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MONTHLY REPORT • ECONOMIC AND FINANCIAL MARKET OUTLOOK
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ECONOMIC & FINANCIAL ENVIRONMENT

DOSSIER: INDIA: THE NEW ASIAN STAR?

CaixaBank Research

MONTHLY REPORT - ECONOMIC AND FINANCIAL MARKET OUTLOOK
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The Europe of the negative

«Hungary and several countries in Central Europe refuse to accept the refugee quotas laid down by the European Commission»

«Great Britain does not want to continue in the European Union without limits on access to the Welfare State for immigrants from the European Union residing in the United Kingdom»

«Germany and Finland oppose the introduction of a European deposit insurance scheme as a means of completing banking union»

«For the second time, Denmark refuses to share Europe's justice and home affairs policies»

«Poland opposes European policy on controlling climate change»

«Greece and several countries in Central Europe are not prepared to accept the European Union's new policy to control its external borders»

2015 has been a difficult year for the European Union and 2016 promises to be no different. Conflictive issues abound and headlines such as these will be repeated.

In addition to the political and social tensions arising throughout the long economic crisis are serious geopolitical conflicts and the severe refugee crisis. Such events are placing formidable political pressure on leaders of the member States in a European Union that contains, in the length and breadth of the continent, highly diverse countries whose priorities and interests, both politically and geostrategically, do not always coincide.

This is fertile ground for populist political proposals based purely on national concerns in response to short-term local interests and, since the last European parliamentary elections, we have seen political parties with this kind of perspective progress in many countries.

Europe is therefore going through an exceptional period and requires great leadership to overcome the challenges entailed. In short, it needs leaders of European nations who are capable of increasingly becoming true leaders for Europe as a whole. If this does not happen, we run the risk of ruining the progress made to date in politically shaping Europe. And, even more importantly, of not advancing enough for Europe to be a relevant political power on the world stage, ultimately benefitting its own citizens and the international community.

Promoting the political construction of Europe does not mean imposing European interests over national ones but rather persuading national electorates that, in the long term, the political organisation of Europe as a whole favours all nations on the continent and that the immediate costs and obstacles, which undoubtedly exist, must be tackled via a broad negotiation strategy to ensure that all member States gain in some areas and concede in others, no matter how gradually such a process must be carried out.

Neither does the political promotion of the idea of Europe mean imposing on citizens, from above, a feeling of belonging to Europe which hardly exists today. True political leadership, a leadership with transformative powers, does not merely follow public opinion polls but rather creates the vision of a motivating, common political project that addresses the general interest of Europeans and is based on those values shared by our societies. Based on such premises, the political leadership required by Europe should promote communication and concrete actions (standards and institutions) that, gradually but firmly, establish the same political horizon for the continent's diverse societies.

Only with this kind of transformative leadership can we avoid the decay of European nations which the Europe of the negative is engendering.

Jordi Gual
Chief Economist
31 December 2015

CHRONOLOGY

DECEMBER 2015

3 The **ECB makes its monetary policy more accommodative** by extending the asset purchase programme to March 2017, including regional and local debt securities within the programme's eligible assets and cutting the deposit facility rate by 10 bps to –0.30%.
16 The US **Federal Reserve** begins to **normalise its official interest rate**, raising it by 25 bps up to 0.25-0.50% while maintaining its policy of reinvesting principal payments from its debt holdings.
20 The outcome of **Spain's general election** is a more fragmented parliament.

NOVEMBER 2015

23 The European Commission urges the Spanish government to present **an update of its 2016 Budget**, incorporating measures to reduce the public deficit in line with the agreed path.
30 **The IMF announces the inclusion of the Chinese yuan** in the basket of currencies with special drawing rights (SDR), together with the US dollar, the euro, the Japanese yen and the pound sterling. The approval of the yuan as a reserve currency will come into effect as from October 2016 and marks an important milestone in the internationalisation of the Chinese currency.

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.
29 The Chinese Communist Party announces the **end of its single child policy** and allows two children per couple to combat the country's ageing population.

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**.

AGENDA

JANUARY 2016

5 Registration with Social Security and registered unemployment (December).
7 Index of economic sentiment euro area (December).
11 Industrial production index (November).
15 Financial accounts (Q3).
18 Loans, deposits and NPL ratio (November).
21 International trade (November).
Governing Council European Central Bank.
26 Fed Open Market Committee.
28 Labour force survey (Q4).
Index of economic sentiment euro area (January).
29 Flash GDP (Q4).
CPI flash estimate (January).
Balance of payments (November).
US GDP (Q4).

FEBRUARY 2016

2 Registration with Social Security and registered unemployment (January).
8 Industrial production index (December).
12 GDP of the euro area (Q4).
15 Japan's GDP (Q4).
18 Loans, deposits and NPL ratio (December).
European Council.
International trade (December).
25 Quarterly national accounts (Q4).
26 GDP flash estimate (February).
Index of economic sentiment euro area (February).
29 Balance of payments (December).

The Federal Reserve embarks on a new monetary phase

The first interest rate hike in the US since 2006. The Federal Reserve (Fed) finally made a move and raised its benchmark interest rate in which was the first hike in almost a decade. Although this tightening up of monetary policy had already been discounted by the markets, it is still a significant step forward towards full normalisation in the US. The country's economic conditions have justified tightening up monetary policy for some time, as the expansion can now be considered consolidated (in Q3 the economy grew by a reasonable 2.1% year-on-year), the labour market has posted a healthy job creation rate for several months and inflation looks like rising in the future. However the Fed delayed its decision because it believed that external financial uncertainty required a more prudent approach; at least this is how it justified keeping interest rates the same at its September and October meetings. But once the summer's episode of strong financial volatility diminished, thanks largely to more encouraging activity figures from China, India, Mexico and other emerging countries of note, the Fed raised its benchmark rate by 25 bps. In principle we can expect a gradual rise that will not lead to any sudden changes in global liquidity conditions (particularly if we consider that both the ECB and Bank of Japan are continuing their quantitative easing). Nonetheless, we will have to keep a close eye on the trend in financial flows, especially towards the fragile emerging economies (Turkey, Brazil and South Africa would form part of this group), which have already shown signs of being sensitive to episodes of financial uncertainty.

Japan and the euro area end 2015 at different rates. In both cases the quantitative easing carried out by their respective central banks has been justified by the notable gap between the inflation targets they had set and the current situation, still relatively close to deflation. Nonetheless, the trend in these two large economies is quite different. While Japan is hardly growing, the euro area is going through an expansion which, although not extraordinary, is certainly substantial and most importantly looks like becoming more sustainable. In macroeconomic terms one of the key differences between the Japanese economy and that of the single currency is the state of domestic demand and, in particular, private consumption. While consumption seems weak in Japan, there has clearly been an expansion in the consumption of European households since the end of 2013. Over a slightly longer timeframe, one important distinction concerns the reforms planned in both economies. In Japan different measures have been taken to boost demand (fiscal expansion has been used together with monetary expansion) but changes of a structural nature, repeatedly announced, have yet to be specified. In the euro area, although recent trends reflect the support provided for growth by various temporary factors (such as falling commodity prices, the euro's depreciation and the ECB's quantitative easing), growth has also been boosted by the positive results of the structural reforms being adopted by different members of the euro area.

Spain is growing thanks to the combination of temporary supports and structural adjustments. One of the economies that provide the best example of this dual dynamic is Spain. There are few doubts that Spain is benefitting considerably from the aforementioned temporary factors (oil, the euro and monetary expansion). This explains how it managed to maintain an appreciable rate of growth in Q4: according to our estimates, GDP growth will have reached 0.8% quarter-on-quarter, the same figure as in Q3, ending 2015 with an annual growth of 3.2%, the highest of the euro area's main economies. This situation will be repeated in 2016 and the Spanish economy will grow more than its benchmark partners in the euro area. But these temporary support factors, although significant, are not the only reason for the country's good economic performance as some important reforms implemented over the last few years are also making a decisive contribution to this expansion in growth. Bank reform is improving credit flows which, in turn, are helping a clear recovery in real estate and the financing of production activity in small and medium-sized firms. Labour reform is also a reason why job creation has ostensibly recovered since the economy left the recession, in turn supporting consumption. The new labour framework has also helped to establish a trend in wages that is more compatible with the very necessary recovery in external competitiveness. Public adjustments have helped to restore credibility internationally, significantly improving external financing conditions. The challenge for future economic policymakers will be to resist complacency and continue with the reforms that guarantee the economy can consolidate a stable, sustainable trend in growth.

