haut Conseil des Finances Publiques*). The deficit is also expected to fall from the level of 3.8% in 2015 to 3.3% in 2016, a reduction that would be almost entirely due to a decrease in the structural deficit, going from 1.7% in 2015 to 1.2% in 2016, in particular thanks to efforts made to contain expenditure. It should be noted that this reduction is being carried out at the same time as a significant cut in the tax burden, both for companies and households.[1] Apart from this effort with the public accounts, the French government is also undertaking other reforms to boost its economy. Let us analyse the most important ones in more detail.

A considerable proportion of the agenda of reforms is related to helping French firms regain the competitiveness they had lost. To this end a tax credit has been introduced, as well as a reduction in Social Security contributions for companies, known as the *Crédit d'impôt pour la compétitivité et l'emploi* (CICE) and the *Pacte de responsabilité et de solidarité*, respectively. Both measures reduce the cost of the labour factor for firms. The Macron Act was also passed in 2015 to liberalise markets and boost activity, introducing measures in a range of areas, from extending shop opening times to Sundays and liberalising the coach service and various regulated professions, such as public notaries, to speeding up legal proceedings in employment tribunals and reducing dismissal costs for SMEs.

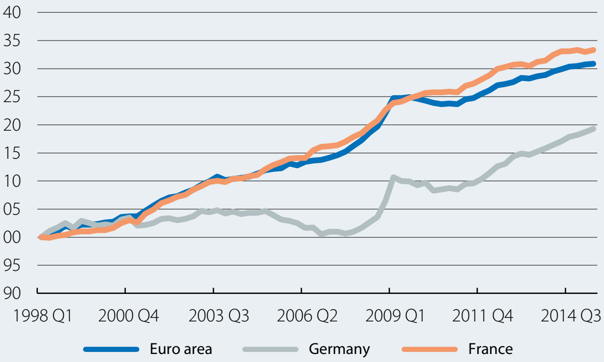
It has also recently been announced that the labour market will be reformed in the near future in order to make it more flexible, with the first draft planned for the beginning of 2016. This reform aims to simplify the employment legislation contained in the *Code du travail*,[2] whose current version runs to almost 3,000 pages. It also aims to reform collective bargaining and bring this process to the level of companies, further establishing the temporary nature of agreements, in line with the guidelines of the *Rapport Combrexelle*. Although the draft has yet to be drawn up, the government has already established three red lines: there will be no modifications to the 35-hour working week, the minimum wage or employment contracts. Another notable reform aimed at making the French labour market more flexible is the creation of an individual account that would cover the rights of unemployment, training, etc. Its aim is to focus on protecting workers' rights instead of specific jobs to maintain the degree of protection enjoyed by workers at the same time as improving the labour market's ability to adapt to economic conditions.

The French government is introducing these initiatives with the aim to create a more flexible, competitive and enterprising economy. France's Economy Minister believes this is being accomplished, stating «the word entrepreneur, let us never forget, is a French word». Nevertheless, although the reforms announced are in the right direction there are too many red lines and there is still a lot of room for improvement. The government's leeway is limited given the extensive response of society with a busy electoral calendar. In any case, it is vital for France to energise its economy as soon as possible and for all those involved to put their shoulder to the wheel.

1. The Budget predicts that, in 2013, companies will save 13.5 billion euros with the *Crédit d'impôt pour la compétitivité et l'emploi* (CICE) and 18 billion with the *Pacte de responsabilité et de solidarité*. Households will also see a 5 billion euro reduction in income tax.
2. The *Code du travail* includes legislation for employment contracts, collective bargaining and other employment-related aspects such as health and safety, training, etc.

Unit labour costs *

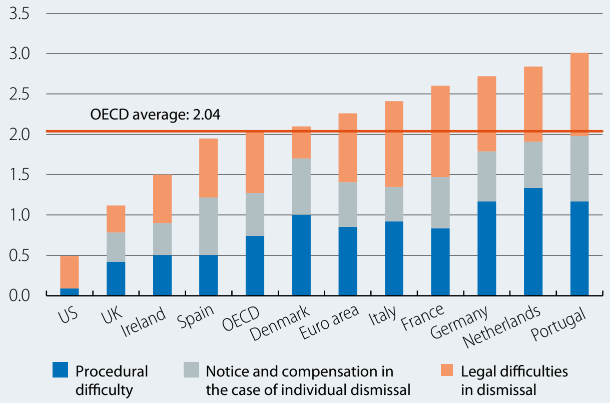
Index (100 = 1998 Q1)



Note: ** Unit labour costs correspond to the quotient between labour compensation per employee and labour productivity (measured as GDP in real terms by employee).*
Source: *CaixaBank Research, based on OECD data.*

Index of rigidity in permanent employment contracts *

Scale (0-6), the higher the number, the greater the rigidity



Note: ** The euro area is the average of 15 countries; the 19 countries less Malta, Lithuania, Latvia and Cyprus.*
Source: *CaixaBank Research, based on OECD data.*

KEY INDICATORS

Activity and employment indicators

Values, unless otherwise specified

	2013	2014	2014 Q4	2015 Q1	2015 Q2	07/15	08/15	09/15	10/15
Retail sales *(year-on-year change)*	–0.8	1.2	1.8	2.1	2.3	3.0	2.3	...	...
Industrial production *(year-on-year change)*	–0.7	0.7	0.3	1.6	1.3	1.7	0.9	...	...
Consumer confidence	–18.7	–10.1	–11.3	–6.3	–5.3	–7.2	–6.9	–7.1	–7.7
Economic sentiment	93.8	101.6	100.8	102.6	103.7	104.0	104.1	105.6	105.9
Manufacturing PMI	49.6	51.8	50.5	51.4	52.2	52.4	52.4	52.0	52.0
Services PMI	49.3	52.5	51.7	53.5	54.1	54.0	54.3	53.7	54.2
Labour market									
Employment (people) *(year-on-year change)*	–0.7	0.6	0.8	0.8	0.9	–	...	–	–
Unemployment rate: euro area *(% labour force)*	12.0	11.6	11.5	11.2	11.0	10.9	10.9	10.8	...
Germany *(% labour force)*	5.2	5.0	4.9	4.8	4.7	4.6	4.5	4.5	...
France *(% labour force)*	10.3	10.3	10.5	10.4	10.4	10.6	10.8	10.7	...
Italy *(% labour force)*	12.2	12.7	12.8	12.3	12.4	12.0	11.9	11.8	...
Spain *(% labour force)*	26.1	24.5	23.7	23.1	22.5	22.0	21.8	21.6	...

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

	2013	2014	2014 Q4	2015 Q1	2015 Q2	07/15	08/15	09/15
Current balance: euro area	**2.0**	**2.5**	**2.5**	**2.7**	**3.0**	**3.1**	**3.1**	**...**
Germany	6.4	7.4	7.4	7.6	7.9	8.1	8.1	...
France[1]	–0.8	–0.9	–0.9	–0.5	0.0	0.0	0.0	...
Italy	0.9	1.9	1.9	2.0	2.1	2.0	2.0	...
Spain	1.5	1.0	1.0	1.2	1.4	1.5	1.5	...
Nominal effective exchange rate[1] *(value)*	**101.2**	**101.8**	**99.0**	**93.0**	**91.1**	**91.3**	**93.0**	**93.8**

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

	2013	2014	2014 Q4	2015 Q1	2015 Q2	07/15	08/15	09/15
Private sector financing								
Credit to non-financial firms[1]	–2.6	–2.6	–1.7	–0.8	–0.4	0.3	0.4	0.1
Credit to households[1, 2]	–0.2	–0.1	0.1	0.2	0.5	0.9	1.0	1.1
Interest rate on loans to non-financial firms[3] *(%)*	2.2	2.0	1.8	1.7	1.6	1.5	1.4	...
Interest rate on loans to households for house purchases[4] *(%)*	2.8	2.6	2.4	2.2	2.0	2.1	2.1	...
Deposits								
On demand deposits	7.8	6.1	7.3	9.8	11.8	13.0	12.1	12.4
Other short-term deposits	–0.1	–2.0	–2.0	–3.2	–4.0	–4.7	–4.5	–4.7
Marketable instruments	–14.9	–7.2	1.3	3.9	5.6	2.7	2.4	0.5
Interest rate on deposits up to 1 year from households *(%)*	2.0	1.3	1.0	1.0	0.9	0.7	0.7	...

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 recovery is still robust but its pace is weakening

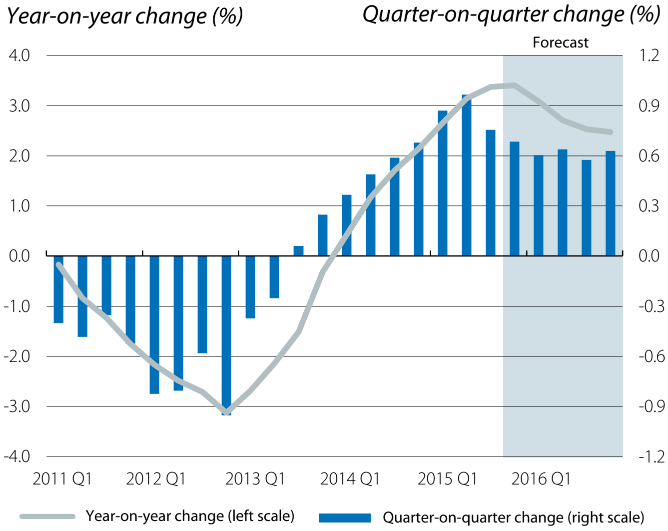
The Spanish economy has now embarked on a phase of more contained expansion after a first half of the year with dynamic growth. In Q3 the rate of growth in GDP stood at 0.8% quarter-on-quarter (in Q2 it was 1.0%). This slight slowdown, in line with expectations, is due to the temporary support factors that had boosted the recovery coming to a gradual end. Pending more details regarding the specific components, leading indicators point to domestic demand still being the main engine of growth although private consumption may have lost some of its energy due to a less dynamic labour market. In any case the good trend observed in fundamentals such as the revival in credit and the recovery of the real estate sector suggests that growth will remain above 2% in the medium term.