FORECASTS

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

International economy

	2014	2015	2016	2017	2015 Q2	2015 Q3	2015 Q4	2016 Q1	2016 Q2	2016 Q3
GDP GROWTH										
Global	3.4	3.1	3.6	3.8	3.2	3.1	3.0	3.4	3.5	3.5
Developed countries [1]	*1.8*	*2.0*	*2.2*	*2.2*	*2.1*	*1.9*	*2.0*	*2.1*	*2.0*	*2.2*
United States	2.4	2.5	2.5	2.4	2.7	2.1	2.4	2.8	2.3	2.5
Euro area	0.9	1.5	1.8	1.7	1.6	1.6	1.6	1.5	1.6	1.9
Germany	1.6	1.5	1.8	1.8	1.6	1.7	1.5	1.7	1.7	1.8
France	0.2	1.1	1.4	1.4	1.1	1.2	1.3	1.0	1.4	1.5
Italy	–0.4	0.7	1.2	1.2	0.6	0.8	1.2	1.0	1.1	1.2
Spain	1.4	3.2	2.7	2.1	3.2	3.4	3.5	3.2	2.7	2.5
Japan	–0.1	0.7	1.0	0.8	0.7	1.7	1.5	0.8	1.1	1.1
United Kingdom	2.9	2.2	2.2	2.2	2.3	2.1	2.0	2.2	2.2	2.3
Emerging countries [1]	*4.6*	*4.0*	*4.5*	*4.9*	*4.0*	*3.9*	*3.8*	*4.4*	*4.5*	*4.5*
China	7.3	6.8	6.5	6.3	7.0	6.9	6.3	6.6	6.5	6.3
India [2]	7.3	7.2	7.2	7.3	7.0	7.4	7.2	7.2	7.2	7.2
Indonesia	5.0	4.8	5.5	6.0	4.7	4.7	5.0	5.2	5.4	5.7
Brazil	0.1	–3.5	–2.5	1.3	–3.0	–4.5	–4.4	–3.8	–2.6	–2.0
Mexico	2.2	2.5	3.3	3.4	2.3	2.6	2.6	2.9	3.2	3.4
Chile	1.9	2.2	3.2	3.5	1.9	2.2	2.2	2.0	3.5	3.5
Russia	0.6	–3.7	–0.2	1.5	–4.6	–4.1	–3.8	–1.5	–0.2	–0.2
Turkey	3.0	3.2	2.9	3.4	3.8	4.0	2.7	1.7	2.6	3.5
Poland	3.4	3.6	3.7	3.6	3.5	3.7	3.4	3.7	3.6	3.6
South Africa	1.6	1.7	2.4	2.7	1.5	1.1	2.1	2.2	2.3	2.4
INFLATION										
Global	3.5	3.3	3.4	3.6	3.3	3.2	3.3	3.5	3.5	3.4
Developed countries [1]	*1.4*	*0.3*	*1.2*	*1.7*	*0.3*	*0.2*	*0.5*	*1.4*	*1.3*	*1.5*
United States	1.6	0.1	1.7	1.9	0.0	0.1	0.5	1.7	1.5	1.6
Euro area	0.4	0.1	1.3	1.4	0.2	0.1	0.3	0.9	1.1	1.4
Germany	0.8	0.1	1.4	1.7	0.4	0.0	0.3	1.0	1.3	1.5
France	0.6	0.1	1.3	1.4	0.3	0.1	0.2	1.1	1.2	1.4
Italy	0.2	0.1	1.2	1.1	0.1	0.3	0.2	0.7	1.1	1.4
Spain	–0.2	–0.5	1.2	1.5	–0.3	–0.4	–0.3	0.7	0.6	1.3
Japan [3]	2.7	0.9	1.3	2.0	0.5	0.2	0.6	1.3	1.0	1.4
United Kingdom	1.5	0.1	1.4	2.0	0.0	0.0	0.2	0.7	1.3	1.6
Emerging countries [1]	*5.1*	*5.6*	*5.1*	*4.9*	*5.6*	*5.5*	*5.4*	*5.1*	*5.2*	*4.9*
China	2.0	1.4	2.0	2.3	1.4	1.7	1.4	1.4	2.1	2.0
India	6.6	5.0	5.7	5.5	5.1	3.9	5.7	7.0	6.2	5.0
Indonesia	6.4	6.3	4.8	5.3	7.1	7.1	4.8	4.4	4.9	4.4
Brazil	6.3	8.8	6.4	5.6	8.5	9.5	9.6	7.6	6.5	5.5
Mexico	4.0	2.9	3.3	3.2	2.9	2.6	3.0	3.3	3.5	3.4
Chile	4.4	4.5	3.7	3.2	4.2	4.8	4.5	4.5	4.0	3.5
Russia	7.8	15.0	6.6	5.7	15.8	15.7	12.5	8.0	7.0	6.0
Turkey	8.9	7.3	6.5	6.3	7.7	7.3	6.8	6.5	6.2	6.5
Poland	0.2	–0.7	1.7	2.5	–0.8	–0.8	0.2	1.4	1.5	1.7
South Africa	6.1	4.7	5.2	5.0	4.6	4.7	5.3	6.1	4.9	4.7

Notes: *1. As from December 2015, the aggregate figures for «Developed countries» and «Emerging countries» include all the countries in each group. Only the main countries were included previously. 2. Annual figures represent the fiscal year. 3. Takes into account the consumption tax hike introduced in April 2014.*

Forecasts

Spanish economy

	2014	2015	2016	2017	2015 Q2	2015 Q3	2015 Q4	2016 Q1	2016 Q2	2016 Q3
Macroeconomic aggregates										
Household consumption	1.2	3.0	2.6	1.7	2.9	3.5	3.3	3.3	2.8	2.3
General government consumption	0.0	2.7	1.0	–0.6	2.1	3.0	4.3	2.1	1.8	0.3
Gross fixed capital formation	3.5	6.2	4.4	3.7	6.3	6.5	6.0	5.5	4.1	4.0
Capital goods	10.7	9.6	5.8	3.6	9.9	10.7	9.7	8.7	5.9	4.6
Construction	–0.1	5.5	3.8	3.8	5.5	5.5	4.9	4.6	3.2	3.6
Domestic demand (contr. Δ GDP)	1.6	3.5	2.6	1.6	3.3	3.9	4.0	3.4	2.8	2.2
Exports of goods and services	5.1	6.1	6.5	4.9	6.2	5.6	6.8	7.2	7.1	5.9
Imports of goods and services	6.4	7.8	6.6	3.9	7.0	7.7	9.3	8.4	8.1	5.1
Gross domestic product	**1.4**	**3.2**	**2.7**	**2.1**	**3.2**	**3.4**	**3.5**	**3.2**	**2.7**	**2.5**
Other variables										
Employment	1.1	3.0	2.5	2.0	3.0	3.1	3.1	2.9	2.5	2.4
Unemployment rate (% labour force)	24.4	22.2	20.3	18.9	22.4	21.2	21.3	21.6	20.4	19.6
Consumer price index	–0.2	–0.5	1.2	1.5	–0.3	–0.4	–0.3	0.7	0.6	1.3
Unit labour costs	–0.8	0.6	1.0	1.0	0.2	0.1	1.2	0.1	1.6	1.1
Current account balance (cum., % GDP)[1]	1.0	1.9	1.7	1.8	1.4	1.5	1.9	1.8	1.8	1.7
Net lending or borrowing rest of the world (cum., % GDP)[1]	1.4	2.5	2.3	2.4	1.8	2.0	2.5	2.4	2.4	2.3
Fiscal balance (cum., % GDP)[1]	–5.8	–4.8	–3.3	–1.8						

Financial markets

INTEREST RATES										
Dollar										
Fed Funds	0.25	0.26	0.79	1.56	0.25	0.25	0.29	0.50	0.75	0.92
3-month Libor	0.23	0.32	0.91	1.79	0.28	0.31	0.41	0.63	0.81	1.00
12-month Libor	0.56	0.79	1.36	2.14	0.73	0.83	0.95	1.16	1.29	1.42
2-year government bonds	0.44	0.67	1.49	2.40	0.59	0.67	0.83	1.15	1.38	1.60
10-year government bonds	2.53	2.13	2.67	3.35	2.16	2.21	2.19	2.41	2.58	2.75
Euro										
ECB Refi	0.16	0.05	0.05	0.07	0.05	0.05	0.05	0.05	0.05	0.05
3-month Euribor	0.21	–0.02	–0.06	0.13	–0.01	–0.03	–0.09	–0.10	–0.08	–0.05
12-month Euribor	0.48	0.17	0.14	0.46	0.17	0.16	0.09	0.07	0.10	0.17
2-year government bonds (Germany)	0.05	–0.24	–0.21	0.33	–0.22	–0.24	–0.32	–0.30	–0.28	–0.21
10-year government bonds (Germany)	1.23	0.53	0.88	1.83	0.53	0.69	0.57	0.55	0.67	0.99
EXCHANGE RATES										
$/€	1.33	1.11	1.03	1.08	1.11	1.11	1.09	1.05	1.02	1.02
¥/€	140.42	134.26	128.41	129.87	134.25	135.89	132.82	130.58	127.63	127.79
£/€	0.81	0.73	0.68	0.68	0.72	0.72	0.72	0.70	0.68	0.67
OIL										
Brent ($/barrel)	99.45	53.61	58.23	68.85	63.43	51.10	44.71	48.74	58.24	61.88
Brent (€/barrel)	74.54	48.30	56.43	63.64	57.32	46.00	40.82	46.46	57.04	60.45

Note: *1. Four quarter cumulative.*

Forecasts

FINANCIAL OUTLOOK · The impact of monetary divergence, the big uncertainty of 2016

The start of interest rate normalisation in the US marks the start of the New Year. Towards the end of 2015 international financial markets suffered from a more volatile climate that ended up marring the already weak tone of the second half of the year. Recurring weaknesses in the commodities market, in particular oil, have clearly hampered the trend in global risky assets. Doubts regarding the ability of emerging economies to withstand this situation have also fuelled instability, as well as disappointment with the stimulus measures announced by the ECB at its December meeting. The volatility of the corporate bonds market in the most speculative segment of the US has also contributed negatively. On a positive note, the market's favourable reaction to the first interest rate hike in the US is a sign of strength. Whether this constructive pattern continues in 2016 depends on two necessary conditions: the gradual nature of future hikes in the fed funds rate and an appropriate communication strategy adopted by the Federal Reserve (Fed).

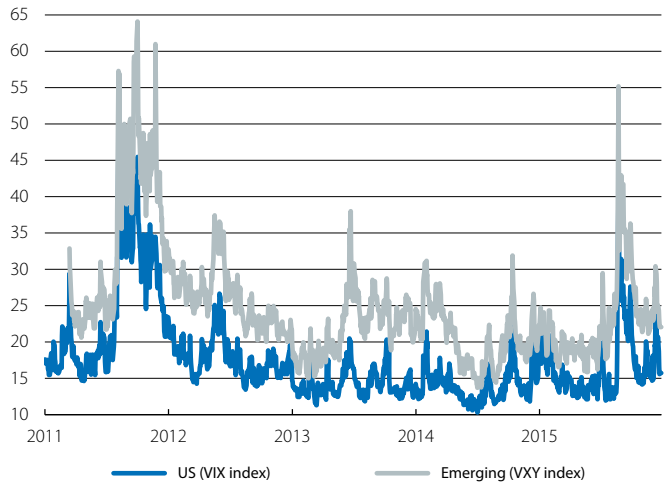
Once again central banks will remain at the centre of the international financial scene. The decoupling of monetary policy between the Fed and other important central banks will undoubtedly be one of the biggest challenges for international markets during the coming year. In particular the implementation of interest rate normalisation by the Fed will play a key role. However, the gradual nature expected for the pace of hikes will help to limit potential negative repercussions (see the Focus «The impact of fed funds rate normalisation on US financial markets»).

After seven years of interest rates close to 0%, the Fed has made its first increase and expects the rate of future hikes to be gradual. As expected, at its December meeting the Federal Open Market Committee (FOMC) decided to start normalising the official interest rate with an increase of 25 bps to 0.25-0.50%. The strength of the US economy justified the Fed's decision and future increases will depend on the trend in economic activity and inflation, although the institution repeated once again that the adjustment of the fed funds rate is expected to be gradual. The decision to continue reinvesting matured debt will keep monetary and financial conditions relatively accommodative. Regarding the strategy implementation to gradually tighten up financial conditions, it is worth noting the start-up of the reverse repo facility whose aim is to progressively drain off excess liquidity from the financial system.

Global markets applaud the Fed's decision. The stock markets welcomed the start of interest rate normalisation in the US, especially European stock markets which led the gains in the days following the move. Emerging markets also

Implied volatility in financial markets

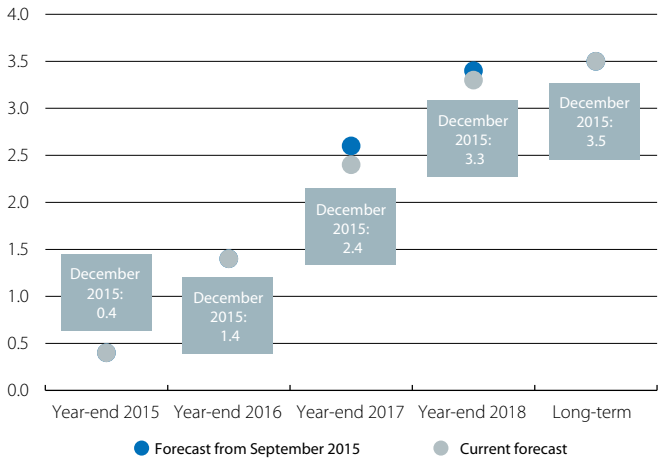
(%)



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

*US: expected level of the official interest rate **

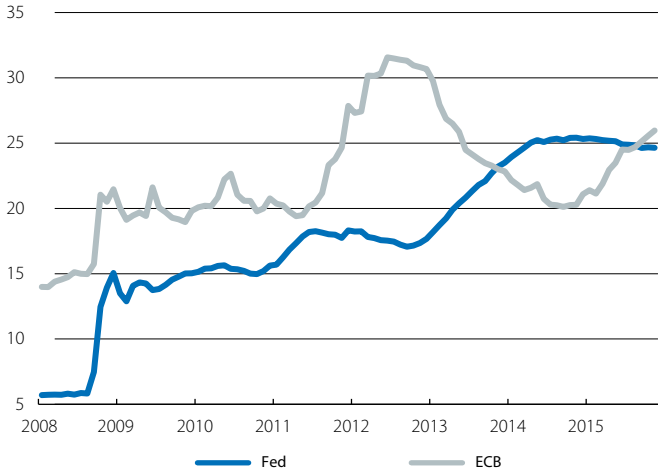
(%)



Note: ** Median of the projections by members of the FOMC of the Federal Reserve.*
Source: *CaixaBank Research, based on data from the Federal Reserve.*

Balance sheet of the Fed and the ECB

(% of GDP)



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

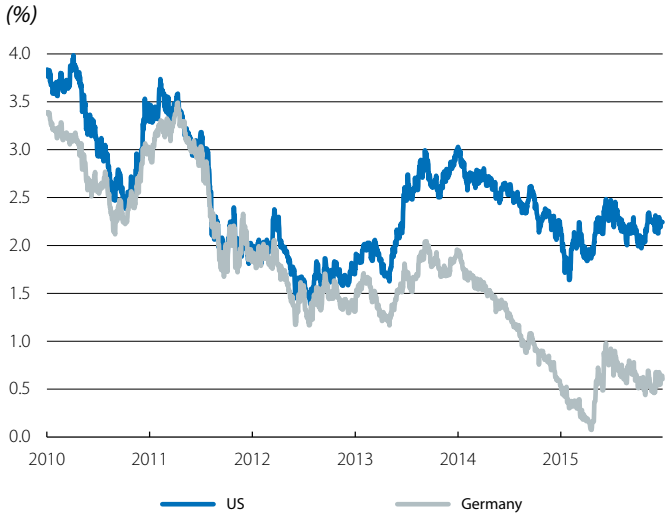
welcomed the decision even though the new interest rate regime could pressurise those emerging economies that have yet to correct their macroeconomic imbalances. In the US yields on 2-year government bonds rose to above 1% for the first time since 2010 while 10-year bond yields were more stable and remained around 2.25%.

The new global financial environment, an additional challenge for the emerging bloc. The emerging financial context remained fragile during the last month of the year. Persistently weak commodities, the dollar's appreciation and tougher financing conditions are a harmful combination for the performance of emerging assets. However, China, Turkey and India have provided positive surprises in terms of their activity, while Brazil still shows no sign of improvement in terms of growth or correcting its imbalances. The political crisis does not look like improving either, as reflected by the impeachment process of President Rousseff and the Finance Minister's resignation. Given the demanding conditions of the external environment and weak commodities, the coming months will be crucial for weak emerging economies to speed up the correction of their internal imbalances.

The ECB adopts more monetary stimuli in its attempt to boost inflation in the euro area. The institution's Governing Council (GC) introduced a battery of adjustments to make its monetary policy more accommodative. Among the different measures announced after its last meeting of the year, the GC cut the deposit facility interest rate by 10 bps to –0.30%. It also announced changes in the parameters of its asset purchase programme (QE): QE has been prolonged to March 2017 and now includes regional and local debt securities in the eligible assets programme. These new measures, together with the decision to reinvest matured bonds already purchased, are aimed at prolonging highly accommodative monetary conditions and reinforcing the institution's policy to guide interest rates (forward guidance).

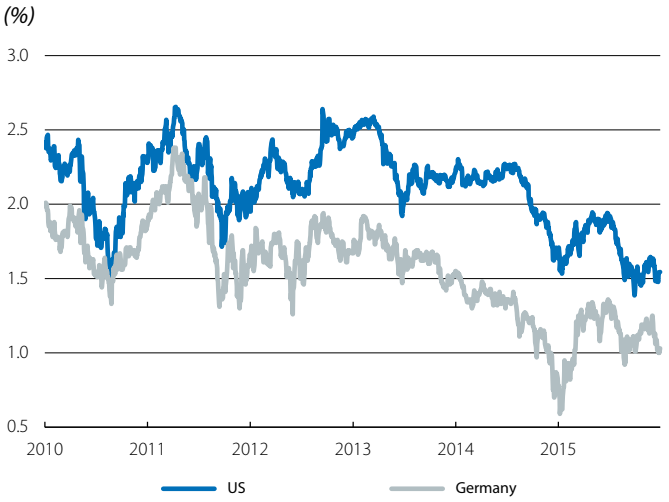
The ECB's measures did not convince investors, who were expecting a more aggressive tone from the central bank. This circumstance led, at first, to strong increases in interest rates in Europe's money and interbank markets. Nonetheless, we believe that the growing amount of excess liquidity in the euro area will help correct spikes in short-term interest rates. Initially there were also upswings in the long-term rates on European public debt. In Spain the 10-year risk premium relaxed significantly in December, fluctuating below 110 bps just before the ECB's meeting. However, the fragmentation of the political spectrum after the elections sparked mistrust among international investors and the risk premium rose to more than 130 bps. Such greater political uncertainty will not help the performance of Spain's sovereign debt, especially taking into account the demanding calendar of maturities faced by the Spanish Treasury in 2016. Nonetheless, we do not expect any great tension for Spanish bonds or any sustained deterioration in perceived risk from Spain.