These good prospects have led the credit agency S&P to upgrade Spain's rating, also helped by a positive evaluation of the structural reforms carried out over the last few years, the improvements made in competitiveness and favourable developments in fiscal consolidation. However, it should be noted that some downside risks still remain, such as high debt, especially if this ends up exceeding 100% of GDP. This circumstance reminds us of just how important it is for the government not to relax its process of reducing the fiscal deficit.

Business indicators run out of steam in Q3 but are still at significant levels. On the supply side, industrial production grew by 2.4% year-on-year in August, a brisk rate of growth but lower than the figure posted in the preceding quarter (3.5%). Moreover the composite business sentiment index (PMI) fell to 57.2 points on average for Q3, also slightly below the average for Q2 (57.7 points), with the decline in manufacturing being more marked than in services. Demand indicators suggest that private consumption is running out of steam slightly: consumer confidence for Q3 (–1.3) was lower than in Q2 (1.6) although still far above the historical average (–13.6), so we expect consumption to continue supporting growth.

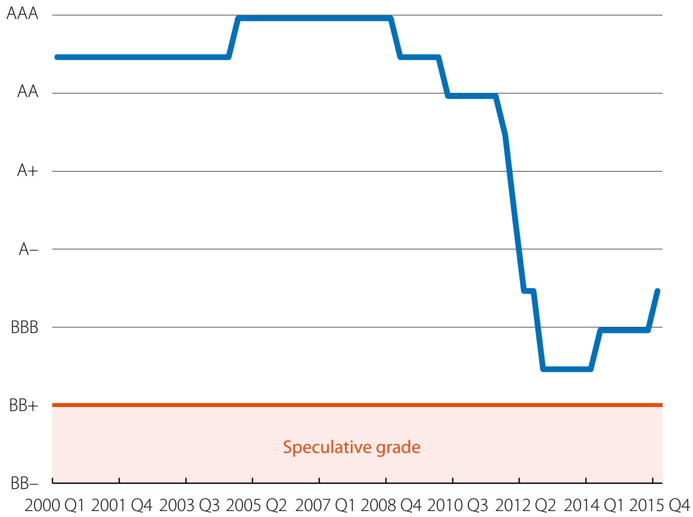
Employment saw a strong increase in Q3 in spite of a slowdown compared with Q2 (from 1.0% quarter-on-quarter to 0.6%, seasonally adjusted). In year-on-year terms the increase was 3.1%, slightly above the figure for Q2. Although the improvement was concentrated in services in Q3, for the year to date the net creation of jobs has consolidated in all sectors. Should this trend continue, the number of jobs created in 2015 might exceed half a million although the fact that these new jobs are largely temporary suggests that any gains in labour productivity are likely to be limited. Specifically, by type of contract, in Q3 the year-on-year growth rate for

GDP



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

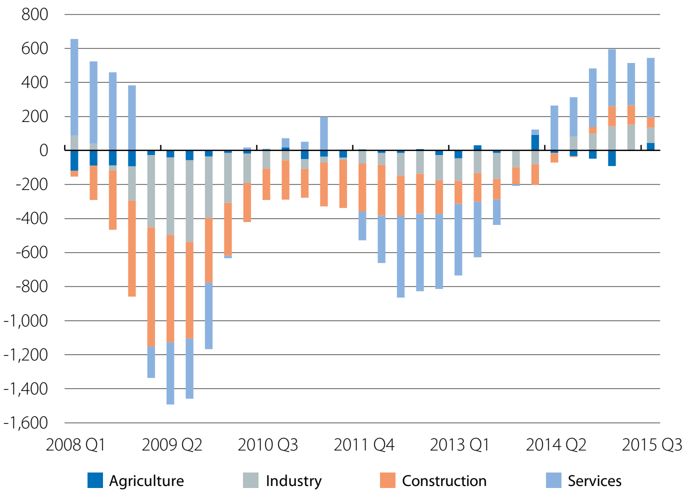
Credit rating of the S&P agency



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

Employment by sector

Year-on-year change (thousands)



Source: *CaixaBank Research, based on INE data (LFS).*

salaried workers with permanent contracts stabilised at 1.6% while the corresponding rate for temporary employees increased to 10.1%. Given this trend, the temporary employment ratio has risen by 1.6 pps since last year, up to 26.2%.

Unemployment fell by 1.2 pps in Q3 to 21.2%, thanks to an increase in employment but also helped by an unexpected reduction in the labour force (of 116,000 people). This decrease in the total labour force, interrupting the growth recorded during the first half of the year, has come as some surprise in a context of economic recovery. We should also note that this drop was not the result of an increase in retirement as most of the decrease took place in the age group of 26 to 55 year olds.

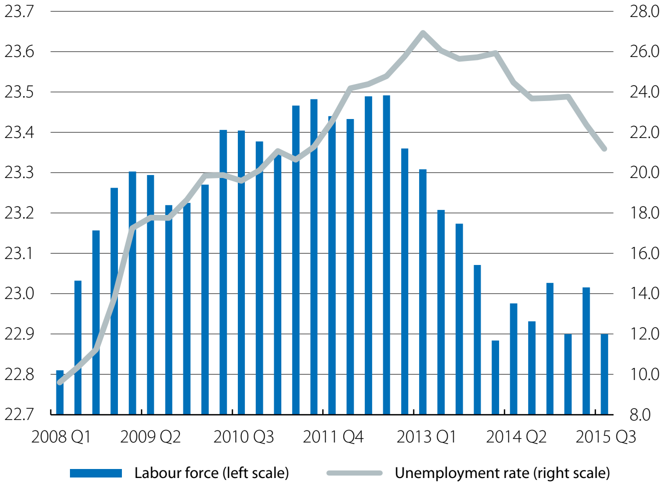
The pace of job creation improves the net financial wealth of households. This grew by 6.8% year-on-year in Q2, totalling 1.26 trillion euros (close to the levels of 2000). On the one hand, the rise in the number of employees has helped to increase the wage income, the most important income received by households. Households have made use of this higher income to acquire financial assets (especially stock prices and investment funds) and this circumstance, together with gains in shares over the same period, has considerably pushed up the value of financial assets and, consequently, net wealth. To a lesser extent households also used their improved income to reduce their mortgage debt so that long-term financial liabilities continued to fall (for a more detailed discussion of this area, see the Focus «Perspectives on household consumption and savings» in this same Report).

The drop in inflation slows down, with the CPI shrinking by 0.7% in October, 0.2 pps less than the previous month. This progress is probably due to fuels and lubricants whose prices will have fallen less than in 2014. Core inflation, unaffected by fluctuations in energy and fresh foods, is likely to have risen slightly. With the announcement of these figures, the risks of the inflation forecast for the whole of 2015 have remained balanced (–0.4% for the general rate and 0.6% for core inflation). Judging by the non-energy component of industrial prices, to some extent an approximation of the trend in the CPI for the coming months, inflation will continue to recover but only gradually. Specifically, in September the rate of year-on-year growth for this indicator fell by 0.2 pps to 0.4% although it has been in positive figures since February (–0.4% in September 2014). Nonetheless, it should be noted that, with the disappearance of the base effect from the slump in oil prices that occurred in December 2014, the inflation rate will rise considerably at the end of this year and reach clearly positive figures (0.9% in December).

Exports continue to provide good news, growing by 5.8% year-on-year in August in cumulative terms over the last three months, even though the most recent figure, corresponding to the month of August, was slightly weaker than expected due to the strong negative contribution to export growth from the sector of energy products. In August, the boost for demand

Labour force and unemployment rate

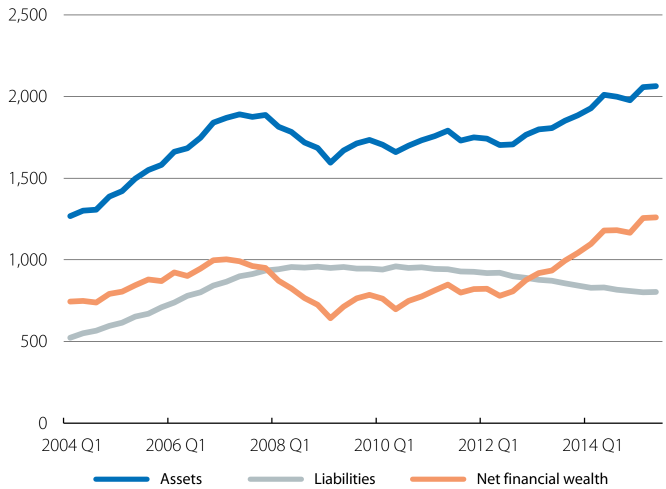
(Million) *(% of the labour force)*



Source: *CaixaBank Research, based on INE data (LFS).*

Household financial wealth

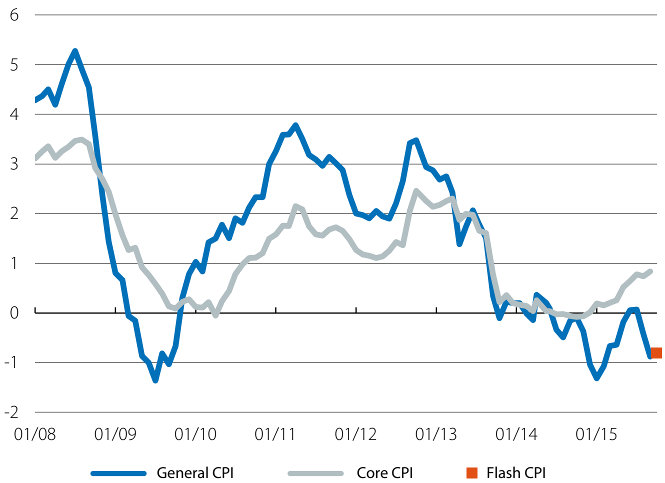
(Billions)



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

CPI

Year-on-year change (%)



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

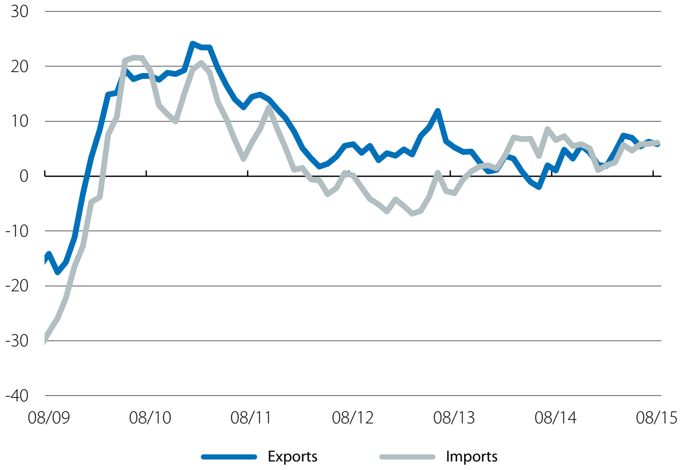
provided by industrial orders from the euro area suggests that foreign sales should go on growing considerably. On the other hand tourism continued its exceptional performance in September with 7.2 million international tourists coming to Spain, 2.2% more than in September 2014. This good performance by the foreign sector should continue, supported by the expected depreciation in the euro after the ECB announced its readiness to make use, if necessary, of the flexibility offered by the current asset purchase programme regarding its size, composition and duration.