Yields on 10-year public debt



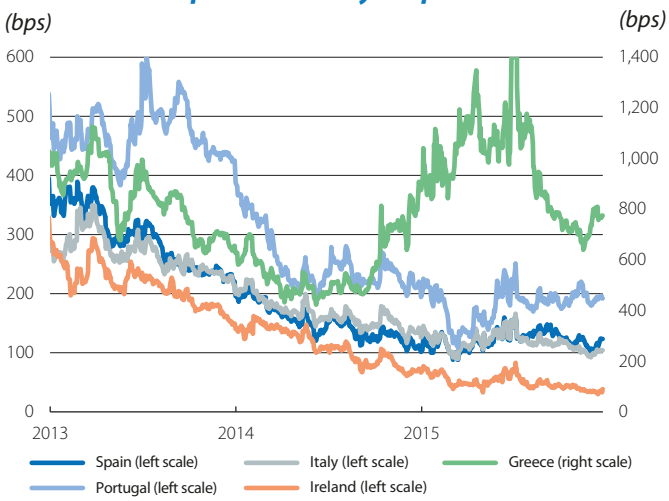
Source: *CaixaBank Research, based on Bloomberg data.*

*Inflation expectations: Germany and the US **



Note: ** Implied in 10-year inflation-linked bonds.*
Source: *CaixaBank Research, based on Bloomberg data.*

Euro area: risk premia of 10-year public debt



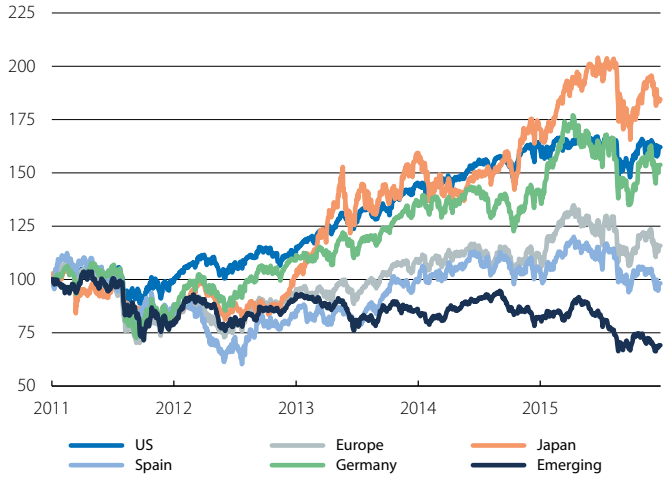
Source: *CaixaBank Research, based on data from Thomson Reuters Datastream.*

The end of year does not bring much enthusiasm to the stock markets. International stock markets ended 2015 without being able to recover completely from the losses recorded during the episode of stress in the summer. US equity is the big exception and the S&P 500 returned to gains in the overall figure for the year after passing the Fed's acid test. However, relatively high share prices and the current weak context for growth in corporate earnings suggest a somewhat discouraging setting for the US stock market. A more intense sell-off of commodities is a source of risk that will help to preserve this uncertain stock market tone. The doubts regarding the solidity of the high yield segments of the corporate bonds market at a global level, in an environment of declining liquidity in the secondary bond market, is another source of instability. In Europe the new measures adopted by the ECB to make its monetary policy more accommodative were not enough to sustain the optimistic sentiment of previous months although 2016 should be the year in which the recovery in corporate earnings builds up steam thanks to underlying factors that are already well-known. Emerging stock markets were also affected by this dynamic and suffered further losses in December. As has already been mentioned, the reformist momentum in emerging countries represents a fundamental variable for investor confidence to recover. Confidence which should improve as fears diminish regarding the growth capacity of the emerging economies and as it becomes clear that the region's share prices still have significant room for improvement (see «2016: challenges and opportunities in a demanding global financial environment» in MR12/2015).

The strength of the dollar and the slump in oil continue to weigh heavily on the emerging currencies while the euro-dollar exchange rate is still at the mercy of the messages and actions of the Fed and ECB. A strong upswing following the ECB's decision took the euro to 1.10 dollars before it depreciated again slightly after the Fed's announcement, down to 1.08 dollars. In the medium term Europe's currency should continue to depreciate slightly given the growing divergence between the monetary policies adopted by these two monetary blocs. In the commodities markets Brent continues to lose support, furthering its slump to 36 dollars/barrel. Excess supply and the lack of agreement between OPEC members have intensified the weakness of crude oil price, falling to its lowest level since 2004.

International stock markets

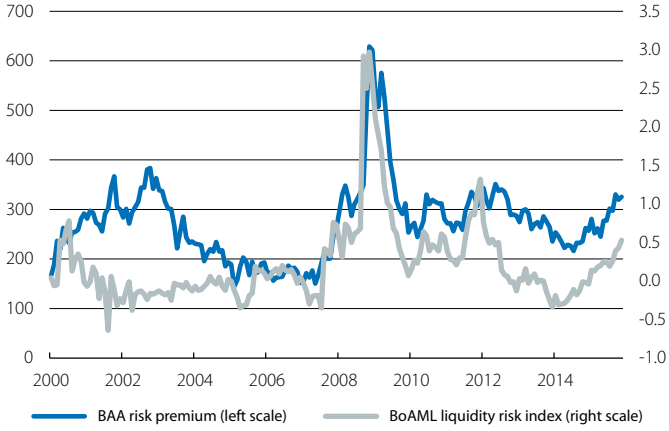
Index (100 = January 2011)



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

*US: risk premium on corporate bonds * and liquidity risk*

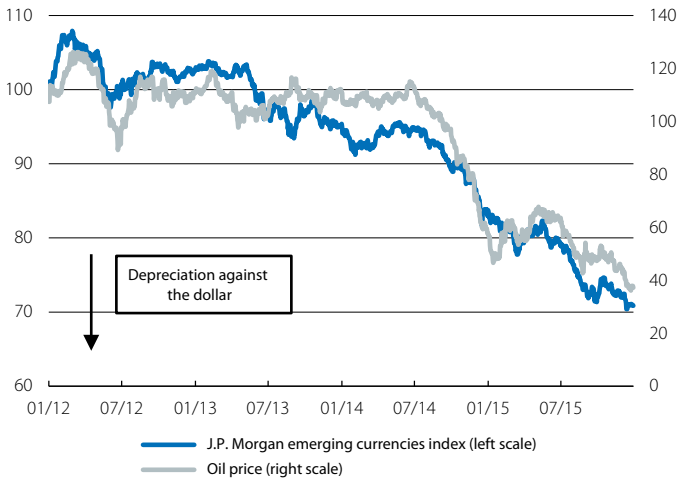
(bps) *(bps)*



Note: ** Compared with the yield on 10-year US Treasury bonds.*
Source: *CaixaBank Research, based on Bloomberg data.*

Emerging currencies and Brent oil price

Index (100 = January 2012) *(dollars / barrel)*



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

FOCUS · The impact of the fed funds rate normalisation on US financial markets

In December the Federal Reserve (Fed) announced it would start what should be an upward path for the fed funds rate. This normalisation of interest rates, which had not risen in almost a decade, is accompanied by considerable uncertainty regarding the possible repercussions for global and in particular US financial markets. An upward cycle tends to lead to a certain amount of caution among investors and this time we should not be surprised if precaution is even greater, as we are starting from an extraordinarily low interest rate.

The hike in the official rate essentially impacts US financial markets via two effects. Firstly, higher interest rates tend to be passed on to fixed asset prices such as sovereign and corporate bonds, particularly with shorter-term maturities, thereby shifting up and flattening out the interest rate curve. This higher yield on bonds means that the discount rates used to value equity are higher, pushing their prices down. Secondly, higher interest rates also push up the financial costs of firms and could cool down demand (sales), two factors which limit the corporate earnings expected and therefore share prices. Asset prices already partly reflect expectations of an interest rate hike so there may not be any huge fluctuations in financial markets. But it is also true that, based on interest rate hikes and the accompanying communication, future expectations may be considerably revised leading to sharper variations.

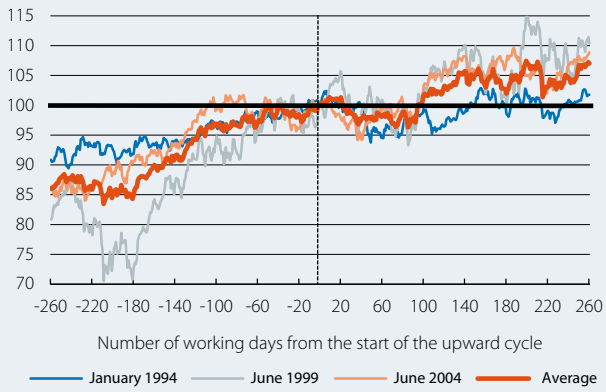
The experience of the last interest rate upward cycles in the US suggests that investors initially tend to penalise equity. Specifically, the S&P 500 posted, on average, slight losses during the three months after interest rate hikes began. But subsequently, as a positive macroeconomic environment was confirmed, the US stock market tended to regain its upward trend (see the graph). On average bond yields have been pushed up, especially short-term bonds and less risky assets such as public debt, so corporate spreads tend to narrow during a interest rate upward cycle as the macroeconomic environment improves.