The recovery in the real estate market is becoming increasingly evident. According to data from the Ministry of Public Works, 35,790 residential properties were started in 2014, representing growth of 0.1% compared with the previous year, the first advance since the start of the crisis. Nonetheless the same improvement has yet to be seen in the number of housing completions, which is still shrinking (falling by 25% year-on-year in June (cumulative over 12 months). This factor, together with the upswing in sales (growing in August by 12.8% year-on-year, cumulative over 12 months), is helping the excess stock of empty housing for sale to gradually decrease (see the Focus «The upswing in demand for real estate is reviving activity in construction» in this same Report). The trend in mortgages is another sign that the recovery in the real estate sector is consolidating. The number of mortgages for residential properties was 25.8% higher in August than the figure for the same month in 2014, albeit still at a low level (19,272 compared with 90,763 in August 2007).

Considerable adjustment in the deficit, although not enough to meet the target. The public deficit stood at 2.4% of GDP in September (compared with 3.1% in the same month of 2014). This is largely due to higher tax revenue and, to a lesser extent, spending cuts. For its part, the deficit of the autonomous communities, 0.7% in August, was also lower than its 2014 counterpart. Nevertheless, in spite of this improvement in the deficit for different public administrations, the rate of adjustment might not be enough to meet the target agreed with Brussels. For instance, if the public deficit fell at the same rate in the second half of 2015 as it did in the second half of 2014, it would end the year at 4.7% (when the target is 4.2%). Given this situation, the European Commission has warned of the risks of deviating from this target and has criticised the government for the lack of structural measures in the 2016 Budget. Moreover, the downward revision of the historical GDP series and the limited increase in the GDP deflator are additional risk factors for meeting this target.

*International trade of goods **

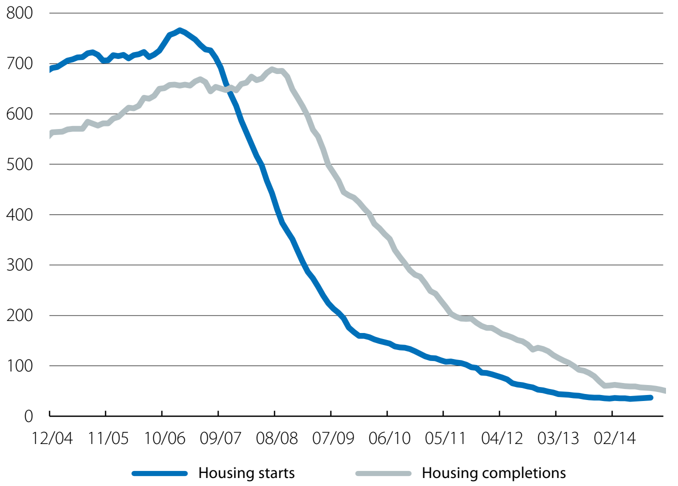
Year-on-year change, cumulative over 3 months (%)



Note: ** Nominal data.*
Source: *CaixaBank Research, based on data from the Customs Dept.*

Housing starts and completions

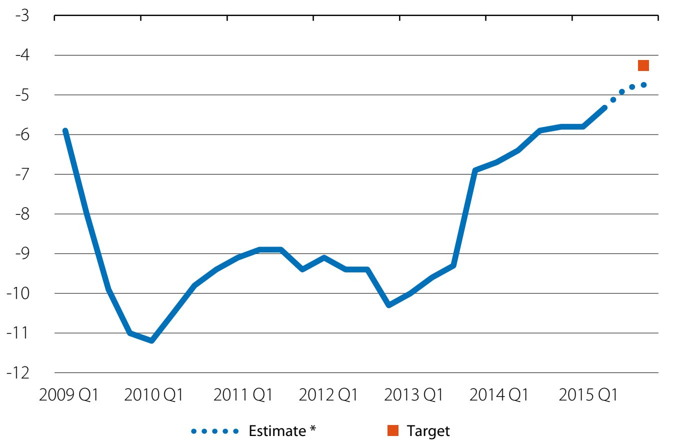
Cumulative figures over 12 months (thousands of residential properties)



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

Public deficit

Cumulative figures over four quarters (% of GDP)



Note: ** Expected trend in the deficit if the adjustment in the second half of 2015 is the same as in the second half of 2014.*
Source: *CaixaBank Research, based on INE data.*

FOCUS · The upswing in demand for real estate is reviving activity in construction

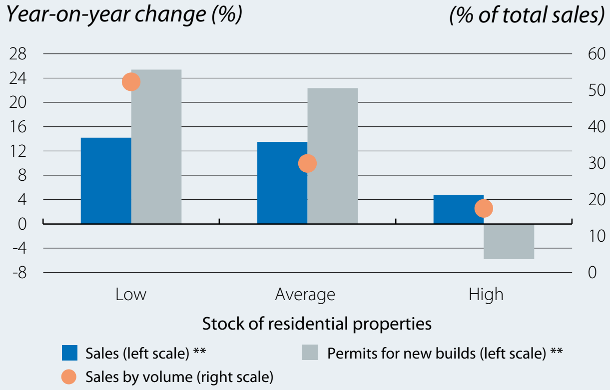
The recovery in the real estate market is gradually taking shape. Demand has been growing for more than one year now and has been gaining traction in the last few months as financial conditions have improved. Activity in the construction industry is still weak with regard to supply but there are some signs of a recovery on the horizon, such as the favourable trend in building permits and the upswing in residential investment.[1] This low level of activity, together with the growth in sales, is helping to gradually reduce the high level of stock of new residential properties available for sale. Although the panorama is encouraging on the whole, there are significant differences at a sub-market level and this heterogeneity, typical of the sector, makes a more detailed analysis essential.

There are markedly disparate trends between provinces. As can be seen in the first graph, those provinces with a lower stock of residential properties for sale[2] are the ones with the highest volume of demand (accumulating 50% of all sales) and where growth in sales is strongest. They are also the provinces where construction has started to pick up: concentrating more than 50% of the permits given for new builds in the country as a whole. However, the panorama is less favourable for those provinces with a large stock of residential properties for sale: the recovery in demand is more moderate and the construction industry has yet to show signs of improvement (the number of applications for new building permits was still shrinking in July, as can be seen in the graph).

In fact, this disparity between provinces is so great that some zones are likely to go through a shortage of homes for sale while others still have an overabundant supply. If the current trends in supply and demand continue over the next few quarters, as is assumed by our forecast scenario, those provinces with little stock and high demand could begin to be in short supply by the end of 2016. Specifically, the level of stock of new, completed residential properties for sale would be below the equilibrium level, which is generally around 0.75 years of sales required to reduce the stock to zero. Little can now be done in 2015 as the homes that will be completed this year started to be built around 18 months ago (the average time required to build a residential property). However, by the end of 2016 the recovery in the construction industry should gain traction as the lack of supply in some zones becomes evident, preventing the situation from getting any worse.

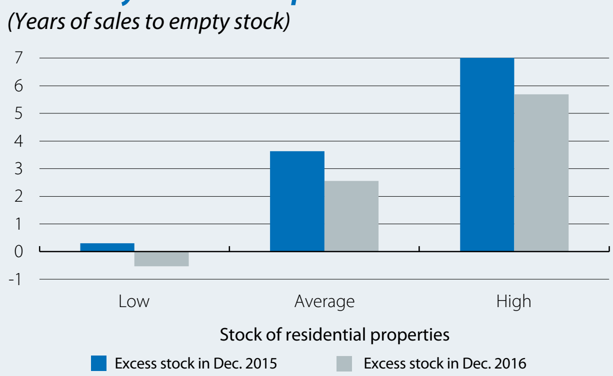
In summary, the recovery in the economy as a whole has now reached the construction sector. Over the coming quarters the upswing in residential investment is likely to be particularly strong in some zones; otherwise, it would not be surprising to see temporary upward pressure on house prices in those zones with a limited supply.

Trend in sales and permits by stock in the provinces *



Notes: ** The provinces are ordered from lower to higher stocks of new residential properties for sale in relation to the total stock of residential properties in 2014 and the cut-off value for the three groups is the percentile 1/3 and 2/3. ** Data from July 2015, cumulative over 12 months.*
Source: *CaixaBank Research, based on data from the Ministry of Public Works and the Spanish Statistics Institute (INE).*

Excess stock of new residential properties for sale by stock in the provinces *



Note: ** The provinces are ordered from lower to higher stocks of new residential properties for sale in relation to the total stock of residential properties in 2014 and the cut-off value for the three groups is the percentile 1/3 and 2/3. * Estimate based on sales that will slow down to 8% year-on-year in 2015 and to 7.5% in 2016.*
Source: *CaixaBank Research, based on data from the Ministry of Public Works and the Spanish Statistics Institute (INE).*

1. Although permits for new builds rose by 19% year-on-year in July in cumulative terms over 12 months, the starting point is low.
2. In the group of provinces with a low stock of new residential properties for sale are Madrid, Huelva, Ourense, Cantabria and Bizkaia, among others. In the group with an average stock are Barcelona, Palencia, Seville and Zaragoza, among others. The group with a large stock includes Toledo, La Rioja, Lleida, Castellón and Ciudad Real, among others.

FOCUS · Perspectives on household consumption and savings

One of the main engines of the Spanish economy's recovery is household consumption. According to the latest data available, corresponding to 2015 Q2, growth in private consumption in nominal terms speeded up to 1.8% year-on-year (cumulative over 4 quarters).[1,2] This increase is being supported by the upswing in nominal gross disposable income (1.9% year-on-year), allowing the household savings rate to remain almost stable at around 9.5%, a figure only slightly below the historical average of 9.7%. Given that the economy is now entering a phase of more moderate rates of growth and job creation, this Focus analyses the role that might be played by the dynamics in consumption and savings to cushion this slowdown.

One fundamental decision taken by households is how much of their disposable income should be consumed and how much should be saved. A balanced consumption pattern is one that is based on growth in disposable income in the medium term, but consumption and income may diverge over the short term. Households might reduce their consumption (and increase their savings) under more uncertain economic conditions, as occurred in Spain in 2009 when the household savings rate exceeded 13.0%. As a result of this increase in precautionary savings, Spanish households accumulated liquid financial assets (deposits and cash) totalling around 50 billion euros (see the Focus «The financial wealth of households: a buffer for consumption» in MR12/2014). On other occasions, when the economic climate is more favourable and looks like improving, households may decide to temporarily increase their consumption (and reduce their savings) above their income level with the aim of smoothing consumption over time. Below we argue that this second situation may occur over the next few quarters.

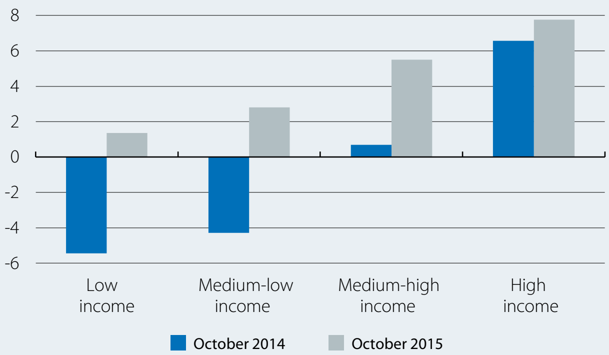
The survey carried out every month by the European Commission to draw up the consumer confidence index asks households about their intention to spend on durables over the next 12 months. As can be seen in the graph, the highest income households are the ones which, since last year, have had greater expectations of buying this kind of product. These households are possibly the ones that have led the recovery in consumption, making purchases that had been postponed during the recession due to the high degree of uncertainty.

However, it is in medium and low-income households where the biggest change in intention to buy can be found: while they were not very willing to make large purchases one year ago, they now expect to do so over the next 12 months. When these lower income households start to consume, the savings rate is likely to fall to some extent over a few quarters: according to our forecasts, it will follow a slightly downward trend next year as we predict an increase in nominal consumption (of 3.5%) that is a little higher than the increase in gross disposable income (of 3.2%). Consequently, although consumption will continue to be supported by growth in income (thanks especially to job creation and, to a lesser extent, to the positive impact of low interest rates), we expect a slight fall in the savings rate to act as an additional mechanism to boost consumption.

In any case, if the savings rate remained at its current level throughout 2016, consumption would only be 0.3 pps lower than the forecast (3.2% instead of 3.5%). On the other hand, if the savings rate fell by 1 pp more than expected, nominal consumption would rise by an additional 1.1 pps, to 4.6%. In summary, an analysis of the expected trend in consumption and savings next year diminishes concerns regarding the impact on activity of the expected slowdown in the rate of job creation.

Intention to buy durables by household income level

Spread compared different with historical average (%)



Note: *Answer to the question whether they expect to make large purchases (such as, furniture, domestic appliances or electronic equipment) over the next 12 months.*
Source: *CaixaBank Research, based on European Commission data.*

1. Year-on-year growth in nominal consumption, non-cumulative over 4 quarters, stood at 2.6% in Q2. In this Focus the data are cumulative over the last 4 quarters because this is the customary way to calculate the savings rate.
2. According to the new GDP series published by the INE on 30 October. The revision of the historical GDP series revealed that consumption was less dynamic than previously estimated. Specifically, in 2014 real consumption grew by 1.2% and nominal by 1.4%, below the estimation of 2.4% in both cases before the revision.

FOCUS · The new resolution framework for credit institutions in Spain

The international financial crisis highlighted the need for a regulatory framework with specific powers and tools to intervene quickly in financial institutions facing problems at the lowest cost for the public treasury. With this aim in mind, in 2014 the EU approved the Bank Recovery and Resolution Directive (BRRD) and the government recently approved the law transposing this Directive into Spanish legislation.

This law contains two fundamental mechanisms to handle a situation of severe weakness in a financial institution: early intervention and resolution. It also sets up a preventative resolution authority (the Bank of Spain or BdE in Spanish) and an executive authority (Fondo de Reestructuración Ordenada Bancaria or FROB).

In the area of early intervention, the law requires all banks to draw up a precautionary recovery plan that must be approved by the supervisor (the ECB in the case of the 13 largest banks and the BdE for the rest). This plan must contain the actions that can be used by the institution (for example, in the area of capital and liquidity) to restore its financial position should this deteriorate. Early intervention will start at the request of the competent supervisor, when the bank fails to comply, or is expected not to comply, with solvency regulations but is expected to be able to comply with these in the future via its own means. Within this scenario, the supervisor can force the institution to adopt the measures contained in its recovery plan and also, if deemed necessary, make changes in the bank's strategy, remove members of the Board or management and, in more extreme cases, intervene in the bank should the previous measures turn out to be insufficient.

In the area of resolution, the Act requires the preventative resolution authority (BdE), under the direction of the Single Resolution Board at the European level and in collaboration with each bank, to draw up a resolution plan describing those actions which, if necessary, the executive resolution authority (FROB) can apply to «resolve» a bank. This plan shall not assume the existence of state financial aid. At the request of the relevant supervisor and after prior consultation with the BdE and FROB, the resolution process begins when a bank becomes no longer viable or is expected to become so in the near future, when this situation cannot be avoided using early intervention and when it is in the public interest to prevent the bank from going into liquidation. In such circumstances the FROB will replace the bank's governing body and will implement the resolution tools that are available and deemed necessary.

The range of tools includes the sale of business, transferring its assets or liabilities to a bridge bank, transferring its assets or liabilities to an asset management company and internal recapitalisation or bail-in.

Undoubtedly the bail-in measure, which comes into force in January 2016 and requires a bank's creditors to absorb losses, is one of the cornerstones of the resolution framework. Thus, the bail-in establishes the elegible liabilities that can be written down or converted into capital to recapitalise the bank, following a pre-determined seniority and ranking: shareholders are the first to absorb losses, followed by holders of hybrid and subordinated debt, etc. Deposits up to 100,000 euros are guaranteed by the Deposit Guarantee Fund (DGF) and covered bonds guaranteed by a portfolio of mortgage loans are excluded from this list, among others.

Regarding the bail-in, as from January 2016 the resolution authorities must establish a minimum requirement for own funds and eligible liabilities (MREL) for each bank, based on its risk profile and other specific characteristics. The aim of the MREL is to ensure that the bank has enough capital and eligible liabilities to absorb losses as well as to adequately recapitalise once the resolution plan has been implemented. In any case this minimum requirement will be at least 8% of the bank's balance sheet.

When applying a resolution process, and after recurring to a minimum bail-in of 8% of the balance sheet, banks will be able to use the Resolution Fund (RF) set up by the sector to complete their recapitalisation needs, up to a maximum of 5% of their balance sheet. If more funds are required, the bail-in will continue to be applied following the pre-established seniority and ranking. In the unlikely event of guaranteed deposits being reached the DGF would assume the cost. There is also the option of using public funds instead of extending the bail-in to uncovered deposits to avoid financial instability situations. A state could use EU funds (ESM) from other countries under rules which have yet to be specified.

It seems evident that these resolution rules will result, as is the aim, in minimising the cost of possible banking crises for a country's public treasury. However, we must not forget that, in the short term, banks will have to issue new and relatively costly liabilities in order to meet the MREL requirements and that this will push up their funding costs, which could have adverse macroeconomic effects. Because, as is often quoted by economists, «there is no such thing as a free lunch».