When attempting to anticipate the possible impacts of the current upward cycle we must also remember that the starting position is very different to that of previous cycles. Firstly the US economy is embarking on the current hike at a more advanced stage in its financial and credit cycle. With relatively high share prices after years of unconventional monetary measures and corporate earnings at record levels, normalising monetary policy could have a more adverse effect on equity than in the past (see the Focus from MR12/2015 «Is the tide turning for the US stock market?»). Relatively high levels of debt in the high yield corporate bond segment could also widen the spreads for these assets. The divergence of the Fed's monetary policy from that of other large central banks is the other big challenge in the current cycle. By pushing up the dollar's value, which could harm competition for a part of the US corporate sector, this phenomenon, which has already been named the «Great Divergence» could, in turn, affect US share prices. One argument in favour of a more optimistic hypothesis for the effect of this upward cycle is the gradual rate expected for hikes (see also the Focus from MR12/2015 «A federal funds rate hike: this time is different»).

In summary, the current upward cycle in interest rates should not necessarily have a great impact on markets. Its effect will largely depend on whether the economic recovery continues to be confirmed in the US, as well as the absence of any adverse collateral effects on emerging countries and no inflationary pressure leading to a drastic change in the expected path of interest rate hikes. Clear, coherent communication by the Fed will also be vital to avoid large fluctuations in investor expectations and consequently sharp movements in the prices of financial assets.

Trend in the S&P 500 related to the announcement of the start of the cycle of fed fund rate hikes

Index (100 = day prior to the announcement)



Source: *CaixaBank Research, based on Bloomberg.*

FOCUS · European banks are biding their time on the stock markets

The global financial crisis brought about a radical shift in monetary policy and a tsunami of regulations that have forced the banking industry to carry out far-reaching adaptations against the clock. In a context of widespread deleveraging and the need to sort out balance sheets, both ultra-low interest rates and higher capital requirements have implied a huge effort for banks to achieve levels of return in line with capital costs. Nonetheless, although all banks still face common challenges, the stock market performance of US and European banks has been diverging since the end of 2009 so that, while the market currently attributes a value higher than its book value for the former (a P/B[1] ratio of 1.08), it has kept the value of the latter below its book value (a P/B ratio of 0.79). Why? And what are the implications for the future?

This divergence can initially be attributed to differences in the pace and intensity of reaction by monetary and regulatory authorities on both sides of the Atlantic. While the Fed acted faster and more comprehensively, Europe took longer to react and was more restrained, at least until Mario Draghi's «whatever it takes» in 2012 and the start of banking union. Without doubt these differences not only contributed to a faster adjustment in the US financial sector but also to an earlier and more vigorous economic recovery than in Europe.

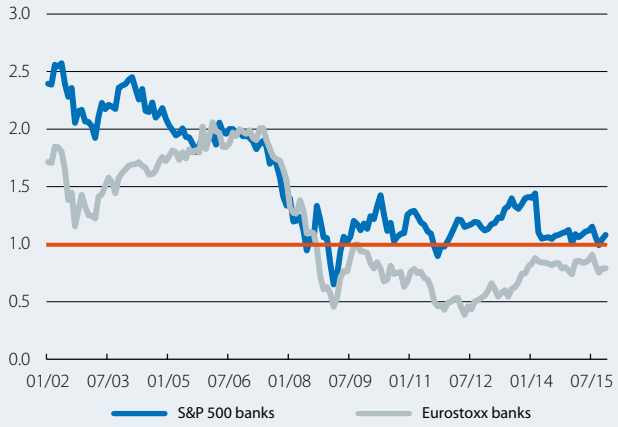
Also, a more favourable macroeconomic environment can be seen in better capital returns (RoE) on the other side of the Atlantic. The average RoE for banks that form part of the S&P 500 stands at 8.9%, far above the 3.9% recorded by Eurostoxx banks. And thanks to the Fed beginning its interest rate hikes the outlook for bank earnings in the US has also improved, as bank revenue increases with higher interest rates since the cost of deposits, some of which (sight deposits) earn no interest, does not increase as much as the interest rate charged on loans.

The beginning of the end of low interest rates and the more advanced economic cycle in the US are therefore providing a more favourable scenario for the business of US financial institutions in the short term, which is pushing up their share prices. European financial institutions, however, continue to be penalised by a number of factors: in addition to monetary normalisation being a long way ahead, some banks are still getting their balance sheets in shape as economic weakness and the deleveraging underway is maintaining pressure on volumes and the cost of risk. On the other hand the need to complete the banking union and the greater harmonisation this will involve represent another source of uncertainty for expectations of future returns.

Given this situation, the US-European gap in terms of share prices could be interpreted in arbitrage terms: a lower price is demanded to invest in European rather than US banks because the returns from European business are lower and this is the determining factor in dividend growth. Investors are only ready to buy shares if there is a clear possibility of their value going up. Ultimately, investors are repaid via dividends and higher share prices. When pressure remains high on the RoE, expected returns depend on share price and a P/B ratio below one facilitates this growth until the sector's results become stronger and more stable, something which, on the other hand, should be a question of time if the current trend continues.

Price-to-book ratio (P/B): Europe and United States

Level



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

Return on Equity (RoE): Europe and United States

(%)

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

1. The P/B or price-to-book ratio is the quotient between market share price and the book value. Banking sector firms on the S&P 500 are used for US banks and those on the Eurostoxx for European banks.

KEY INDICATORS

Interest rates (%)

	31-Dec	30-Nov	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	–0.13	–0.11	–2	–20.9	–20.9
1-year Euribor	0.06	0.05	1	–26.5	–26.5
1-year government bonds (Germany)	–0.38	–0.38	0	–31.6	–31.6
2-year government bonds (Germany)	–0.35	–0.42	7	–25.2	–25.2
10-year government bonds (Germany)	0.63	0.47	16	8.9	8.9
10-year government bonds (Spain)	1.77	1.52	25	15.9	15.9
10-year spread (bps) [1]	114	105	9	7.0	7.0
US					
Fed funds (upper limit)	0.50	0.25	25	25.0	25.0
3-month Libor	0.61	0.42	19	35.4	35.4
12-month Libor	1.18	0.98	20	55.1	55.1
1-year government bonds	0.60	0.48	12	38.7	38.7
2-year government bonds	1.05	0.93	12	38.6	38.6
10-year government bonds	2.27	2.21	6	9.9	9.9

Spreads corporate bonds (bps)

	31-Dec	30-Nov	Monthly change (bps)	Year-to-date (bps)	Year-on-year change (bps)
Itraxx Corporate	77	70	7	14.4	14.4
Itraxx Financials Senior	77	68	9	9.4	9.4
Itraxx Subordinated Financials	156	142	13	6.9	6.9

Exchange rates

	31-Dec	30-Nov	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
$/€	1.086	1.057	2.8	–10.2	–10.2
¥/€	130.640	130.050	0.5	–9.8	–9.8
£/€	0.737	0.702	5.0	–5.1	–5.1
¥/$	120.220	123.110	–2.3	0.4	0.4

Commodities

	31-Dec	30-Nov	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
CRB Commodity Index	374.7	384.2	–2.5	–14.4	–14.4
Brent ($/barrel)	35.8	42.8	–16.5	–35.9	–35.9
Gold ($/ounce)	1,061.4	1,064.8	–0.3	–10.4	–10.4

Equity

	31-Dec	30-Nov	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
S&P 500 (US)	2,043.9	2,080.4	–1.8	–0.7	–0.7
Eurostoxx 50 (euro area)	3,267.5	3,506.5	–6.8	3.8	3.8
Ibex 35 (Spain)	9,544.2	10,386.9	–8.1	–7.2	–7.2
Nikkei 225 (Japan)	19,033.7	19,747.5	–3.6	9.1	9.1
MSCI Emerging	794.1	814.3	–2.5	–17.0	–17.0
Nasdaq (US)	5,007.4	5,108.7	–2.0	5.7	5.7

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

ECONOMIC OUTLOOK · **2016: global acceleration but with important risks**

World growth will speed up in 2016 (3.6% compared with 3.1% in 2015) with the advanced economies consolidating a moderate expansion (2.2%) and growth building up steam in the emerging economies in spite of uncertainty (4.5%). This scenario might be affected by global and local factors. Among the first, at present is the interest rate hike by the Federal Reserve (Fed). This is the first increase in almost a decade and could have important global consequences, especially for emerging economies whose financial flows increased significantly as a consequence of the liquidity injected by the Fed (see the Focus «The Fed hikes - outflows of capital from emerging economies?» in this *Monthly Report*). A second factor of global scope is the price of oil, surprising once again by falling in December. We predict, however, that crude will start to appreciate gradually over the first few months of 2016, helping to rebalance the winners and losers and returning inflation to more normal levels. A third notable factor in the last month has been the greater deterioration in Brazil's economy, the largest in Latin America and one of the biggest emerging economies.