KEY INDICATORS

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

Activity indicators

	2013	2014	2014 Q4	2015 Q1	2015 Q2	07/15	08/15	09/15	10/15
Industry									
Electricity consumption	–2.1	–0.1	–1.6	1.2	–0.1	6.0	2.0	–0.7	...
Industrial production index	–1.5	1.3	0.3	1.5	3.5	5.8	2.4	...	...
Indicator of confidence in industry *(value)*	–13.9	–7.1	–5.3	–3.2	0.9	–0.9	1.6	1.4	–0.7
Manufacturing PMI *(value)*	48.5	53.2	53.7	54.4	54.8	53.6	53.2	51.7	...
Construction									
Building permits *(cumulative over 12 months)*	–36.3	–7.7	4.0	12.1	17.0	18.8	19.0	...	...
House sales *(cumulative over 12 months)*	0.4	–5.6	0.3	8.9	10.2	10.9	12.8	...	...
Services									
Foreign tourists	5.8	7.2	5.4	5.2	3.7	6.3	1.6	2.2	...
Services PMI *(value)*	48.3	55.2	54.3	56.7	58.3	59.7	59.6	55.1	...
Consumption									
Retail sales	–3.7	1.0	2.8	2.5	2.9	3.6	2.3	3.6	...
Car registrations	5.6	18.4	21.7	31.4	13.6	23.5	23.3	22.5	...
Consumer confidence index *(value)*	–25.3	–8.9	–9.6	–0.6	1.6	0.0	–1.3	–2.6	–1.2

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

Employment indicators

	2013	2014	2014 Q4	2015 Q1	2015 Q2	07/15	08/15	09/15
Registered as employed with Social Security [1]								
Employment by industry sector								
Manufacturing	–4.3	0.1	0.9	1.5	2.2	2.4	2.4	2.4
Construction	–12.1	–1.6	1.6	4.6	5.6	4.9	4.5	4.5
Services	–2.0	2.2	2.8	3.5	3.7	3.6	3.4	3.4
Employment by professional status								
Employees	–3.8	1.4	2.3	3.0	3.8	3.7	3.5	3.5
Self-employed and others	–0.6	2.2	2.5	2.4	2.2	1.9	1.7	1.6
TOTAL	**–3.2**	**1.6**	**2.3**	**2.9**	**3.5**	**3.4**	**3.2**	**3.2**
Employment [2]	**–2.8**	**1.2**	**2.5**	**3.0**	**3.0**	**–**	**3.1**	**–**
Hiring contracts registered [3]								
Permanent	–14.2	18.8	23.0	24.1	7.7	8.6	10.1	10.4
Temporary	6.4	13.1	7.7	12.2	11.2	9.2	10.0	9.8
TOTAL	**4.0**	**13.4**	**8.8**	**13.2**	**10.9**	**9.1**	**10.0**	**9.9**
Unemployment claimant count [3]								
Under 25	–6.2	–8.2	–6.9	–9.8	–9.3	–14.3	–13.4	–12.4
All aged 25 and over	3.7	–5.3	–5.7	–6.1	–7.4	–7.9	–7.6	–7.5
TOTAL	**2.7**	**–5.6**	**–5.8**	**–6.5**	**–7.6**	**–8.5**	**–8.1**	**–8.0**

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

	2013	2014	2014 Q4	2015 Q1	2015 Q2	07/15	08/15	09/15	10/15
General	**1.4**	**–0.1**	**–0.5**	**–1.0**	**–0.3**	**0.1**	**–0.4**	**–0.9**	**–0.7**
Core	1.5	0.0	0.0	0.2	0.5	0.8	0.7	0.8	...
Unprocessed foods	3.6	–1.2	0.8	0.3	1.9	1.7	2.7	2.6	...
Energy products	0.1	–0.8	–4.3	–9.7	–6.4	–5.8	–9.8	–13.6	...

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

	2013	2014	2014 Q3	2014 Q4	2015 Q1	2015 Q2	07/15	08/15
Trade of goods								
Exports *(year-on-year change)*	5.2	2.5	4.8	4.3	4.4	5.4	8.9	–0.8
Imports *(year-on-year change)*	–1.3	5.7	7.3	5.0	2.5	5.8	6.4	1.5
Current balance	**15.6**	**10.2**	**7.5**	**10.2**	**12.1**	**15.0**	**16.2**	**15.8**
Goods and services	33.5	26.0	25.6	26.0	27.4	27.6	28.2	27.9
Primary and secondary income	–17.9	–15.7	–18.1	–15.7	–15.3	–12.6	–12.0	–12.1
Net lending (+) / borrowing (–) capacity	**22.3**	**14.7**	**13.4**	**14.7**	**15.6**	**19.1**	**21.0**	**21.1**

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

	2013	2014	2014 Q4	2015 Q1	2015 Q2	07/15	08/15	09/15
Net lending (+) / borrowing (–) capacity	**–6.8**	**–5.8**	**–5.9**	**–0.7**	**–2.9**	**–**	**–**	**...**
Central government [1]	–4.9	–3.9	–3.9	–1.0	–2.1	–2.4	–2.6	–2.4
Autonomous regions	–1.5	–1.7	–1.7	–0.2	–0.8	–0.7	–0.7	...
Local government	0.5	0.6	0.6	0.1	0.2	–	–	...
Social Security	–1.1	–1.0	–1.1	0.3	–0.4	–0.2	–0.3	...
Public debt *(% GDP)*	**93.8**	**99.4**	**99.4**	**99.8**	**99.5**	**...**	**...**	**...**

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

	2013	2014	2014 Q3	2014 Q4	2015 Q1	2015 Q2	07/15	08/15	Balance 08/15 [1]
Financing of non-financial sectors [2]									
Private sector	–7.4	–6.2	–5.7	–5.9	–4.8	–4.2	–4.0	–4.4	1,658.3
Non-financial firms	–9.2	–7.0	–6.2	–6.9	–5.4	–4.6	–4.2	–5.0	927.4
Households [3]	–5.0	–5.1	–5.0	–4.6	–4.1	–3.7	–3.6	–3.6	730.9
General government [4]	16.8	6.9	5.9	6.7	5.1	4.2	3.5	4.0	1,050.5
TOTAL	**–0.5**	**–1.8**	**–1.7**	**–1.5**	**–1.2**	**–1.1**	**–1.2**	**–1.3**	**2,708.3**
Liabilities of financial institutions due to firms and households									
Total deposits	2.1	–0.9	–1.2	–1.7	–1.3	–1.2	–1.0	–1.4	1,157.6
On demand deposits	4.2	10.8	13.6	14.8	17.9	19.5	19.7	17.4	365.3
Savings deposits	–0.1	5.8	6.9	6.8	10.5	12.3	13.6	13.1	243.3
Term deposits	1.7	–7.6	–9.4	–11.3	–13.5	–15.5	–16.1	–15.9	526.9
Deposits in foreign currency	16.8	1.1	0.3	5.2	8.9	10.5	6.0	5.0	22.1
Rest of liabilities [5]	–16.8	–8.2	–6.8	–6.8	–11.4	–11.5	–16.1	–16.3	98.5
TOTAL	**–0.2**	**–1.7**	**–1.7**	**–2.2**	**–2.3**	**–2.2**	**–2.4**	**–2.7**	**1,256.1**
NPL ratio *(%)* [6]	**13.6**	**12.5**	**13.0**	**12.5**	**12.1**	**11.0**	**10.9**	**11.0**	–
Coverage ratio *(%)* [6]	**58.0**	**58.1**	**59.1**	**58.1**	**58.5**	**60.0**	**60.3**	**60.5**	–

Notes: *1. Billion euros. 2. Resident in Spain. 3. Including NPISH. 4. Total liabilities (consolidated). Liabilities between different levels of government are deduced. 5. Aggregate balance according to supervision statements. Includes asset transfers, securitized financial liabilities, repos and subordinated deposits. 6. Data end of period.*
Source: *CaixaBank Research, based on data from the Bank of Spain.*

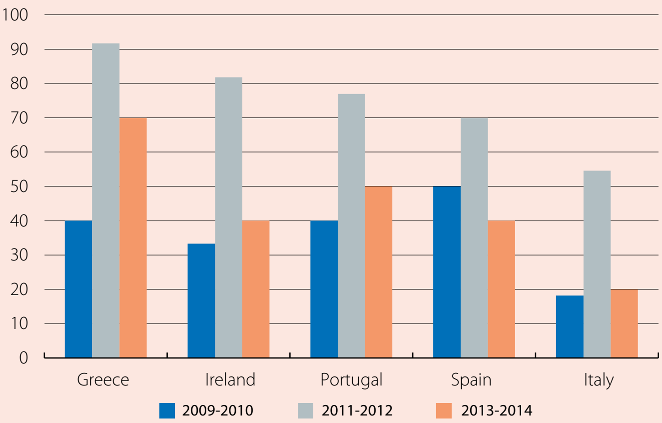
POST-REFORM PERIPHERAL EUROPE

Recovery in the periphery and the role played by reforms

If any good came from the euro area's sovereign debt crisis it was the resulting drive for reform in the region, both at a national and European level. Under huge pressure from the financial markets, the peripheral countries implemented a wide range of reforms to correct macroeconomic imbalances accumulated during the boom that followed the euro coming into circulation. This Dossier analyses the impact of the reforms which, to a greater or lesser degree, were carried out in Spain, Ireland, Portugal, Italy and Greece and which affected many different areas, including the labour and goods markets and the public and financial sectors. The evidence available suggests that all this effort has not been in vain: the surprisingly vigorous economic recovery of the peripheral countries is largely thanks to the positive impact of the reforms adopted, laying the foundations for more balanced and sustainable growth in the long term.

Reform responsiveness index *

(%)



Note: ** Percentage of reforms implemented out of all recommendations made annually by the OECD to each country.*
Source: *CaixaBank Research, based on OECD data.*

The first financial assistance programme for Greece, signed in May 2010, marked the start of the wave of reforms that spread through the euro area. Logically the reforms were more sweeping in those countries requesting external financial assistance, given the explicit conditions contained in such programmes. But the need to adopt structural measures affected a broader group of countries such as Italy which, in 2011 and in 2012, also significantly increased its response to the structural reforms recommended by the OECD (see the first graph). As is widely known, priority was given to fiscal consolidation measures in order to reduce the public deficit and redirect public debt towards a sustainable path, with the aim of putting a stop to the sovereign debt crisis. Banking reforms were also crucial in those countries that had experienced a credit boom, such as Ireland and Spain. Over time, when financial tensions had eased considerably, there was a slight shift in economic policy towards growth-friendly fiscal adjustment and reforms aimed at restoring the competitiveness of these economies came to the fore.

After more than five years of reforms, and at a time when the recovery is gaining ground in most peripheral countries, it is a good moment to look back and judge how successful they have been. Overall the assessment is positive given the significant progress made in reducing macroeconomic imbalances. Firstly, reforms in the labour and goods markets have helped to restore the competitiveness lost, as seen in a clear improvement in the current account balance (see «Competitiveness in the periphery: liberalisation of labour and the goods and services market»). Secondly, considerable progress has also been made in reducing the public deficit and sovereign debt has stabilised, albeit it is still at a high level (see «Will fiscal consolidation in the periphery entail a different model for public accounts?»). Lastly, the improvement of balance sheets in the private sector and financial institutions is firmly on track (see «The restructuring of periphery banks»). In this respect, it can be stated that the measures were generally adequate. The growth now being experienced by peripheral Europe should be partially attributed to a more competitive economy, public finances oriented towards sustainability, lower private sector debt and a banking industry with more capacity to grant credit and support the recovery.

It is sometimes argued that the results achieved might have been better if the programmes had been implemented in their entirety and more rapidly. The IMF's register[1] that monitors these programmes sheds some light on this area. Specifically, the proportion of measures carried out (with and without delay) is over 95% in the cases of Portugal and Ireland while Greece, so often criticised for an alleged lack of commitment to reforms, has implemented 90% of the measures. The fact that such reforms may not have been as effective as expected should therefore be blamed on the difficulty in designing effective programmes that are in relation to the specific conditions of each country and, on the other hand, on the importance for local authorities to be committed to and lead the reforming drive. Another factor that may have influenced the perception of the effectiveness of the reforms implemented is the negative public opinion generated by any reforming process, especially when such reforms are

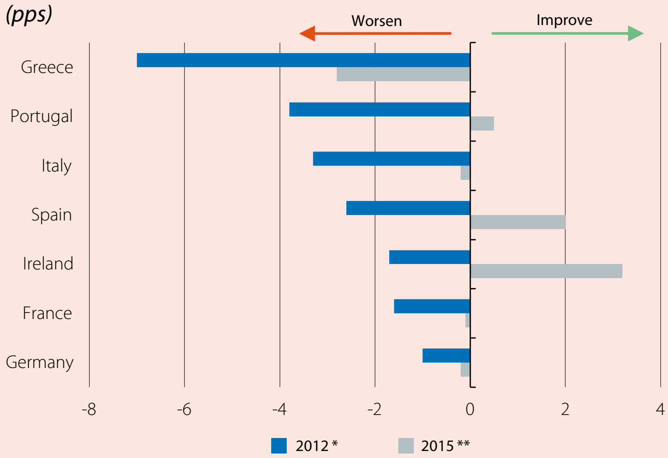
1. Data taken from «Monitoring of Fund Arrangements» (MONA), IMF.

far-reaching. There is normally a minority who are very directly damaged by the reform in question and they fight for it not to be carried out, even when it may be advantageous for society as a whole. The difficulty lies in the fact that the benefits are shared among many different agents while the costs are borne by a minority that is very reluctant to change. This problem is even greater for economic reforms of a structural nature given the time lapse between their implementation and outcome. Although empirical studies show that structural reforms provide great benefits over the medium to long term, it is true that the short-term gains are very limited because, for example, of the costs of reassigning productive resources to different sectors (Bouis and Duval, 2011).

One way of easing the negative effects in the short term is to use fiscal and monetary stimuli. Given the little (or zero) fiscal margin enjoyed by peripheral countries, monetary policy appeared to be the main tool available. In this respect the ECB did its duty, especially after July 2012, via ultra-accommodative monetary policy: it cut the interest rate to an all-time low, adopted numerous measures to improve the banking system's access to liquidity and finally, in March 2015, it embarked on a programme to purchase sovereign bonds that ended up supporting the recovery in the periphery. In particular, the drop in risk premia has helped to considerably improve conditions for accessing credit in these countries. Moreover, falling oil prices and the euro's depreciation have also helped to boost growth. All this can be seen in the spectacular improvement in growth prospects for 2015, especially in Ireland and Spain. While, in January of 2014, Ireland's GDP was expected to grow by 2.2%, the current forecast is 5.4% (a difference of more than 3 pps, as shown in the second graph). The upward revision of forecasts has also been substantial for the Spanish economy and, to a lesser extent, the Portuguese.[2] However, forecasts for the core countries have remained almost unchanged, even when they have also benefitted from the aforementioned positive shocks. It therefore seems that, beyond the factors providing temporary support, the reforms implemented lie behind this better relative performance by the peripheral countries.

Change in growth prospects

(pps)



Notes: ** Change in the growth forecast for 2012 between January 2011 and December 2012.*
*** Change in the growth forecast for 2015 between January 2014 and October 2015.*
Source: *CaixaBank Research, based on data from Consensus Forecast.*

There is broad consensus that structural reforms have a positive impact on an economy's long-term growth, backed up by a large number of empirical analyses. Moreover, we can estimate what kind of reform would have a greater effect for each country. For instance, a study by the European Commission[3] estimates that Greece would benefit substantially from reforming its goods market; encouraging competition and reducing barriers to entry would lead to a 47% increase in the level of Greek GDP in the long term. The study also shows that reforms aimed at improving the training of unskilled workers would be very positive in all the peripheral countries, particularly in Portugal where the level of GDP would rise by 28% in the long term. Based as they are on a variety of models and hypotheses, these estimates are inexact but, nevertheless, the message conveyed is that structural reforms have a very positive effect.

In spite of the significant progress made over the last few years, countries must continue their reforming efforts to ensure their long-term growth capacity. Although risk premia are low, and thus are no longer exerting pressure, and the cycle has evidently improved, reforms must continue to be implemented both at a national level and also by progressing with the construction of the European architecture. There is no room for complacency.

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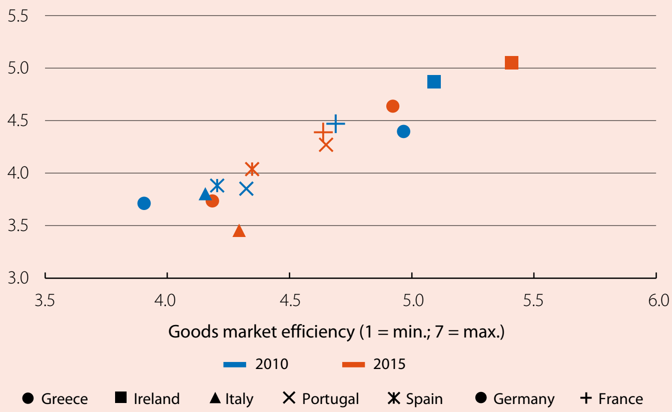
2. The positive trend in growth prospects for 2015 contrasts with the deterioration seen in 2012, when estimates for Spain went from 1.2% growth in January 2011 to –1.4% in December 2012 (a drop of 2.6 pps).
3. «Growth effects of structural reforms in Southern Europe», Economic Papers no. 511, European Commission, December 2013.

Competitiveness in the periphery: liberalisation of labour and the goods and services market

After European monetary union was formed the external imbalances of the periphery countries increased substantially; the crisis itself but also the reforms implemented helped to correct most of these cases. Although a large proportion of this correction has been a direct consequence of the depth of the crisis and the resulting drop in domestic demand, external balances also improved thanks to gains in competitiveness as a result of the liberalisation of the both the labour market and the market of goods and services. These gains should increase further as the reforms and liberalisation gradually take effect.[1]

Europe: labour and goods market efficiency indices (2010 compared with 2015)

Labour market efficiency (1 = min.; 7 = max.)



Source: *CaixaBank Research, based on data from the World Economic Forum (Global Competitiveness Index).*

Just before the crisis erupted, most periphery countries (with the exception of Italy) had current account deficits of around 10% of GDP. Between 2008 and 2013 these current account balances returned to surpluses, driven by lower imports but also by strong exports. This month's Dossier analyses the measures which, thanks to their impact on competitiveness, should continue to boost exports and help to reduce imports. In particular, we will focus on those affecting both labour and the goods and services market.

The measures implemented in the area of labour have attempted to fine-tune the labour force and wages to economic conditions throughout the cycle. Amongs them, an important one has been the reduction in the cost of severance pay in Greece, Spain and especially Portugal. Nonetheless, in spite of this reduction, the cost in Spain is still much higher than the average for Europe, Greece and Portugal: totalling 14.3 weeks' wages for the fair dismissal of workers with five years' service compared with 13.0 weeks for Greek employees and the much more limited 8.6 weeks in Portugal, according to the Doing Business report produced by the World Bank.

Among the different reforms affecting workers' wages there have been important changes in collective bargaining procedures, encouraging more decentralised negotiations where company-level agreements take priority over other agreements at the sector or province level. This kind of measure, which increases companies' internal flexibility and helps them to adjust wages more accurately to their level of productivity, should improve countries' competitiveness in the medium term. Spain and Greece have made considerable progress in this respect. For example, in 2011 Greece suspended «legacy contracts» which meant any negotiation had to start from the level of the most favourable contract achieved by similar workers. That same year Greece also started to allow new contracts to be signed with representative groups of workers for firms with no trade union representation. The advances made by Portugal in this area have been less significant, however. The reason is that, although collective agreements at a sector level can be suspended in favour of a new agreement at a company level, the original signatories must accept that the sector agreement be suspended. This condition has limited the number of suspensions and consequently new agreements at a company level.[2] Nonetheless, overall Portugal has carried out significant labour reforms. In addition to the aforementioned reduction in dismissal costs it has also made working time more flexible, strengthened active employment policies via training courses and by encouraging apprenticeships in companies and has also reduced unemployment subsidies. That's why Portugal is one of the periphery countries whose labour market efficiency has improved the most according to the index produced by the World Economic Forum (see the first graph, vertical axis).

On the other hand, according to the same index, Italy is the peripheral country with the worst performance in terms of improving its labour market efficiency. The main reason is that it had not implemented any significant labour measures until very recently. However, in December 2014 an important labour measure was announced that has come into force in 2015 and

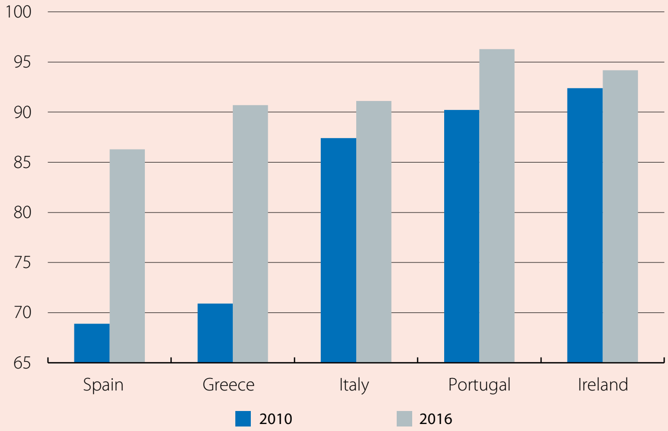
1. Ireland forms part of the group of countries that have substantially corrected their external imbalance and carried out significant reforms. However, these reforms have focused on the financial and public sector and not on the labour or goods and services markets as these markets are already much more liberalised in Ireland. That is why this Dossier article will not look at the case of Ireland.
2. Up to May 2015 no agreement had been suspended (see «Post-Programme Surveillance Report», Portugal Spring 2015, European Commission, 2015).

aims to attack the problem of the duality of the labour market. Another important measure in this labour reform is a new kind of contract for newly recruited employees that has an increasing severance payment. Also of interest is the fact that employees who have been dismissed no longer have to be reinstated should a tribunal rule against the company.[3] We can therefore expect significant improvement in the World Economic Forum's efficiency index for the country once these recently implemented policies take effect.