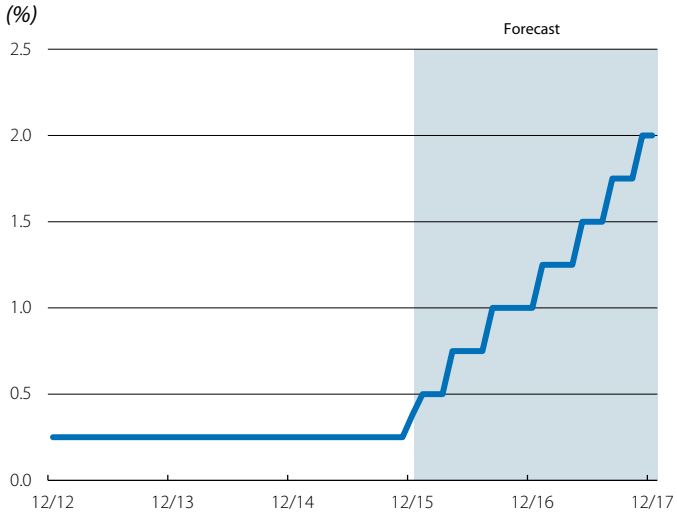
UNITED STATES

The Fed raises the official interest rate by 25 bps to the range of 0.25%-0.50%. In December the Fed confirmed all expectations by starting to raise interest rates after almost 10 years without any increase. Nonetheless, in its communication the institution stressed the gradual nature of this process: «The Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate». So, now that the interest rate hikes have begun, the important feature is their pace. In this respect we expect four hikes to be carried out by the beginning of 2017 and interest rates are likely to be at 1.25%, a level higher than that predicted by fed fund rate futures but lower than the opinions expressed by members of the Federal Open Market Committee.

US inflation is on the up. The general CPI grew by 0.5% year-on-year in November, 0.3 pps more than the figure posted the previous month and in line with our forecasts. However the general CPI remained flat in month-on-month terms due to a further fall in the energy component (–1.3% month-on-month). The recent trend in oil prices represents a downside risk for our main scenario which places general inflation at 2.0% by the end of 2016, although core inflation continued to look strong and was 0.1 pps higher than October's figure (2.0%).

The latest indicators point to this rate of expansion continuing in the US. GDP grew by 0.5% quarter-on-quarter

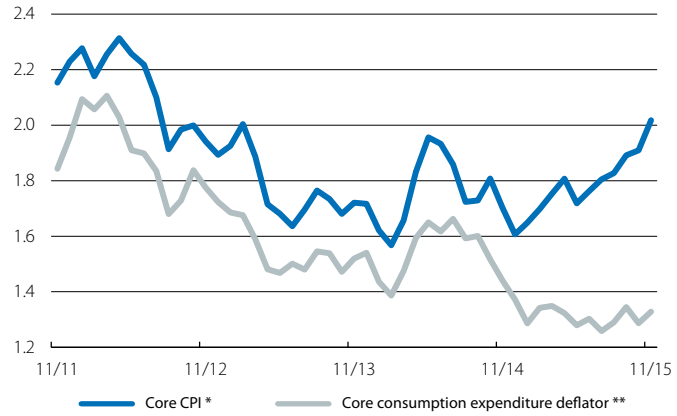
US: fed funds rate



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

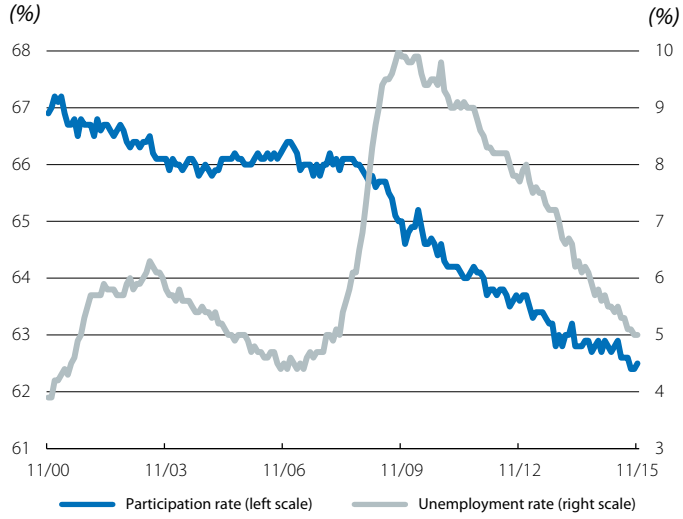
US: CPI and consumption expenditure deflator

Year-on-year change (%)



Notes: ** Core CPI: general index without energy or food. ** Deflator of personal consumption expenditure without energy or food.*
Source: *CaixaBank Research, based on data from the Bureau of Labor Statistics and the Bureau of Economic Analysis.*

US: unemployment and participation rate



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

in Q3 according to the third estimate of the Bureau of Economic Analysis, almost unchanged from its second estimate. Private consumption, which increased by 1.0%, was confirmed as its strongest component. On the other hand, the ISM business sentiment index for manufacturing fell to 48.6 points in November, corresponding with economic growth of almost 1.4%. However, the ISM for services (which account for 80% of economic activity and 85% of the jobs in the private sector) stood at 55.9 points, in line with growth of 3.0%. Given this situation we have kept our growth forecasts at 2.5% year-on-year, both for 2015 and for 2016.

The US labour market still looks in good shape. 211,000 net jobs were created in November, maintaining the average of 215,000 over the last 12 months. Wages also rose by a favourable 2.3% year-on-year, significant growth if we remember that inflation is still contained. The unemployment rate stayed at a low 5.0%, very close to 2007's average of 4.6% and far from the peak of 10.0% recorded in October 2009. One questionable aspect of this favourable situation is that a considerable proportion of this 5 pps drop in unemployment is due to a lower participation rate, standing at 62.5% of the labour force in November, significantly below the 66.0% recorded in 2007.

JAPAN

Japan grows in Q3 and sidesteps recession. After the upward revision made by the country's Department of Trade, GDP for 2015 Q3 grew by 0.3% quarter-on-quarter (the previous figure announced had been a drop of 0.2%), meaning that Japan has avoided falling into recession after the quarter-on-quarter decline in Q2. However, an analysis by component suggests caution: three-quarters of this improvement was due to a much smaller inventory adjustment than previously announced, which will hinder the Japanese economy over the coming months. For its part private consumption has yet to take off. Nonetheless, the substantial improvement in the figures for Q3 has forced us to carry out a technical upward revision of our annual forecast for 2015 (from 0.6% to 0.7%).

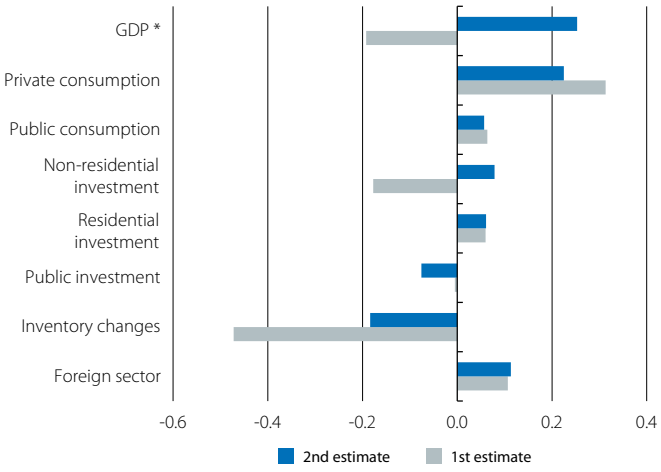
Economic sentiment indicators show limited improvement. The Tankan business sentiment index for large firms produced by the BoJ stabilised in 2015 Q4 in spite of a deterioration in expectations for 2016 Q1. The high level shown by the index for large firms also contrasts with a more contained figure overall (which includes small and medium-sized firms). On the other hand the foreign sector once again suffered from weak Chinese and US demand for Japanese goods in spite of a relatively cheap yen.

EMERGING ECONOMIES AND COMMODITIES

Strong economic and political decline in Brazil. The recession is getting worse in Brazil. In Q3 GDP fell by a huge 1.7% quarter-on-quarter (–2.1% in Q2), equivalent to a fall

Japan: GDP

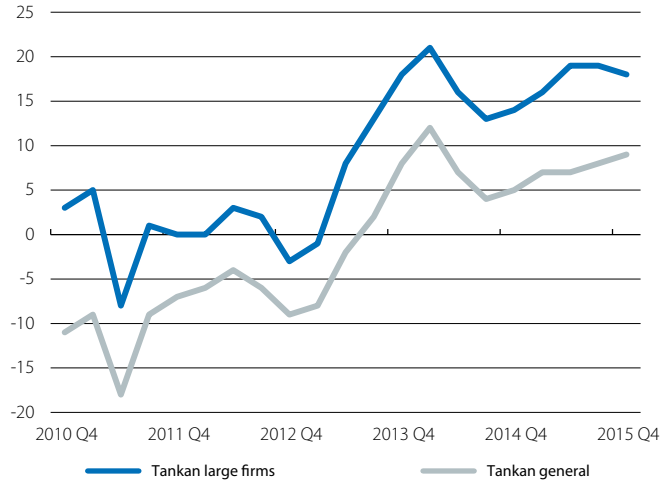
Contribution to quarter-on-quarter growth in GDP in 2015 Q3 (pps)



Note: ** Quarter-on-quarter change.*
Source: *CaixaBank Research, based on data from the Ministry of the Interior and Communication.*

Japan: business sentiment index (Tankan)

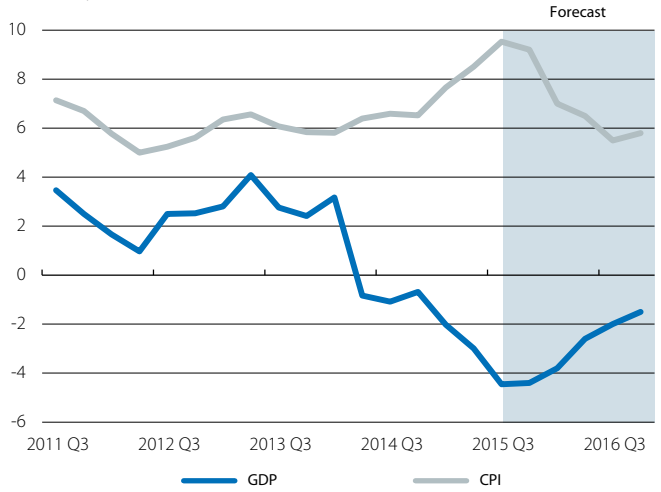
Level



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

Brazil: GDP and CPI

Year-on-year change (%)