Regarding reforms of the goods and services market, most measures have focused on reducing administrative costs and also on improving competition in industries that are crucial for the overall performance of the economy. Portugal, Spain and Greece in particular have made considerable progress in simplifying the administrative procedures required to start a new business. In 2011 Portugal launched a «Zero Authorisation» initiative which has simplified online licensing at a state level. Although the European Commission still believes the Portuguese economy needs to make local administrative procedures even easier, according to the Doing Business index produced by the World Bank the country has made important improvements in this respect: in the Starting a Business subindex it has gone from 90.22 points in 2010 to 96.28 in 2016.[4] Spain's improvement in this subindex has been even greater although there is still a great deal of room for improvement: it has gone from 68.88 points to 86.30 (see the second graph).

*Ease of starting a business **

Distance to frontier (100 = best)



Note: ** «Starting a Business» subindex of the «Doing Business» index.*
Source: *CaixaBank Research, based on data from the World Bank (Doing Business Index).*

Lastly, numerous measures have also been implemented to increase the degree of competition in certain relevant sectors. However, according to a recent report produced by the OECD there is still a long way to go.[5] In particular, the report stresses that Portugal must continue to increase competition in network industries as well as in some professional services, while Spain needs to do the same with its large number of professions requiring membership of a professional body. On the other hand, the effects of Italy's extensive deregulation of professional services carried out between 2011 and 2013 are still not clear (see the first graph, horizontal axis). And although Greece has substantially reduced barriers to competition in numerous industries and professions, it should be noted that it was one of the countries with the most regulations for professional services in the EU and its progress in this area therefore needs to be monitored.

In short, there has been considerable liberalisation in the labour market and the goods and services markets in the periphery countries and the measures implemented have made the labour market more flexible and have reduced barriers to competition in a range of sectors. Nevertheless, in spite of these efforts, the dual nature of these countries' labour markets still needs to be tackled by taking more definitive action. In the area of market reforms, increasing the degree of competition in numerous services and liberal professions also seems to be an aspect which all periphery countries should strengthen further. The good data being reported for economic activity in a large part of the euro area is no reason for us to slacken the reformist agenda which the years of crisis had forced us to undertake.

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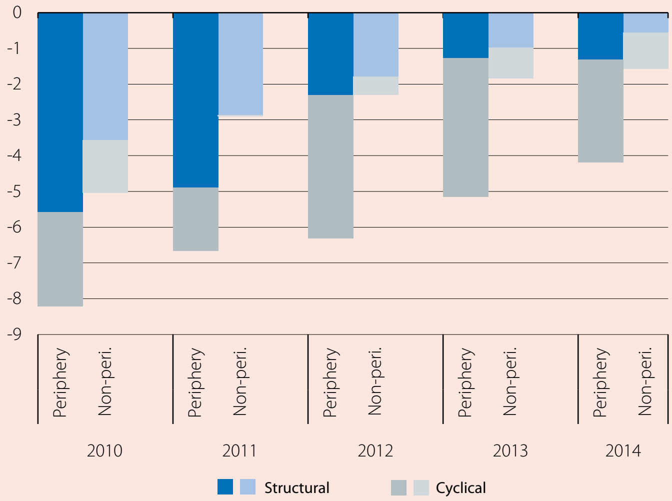
3. See «Labour reform in Italy: a big step forward», IM03/2015.
4. When distance to frontier is measured, each economy is classified within a group of similar economies and the economy in the group with the best characteristics in each aspect is given a rating of 100. When Portugal goes from 90.22 to 96.28, this means it is approaching the best country in the *Starting a Business* sub-index.
5. See «Economic Policy Reforms 2015. Going for growth», OECD, 2015.

Will fiscal consolidation in the periphery entail a different model for public accounts?

As its name suggests, the sovereign debt crisis originated in doubts regarding the public sector's solvency, based on an unsustainable finance model with revenue chronically below the level of expenditure. The average public deficit of Europe's peripheral countries (Ireland, Portugal, Spain, Italy and Greece) reached 8.7% in 2009. Given this situation, it was not only vital to adjust national accounts and achieve sustainable growth but also to restore international confidence as well as access to markets. Since then, fiscal consolidation has been carried out with relative success and, although there is still some way to go to achieve healthy public accounts, in 2014 the deficit of the peripheral countries fell to 4.2% and is expected to fall even further. In this Dossier we analyse the adjustment made in the res publica and the measures taken to determine whether these have been temporary (to «patch up holes») or are strengthening foundations of the house to avoid further structural imbalances in the future.

Structural and cyclical public deficit
(% GDP)



Source: *CaixaBank Research, based on data from the European Commission (AMECO).*

Soaring public deficits (see the first graph) were partly due to the economic cycle. The acute economic crisis suffered by the peripheral countries led to a reduction in public revenue (less tax revenue, fewer Social Security contributions, etc.) as well as a greater need for spending (unemployment subsidies, interest on debt payments, etc.). However, the structural deficit, i.e. the resulting deficit once adjusted for cycle-related effects and one-off measures,[1] also reached high levels (5.6% in 2010). This highlights the fact that the model of cyclical revenue and structural expenditure was, given its very nature, unsustainable over the long term and needed to be corrected. One clear example is provided by the structural expenditure commitments taken in countries such as Ireland and Spain thanks to cyclical revenue from the real estate boom but which, once the latter had evaporated, could not be met. The reduction made in the structural deficit, which reached 1.3% in 2014, shows the considerable consolidation effort made by the peripheral governments although not all the reforms initially planned have actually been completed. Let us look at how this consolidation has been achieved; by increasing revenue or by reducing expenditure.

The measures undertaken to increase revenue in the fiscal area consisted mainly of changes in the tax system although action was also taken to reduce tax evasion. Albeit to differing degrees and with differing success, the peripheral countries implemented reforms in order to boost tax revenue and make taxation more efficient. To this end most of the countries increased both the taxable base and the rates of indirect taxes and eliminated some types of reduced rate VAT.[2] Some countries, such as Portugal, attempted to carry out a fiscal devaluation, combining the VAT hike with a reduction in Social Security contributions to improve external competitiveness, but the measure was never implemented. Countries also had to resort to increasing income tax, corporate tax and other special taxes such as the tax on property or inheritance. Measures were also taken to reduce tax evasion, from the most traditional (increasing control by tax inspectors and their number, a tax amnesty, etc.) to other, more imaginative measures to discourage fraud (such as the chance for Portuguese consumers to take part in a lottery when requesting a receipt for purchases). For the moment these measures have only had a small effect on revenue.

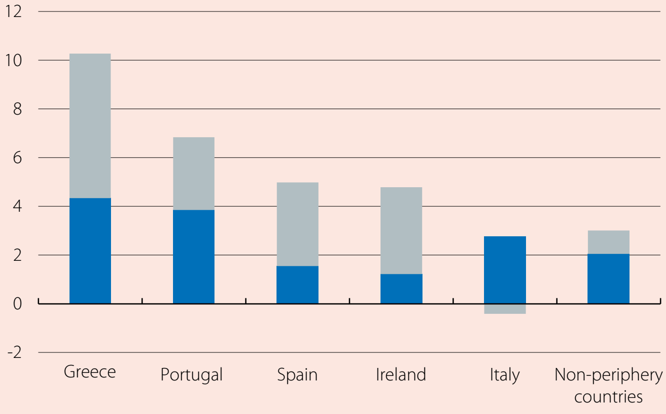
The adjustment in public expenditure was carried out, firstly, by reducing consumption both in terms of the overall running costs of public administrations and also by cutting spending on education and healthcare. Most countries chose actions that could be implemented quickly such as reducing civil service wages or reducing the number of civil servants, in particular temporary

1. This category includes a whole series of measures with a temporary impact on public finances, both in terms of revenue (privatisations, licence sales, etc.) and expenditure (losses resulting from bank restructuring, etc.).
2. Lower VAT rates for certain products have traditionally been justified as a means of redistributing wealth although, according to the IMF, it is much more efficient to carry out this redistribution via social transfers aimed only at those who need them.

workers. The measures used to reduce the size of government were more difficult to implement although, to differing degrees, the number of entities was cut and expenditure became more efficient (by centralising procurement, for example). Another important part of the adjustment in expenditure was carried out by reducing transfers in pensions and unemployment subsidies, among other social benefits. The pension system reforms carried out reasonably successfully in Italy, Spain and Portugal are notable for being structural in nature since they include formulas that attempt to ensure long-term sustainability. In Greece, after several reforms and substantially decreasing the size of pensions, one condition for the country's third financial assistance programme is to implement legislation with measures to ensure a sustainable pension system in the future. Lastly, other items included in the cuts were public subsidies and investment. In Spain, Greece and Ireland most of the adjustment focused on expenditure (see the second graph) while in Portugal and particularly in Italy and non-periphery countries this was carried out more extensively via revenue.

Fiscal effort

Adjustment of the structural public deficit between the peak (2010-2013) and the current level (2014) (% of GDP)



Source: *CaixaBank Research, based on data from the European Commission (AMECO).*

The most beneficial outcome of this consolidation is the establishment of rules requiring stricter fiscal discipline. In Spain, for example, the Constitution has incorporated rules for public spending and a deficit limit to guarantee the public accounts are sustainable. Independent fiscal authorities have also been set up, such as the AIReF (or the Fiscal Advisory Council in Ireland), which analyse the credibility and risks of public accounts and call attention to them. At a European level, the joint supervision of public accounts has been strengthened as part of the European Semester with the aim of monitoring excessive deficits and ensuring they are corrected. The European Commission has established the path to be taken by fiscal consolidation in structural terms with medium-term budget targets to minimise the cycle's impact on fiscal consolidation.

There is still room to reduce the structural deficit even further by improving public sector efficiency although the peripheral countries have made significant progress in this direction, such as the reform of public administration in Spain and Italy. The aim is for structural reforms to be carried out that help to increase efficiency and reduce public spending by offering better services that are more in line with individual requirements. Nevertheless it is complicated to implement these reforms as there are many beneficiaries (the whole population) while only a limited number can be adversely affected (by reducing the size of a public body, for example). On the other hand new technologies can help to modernise the public sector by individualising the services provided and reducing their cost: the res publica should take advantage of all the potential they offer.

In conclusion, the crisis has forced a reform of public accounts that was long overdue. Although considerable progress has been made, such as the reforms of pension systems and the establishment of fiscal consolidation rules, some important changes still need to be made, in particular those that can substantially improve public sector efficiency.

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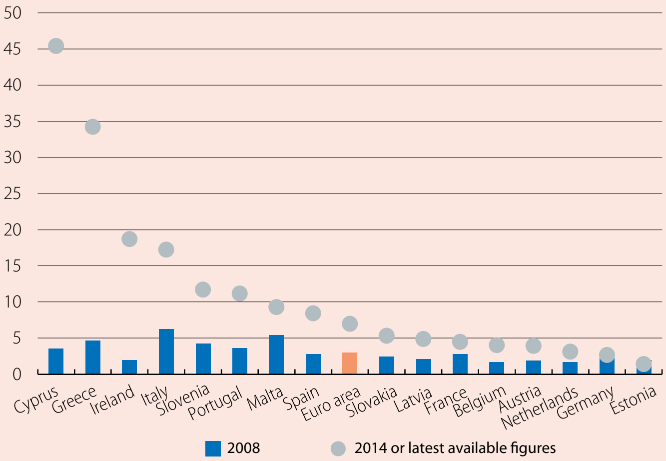
The restructuring of periphery banks

During the last expansionary economic cycle, lending standards were loosened in the peripheral countries, bringing about strong growth in credit. In some cases, such as Ireland and Spain, this credit boom was concentrated in the construction industry whereas in countries such as Portugal and, to a lesser extent, Italy, bank financing was mainly used by companies in the rest of the sectors. In the case of Greece, banks were highly exposed to the public sector, whose debt grew very sharply, endangering its sustainability. In spite of these differences, in all cases the excesses committed during the pre-crisis years laid the foundations for the recession. One of the main consequences of the crisis for banks is that their assets are now of a much lower quality, affecting the profitability and solvency of the banking system. This Dossier article analyses the measures implemented to resolve such deficiencies in periphery banks.

Non-performing loans

(% of total credit)



Source: *CaixaBank Research, based on IMF data (GFSR).*

When the financial crisis erupted, and after a period of uncertainty, the ECB decided to relax its monetary policy, providing an extremely accommodative environment and injecting a large amount of cheap liquidity throughout the euro area's banking system. Although this intervention was necessary to ensure banks could replace the wholesale funding which had disappeared when the crisis started, as the recession became entrenched and the economic situation worsened such measures did not manage to prevent the assets on bank balance sheets from deteriorating rapidly, jeopardising the solvency of many financial institutions. For this reason most peripheral countries (Portugal, Greece, Ireland and Spain) required financial aid from the rest of their European partners to recapitalise the hardest hit banks. This assistance was accompanied in many cases by a programme to provide the public treasury with economic aid and was conditioned by the implementation of reforms and fiscal consolidation.

In addition to these emergency measures at a European level, urgent efforts were also made nationally to restore banks' balance sheets, vital to ensure the sector's weaknesses would not affect the rest of the economy. For those countries where non-performing loans (NPL) were concentrated in specific sectors, asset management companies were set up (AMC, also known as «bad banks») whose aim was to quickly and effectively cleanse bank balance sheets by purchasing such assets, with fixed haircuts and in exchange for government-backed bonds. Of particular note are the companies of Ireland (NAMA) and Spain (SAREB),[1] both focusing on buying up credit from the real estate sector. The creation of these companies produced broad benefits. From the banks' point of view, it helped them to (i) concentrate their resources on managing their healthy business; (ii) secure liquidity quickly; and (iii) eliminate uncertainty regarding the quality of the assets remaining on their balance sheets.[2] Other benefits of a more general nature were that AMCs could take advantage of the economies of scale resulting from managing a large volume of similar assets and, as far as possible, they acted as a catalyst for a market of NPL portfolios in the euro area.[3]

Measures of a more general nature were required for the other non-performing loans spread around the rest of the economy's sectors. Once again Spain is a case in point, making progress in incentivating corporate debt capitalisation (swapping debt for capital) by reinforcing the powers of creditors during refinancing and restructuring processes. Other countries modified their tax regimes to speed up the resolution of non-performing loans; such as Italy, which altered its tax system to allow provisions to be tax deductible in the year they were produced.

Although all these measures, both at a national and European level, provided immediate relief for the periphery banking sector, their main aim was to sterilise the environment and cure the symptoms of the disease (i.e. reduce non-performing loans). Additional effort was therefore required to treat the root cause of the problem.

1. Italy is analysing the creation of an AMC for non-performing loans granted to companies. See the Focus «The challenges still facing Italy's banking system» in MR10/2015.
2. This also provides some relief regarding capital requirements by reducing risk-weighted assets.
3. Transactions to buy non-performing loan portfolios in Europe totalled 64 billion euros in 2013 and 470 billion dollars in the US.

Various reforms were implemented at a national level to correct the banking industry's structural deficiencies. At first, in countries such as Spain and Italy, a legal framework was developed to improve the corporate governance of banks. One clear example is the reform of the legal regime for savings banks in Spain, encouraging them to become banks, which has made it easier for them to obtain capital in the markets as well as improving their transparency and discipline. Italy also passed a Decree-Law to encourage its large cooperative banks (*banche popolari*) to become listed companies. This reform aims to modernise the governance of banks, improving their risk management mechanisms as well as promoting consolidation in the sector.

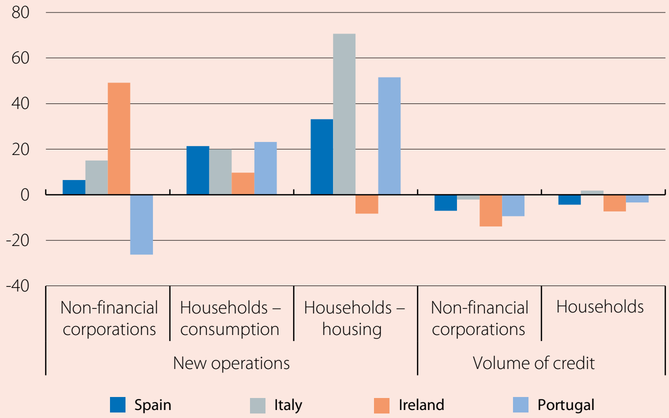
Other reforms of a structural nature were aimed at making bankruptcy and insolvency proceedings faster and more efficient.[4] This not only speeds up the resolution of non-performing assets but also promotes private sector deleveraging at the same time as ensuring viable companies survive. All the peripheral countries apart from Greece have made progress in this area and particularly Spain, approving a «Second Opportunity» law for self-employed people and private individuals with a partial discharge of their debts when they have filed for bankruptcy, dependent on certain conditions.

The goal of all these structural measures is to promote sustainable business models for banks in the long term and ensure loans are granted in line with the needs of the private sector, as part of a larger banking union which, in the medium term, should eliminate financial fragmentation and break the damaging link between sovereign and credit risk. For this to be possible, powers will need to be transferred in the area of supervision (single supervisory mechanism) and in the management and resolution of future banking crises (single resolution mechanism). More progress also needs to be made towards a deposit insurance scheme, the third pillar of banking union, which guarantees equal conditions for the deposits of any financial institution irrespective of the country of origin.

The results of all the reforms implemented so far in the financial sector can be seen in the dynamics of bank credit in the different countries. The volume of bank loans in these countries is still falling due to private sector deleveraging but the rate has slowed down over the last few months and is now approaching positive terrain once more. For a more realistic view of the underlying dynamics of bank loans we must therefore analyse the trend in new operations. In this case, the number of loans granted to non-financial firms grew in August compared with the previous year in Spain, Italy and Ireland while new operations with households saw positive growth in Spain, Italy, Ireland and Portugal, although in the case of Ireland the loans granted to households to purchase housing have yet to recover.

Dynamics of bank loans to the private sector

Year-on-year change (%)



Note: *Data from August 2015. The figures for new operations (year-on-year change, cumulative over a 12 months) do not include renegotiated loans, except for Spain.*
Source: *CaixaBank Research, based on data from the ECB.*

In conclusion, those peripheral countries that have implemented far-reaching reforms in the banking sector now have recapitalised, efficient banks, improving their capacity to grant credit and support the region's economic recovery. Those that have yet to embark on this arduous reformist route, such as Greece, need to quickly follow the example of their more advanced neighbours while all countries should continue to work on reducing bad debt to definitively restore Europe's banking system back to health.

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4. The European Commission has provided recommendations regarding common principles in this area in order to reduce differences between countries.

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As of June 30, 2015

	MILLION €
Customer funds	296,412
Receivable from customers	211,559
Profit atributable to Group (January-June 2015)	708
Market capitalisation	23,961
Customers (million)	13.8
Staff	33,157
Branches in Spain	5,345
Self-service terminals	9,724

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	MILLION €
Social	336
Science and environmental	56
Cultural	67
Educational and research	41
TOTAL BUDGET	**500**

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Design and production: www.cege.es

Legal Deposit: B. 21063-1988 ISSN: 1134-1920

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