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

of 4.5% in year-on-year terms (–3.0% in Q2). By demand component, of note is the bad performance by investment and, to a lesser degree, public consumption. Rising inflation, in October reaching 9.9%, and the large current deficit (3.9% in Q3) complete a poor economic situation. Political uncertainty also worsened with the start of impeachment against the President Dilma Rousseff. This process, which could last several months, is complex (a committee in the Congress, plenary in the Congress and plenary in the Senate). In principle it will be difficult to achieve the majority required for impeachment (two thirds of the seats) but, given the country's current political volatility, extreme scenarios cannot be ruled out. One initial consequence of this political deterioration was the replacement of the Finance Minister, Joaquim Levy, with Nelson Barbosa, less committed to fiscal consolidation. Subsequently the Fitch agency downgraded Brazil's credit rating from BBB– to BB+. The country's poor economic figures and political uncertainty have led us to revise downwards our own forecast, altering the drop in GDP from –2.3% to –3.5% in 2015 and from –0.6% to –2.5% in 2016.

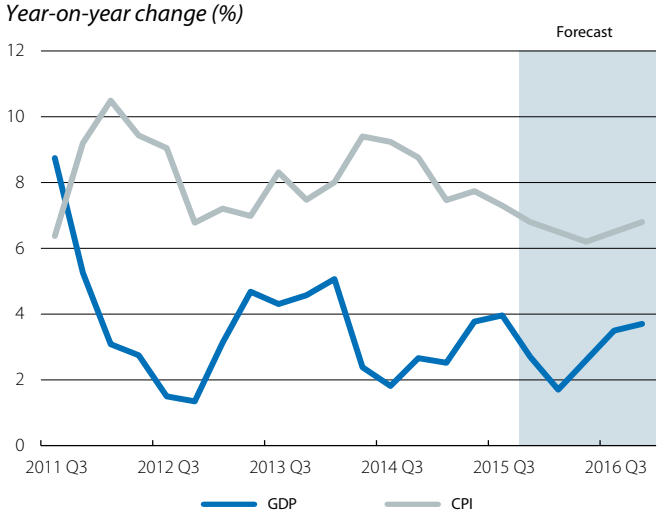
China's activity figures suggest growth is stabilising slightly. This supports our main scenario of a soft landing with a growth forecast of 6.8% for 2015 and 6.5% for 2016. Specifically, retail sales advanced in November by 11.2% year-on-year, the best figure for the year to date, while industrial production rose by 6.2% year-on-year, the best month since June. The foreign sector, on the other hand, disappointed once again: exports fell by 6.8% year-on-year in November.

Turkey posts surprisingly good figures. In Q3 GDP increased by 4.0% year-on-year, a little more than expected and a slight acceleration compared with Q2 (3.8%). The main factors behind this figure are strong growth in public consumption and the lower negative contribution made by the foreign sector (mainly resulting from a drop in imports). Nonetheless the economic outlook is somewhat less positive than the data suggest as significant macroeconomic imbalances remain (inflation was 8.1% in November and the current deficit reached 5.2% of GDP in Q3) as well as geopolitical uncertainty.

Oil falls to its lowest price in the last seven years. Lack of agreement regarding production at the twice-yearly OPEC meeting and the increase in US stocks led to a sharp fall in the price of crude. Specifically Brent accumulated a 17% drop in the first two weeks of December, pushing it down to the minimums reached in December 2008, below 40 dollars/barrel. However, we expect the reduction in US shale investment and the predictable recovery in global demand to help crude prices to gradually recover throughout 2016, reaching 64 dollars/barrel by the end of year, while in mid-December the US Congress reached an agreement to raise restrictions on crude exports for US companies.

Turkey: GDP and CPI

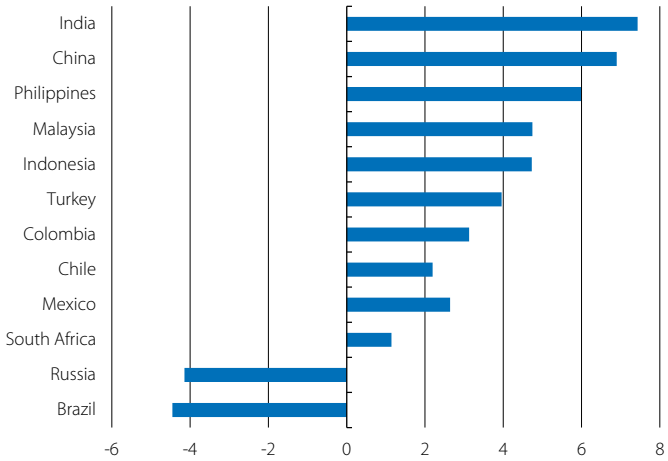
Year-on-year change (%)



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

Emerging countries: GDP growth in 2015 Q3

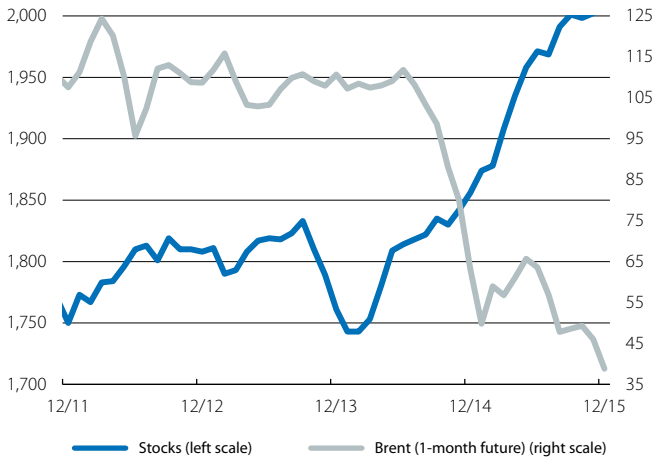
Year-on-year change (%)



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

Oil: price and stocks in the US

(Millions of barrels) *(Dollars/barrel)*



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

FOCUS · The Fed hikes - outflows of capital from emerging economies?

On 16 December the Federal Reserve (Fed) raised its interest rate for the first time in almost a decade. As low US interest rates (and the extraordinary amount of liquidity injected by the Fed and other central banks) are factors that have pushed up financial flows towards emerging countries, there is some concern that tighter monetary conditions could lead to significant outflows of capital. Given that, since May 2015, there has been a slowdown in capital entering the emerging economies and that this process actually became an outflow of capital between August and November in many of them, might this be a prelude to a more serious loss of capital?

We should remember that monetary normalisation did not begin with December's interest rate hike. As an initial phase (as from May 2013), the Fed started to outline how it would exit the period of unconventional monetary policy and provided forward guidance. In a second phase (as from December 2013), the rate of bond purchases started to decrease (the so-called tapering). Interest rate hikes therefore constitute the third phase in monetary normalisation. So what has been the trend in capital flows to emerging countries since this whole process started?

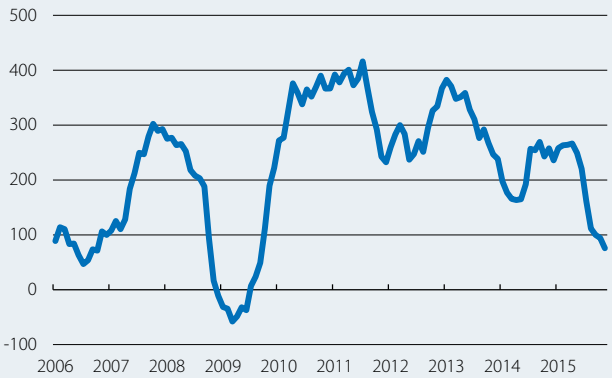
Whereas, in May 2013, the 12-month cumulative net inflows of capital in shares and debt stood at around 358 billion dollars, one year after the Fed's shift in its forward guidance the net inflows of capital were 53% lower.[1] They were still positive but their level was, at that time, the lowest it had been since the Great Recession of 2008-2009, the only time in the last decade when net portfolio capital inflows had been negative. After recovering appreciably between May 2014 and May 2015, another slowdown began in emerging capital inflows, reaching significant levels: in November net portfolio capital inflows fell by 71% year-on-year, always in 12-month cumulative terms.

Although intense, this episode did not affect all emerging economies equally, however. Many suffered net portfolio capital outflows while others, such as Mexico, Chile, the Czech Republic and Poland, did not. So what do these four countries have in common? A healthy macroeconomic situation: those countries suffering from net portfolio capital outflows since August tend to have excessive macroeconomic imbalances (Brazil and Turkey). It should also be noted that capital outflows have been considerable in some countries. This is the case of South Africa (which between July and November posted net sales of shares and debt equivalent to 4.1% of the value of its foreign currency reserves), Turkey (2.5%) and Brazil (1.8%). This is important because if a country that is particularly relevant in regional terms (albeit not in systemic terms) starts to encounter difficulties, this is a source of concern given the current environment of financial pressure on emerging countries (such is the case of Turkey, located in the centre of a delicate region).

What can we deduce from this sequence regarding the possible events in 2016? History and theory suggest that it is normal for markets to anticipate monetary policy decisions and consequently part of what happened in 2015 is due to this effect. Nonetheless, the fact that some countries still have macroeconomic imbalances, including some regionally systemic ones, means that investor sensitivity to fluctuations in risk aversion will be high in such cases. We can therefore expect quite intense episodes of capital outflows at some point. But will such outflows be widespread and long-lasting? In the absence of genuinely systemic negative shocks, this would be an extreme scenario that does not seem very likely, but we must remember that we are entering unknown territory: the period of ultra-accommodative monetary conditions has been long and the injection of global liquidity unusually high, so it cannot be assumed that the exit from this period and its financial consequences will be in line with past experiences. Moreover, the deterioration in liquidity conditions in several financial asset markets could amplify the scope and intensity of possible shocks of an idiosyncratic and non-recurring nature. It will therefore be a challenge.

Emerging countries: net portfolio capital inflows (debt and shares)

(Billions of US dollars, cumulative over 12 months)



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

1. Regarding the effects of the analysis in question, it is important to note that the increase in interest rates in advanced economies especially affects capital inflows used to buy debt and shares in emerging countries but less so bank flows and direct foreign investment. For a review of this issue, see Koepke, R. (2015), «What Drives Capital Flows to Emerging Markets? A Survey of the Empirical Literature», IIF Working Paper.

FOCUS · China: the two-child policy and its possible effects on growth

China's medium to long-term growth prospects are suffering from a rather unusual phenomenon among the emerging economies: an ageing population as a consequence of a falling fertility rate and rising life expectancy. In order to delay this phenomenon, at its annual meeting in October the Chinese Communist Party proposed the suspension of the one-child policy introduced in the country between 1978 and 1980, allowing all couples to have two children if they want. How will this measure affect the country's economic growth in the medium term?

One initial element to take into account is the fact that China's sharp drop in fertility rate pre-dates the one-child policy and is due to other measures which, like this policy, promoted birth control. In particular the largest drop in the fertility rate, from 5.8 in 1970 to 2.7 in 1978,[1] was encouraged by the «late, spare, few» campaign advising women to get married later, have fewer children and with more time in-between them.

Moreover, a second significant factor is that the one-child measure included important exceptions and was less restrictive than its name might suggest. Already in the early 1980s two or more children per couple were permitted in rural areas, which at that time held over 80% of the population. This figure fell slightly to 70% in the 1990s but it was not until the end of the first decade of the new millennium when it went below 50%. Similarly, as from 1986, the government allowed two children for a large number of households meeting certain requirements such as one of the parents being an only child. Nevertheless, in spite of these important exceptions the birth rate continued to fall, from 2.7 children per woman at the end of the 1970s to the current figure of 1.55, so that other factors beyond the single child limitation have been put forward as the reason for this continued decline, some of these being the high cost of bringing up a child especially in cities, the far-reaching cultural impact of birth policies and the rise in women's level of education.

To get an idea of the possible effect of suppressing the single child policy we can use two scenarios for the trend in China's population carried out by the United Nations.[2] Specifically, the high scenario reflects the probable trend in the fertility rate caused by the suppression of this demographic measure: it assumes a rapid increase in the fertility rate which would place it slightly above two children per woman by 2020 and at 2.25 by 2050. On the other hand, the low scenario assumes that the fertility rate will continue to fall, reaching 1.25 by 2050, in line with a situation of the one-child restriction continuing. In spite of this big gap between one scenario and another, during 2015-2050 the labour force decreases in both cases as most of the workers during this period (over 85%) will be individuals born before 2015, their number reflecting the prolonged drop in the fertility rate to date. Any «extra babies» born as a result of ending the single child policy will not join the labour market until well into the 2030s.

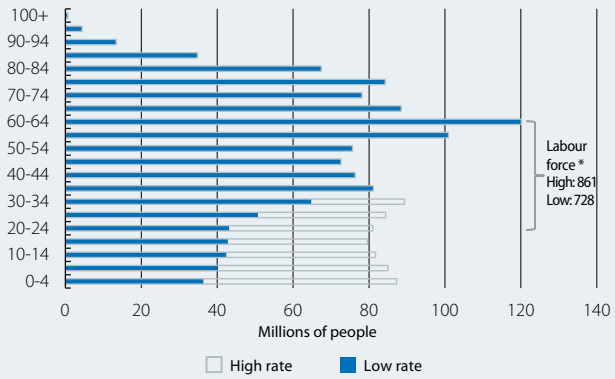
By 2050, however, the estimated labour force in the high fertility scenario would be 133 million larger than the labour force in the low fertility scenario (861 million workers compared with 728 million) since almost 40% of the workers in 2050 would be individuals born after 2015 and therefore affected by the change in policy. If we assume that productivity remains equal in both scenarios, in 2050 real GDP in the high scenario would be about 18% higher than real GDP in the low scenario.

Lastly, it is important to note how the suppression of the one-child policy might also affect precautionary savings over the coming years. In less developed countries children play an essential role in looking after and maintaining their parents once they are old and, in China, the one-child policy resulted in a considerable rise in savings for precautionary reasons. The suppression of this policy is therefore likely to have the opposite effect, reducing precautionary savings and thereby boosting consumption.

In short, the numerous and far-reaching birth control policies implemented in China over the last 50 years have left a mark on the country that will still be seen for several decades to come. Nevertheless the suppression of the one-child policy is welcome, bringing with it significant economic advances in the medium term.

China's population pyramid in 2050 under two different fertility rate scenarios

(Age range)



Note: ** The labour force is defined as individuals aged between 15 and 64.*
Source: *CaixaBank Research, based on data from the United Nations (2015 Revision of World Population Prospects).*

1. Gu, B. and Cai, Y. (2011), «Fertility prospects in China», United Nations.
2. United Nations, 2015 Revision of World Population Prospects.

KEY INDICATORS

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

UNITED STATES

	2013	2014	2014 Q4	2015 Q1	2015 Q2	2015 Q3	10/15	11/15	12/15
Activity									
Real GDP	1.5	2.4	2.5	2.9	2.7	2.1	–	...	–
Retail sales (excluding cars and petrol)	3.4	3.9	4.8	4.8	3.7	4.0	3.4	3.6	...
Consumer confidence *(value)*	73.2	86.9	92.7	101.3	96.2	98.3	99.1	92.6	96.5
Industrial production	1.9	3.7	4.5	3.5	1.5	1.2	0.3	–1.2	...
Manufacturing activity index (ISM) *(value)*	53.8	55.7	56.9	52.6	52.6	51.3	50.1	48.6	...
Housing starts *(thousands)*	928	1,001	1,055	978	1,158	1,158	1,062	1,173	...
Case-Shiller home price index *(value)*	158	171	173	177	179	179	181	...	...
Unemployment rate *(% lab. force)*	7.4	6.2	5.7	5.6	5.4	5.2	5.0	5.0	...
Employment-population ratio *(% pop. > 16 years)*	58.6	59.0	59.2	59.3	59.3	59.3	59.3	59.3	...
Trade balance [1] *(% GDP)*	–2.9	–2.9	–2.9	–3.0	–3.0	–3.0	–4.0	...	...
Prices									
Consumer prices	1.5	1.6	1.2	–0.1	0.0	0.1	0.2	0.5	...
Core consumer prices	1.8	1.7	1.7	1.7	1.8	1.8	1.9	2.0	...

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 Q4	2015 Q1	2015 Q2	2015 Q3	10/15	11/15
Activity								
Real GDP	1.4	–0.1	–0.9	–1.0	0.7	1.7	–	...
Consumer confidence *(value)*	43.6	39.3	38.9	40.7	41.5	40.9	41.5	42.6
Industrial production	–0.6	2.1	–1.4	–2.2	–0.5	–0.4	0.3	...
Business activity index (Tankan) *(value)*	6.0	13.5	12.0	12.0	15.0	12.0	–	12.0
Unemployment rate *(% lab. force)*	4.0	3.6	3.5	3.5	3.3	3.4	3.1	...
Trade balance [1] *(% GDP)*	–2.4	–2.6	–2.6	–1.8	–1.4	–1.0	–0.9	–0.7
Prices								
Consumer prices	0.4	2.7	2.5	2.3	0.5	0.2	0.3	0.3
Core consumer prices	–0.2	1.8	2.1	2.1	0.4	0.8	0.7	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 Q4	2015 Q1	2015 Q2	2015 Q3	10/15	11/15
Activity								
Real GDP	7.7	7.3	7.2	7.0	7.0	6.9	–	...
Retail sales	15.5	12.0	16.5	10.5	10.2	10.7	11.0	11.2
Industrial production	9.7	8.3	7.6	6.4	6.3	5.9	5.6	6.2
PMI manufacturing *(value)*	50.8	50.7	50.4	49.9	50.2	49.8	49.8	49.6
Foreign sector								
Trade balance [1] *(value)*	258	383	383	489	541	577	593	592
Exports	7.8	6.0	8.6	4.6	–2.2	–5.8	–6.9	–7.2
Imports	7.3	0.4	–1.9	–17.6	–13.5	–14.3	–18.8	–9.0
Prices								
Consumer prices	2.6	2.0	1.5	1.2	1.4	1.7	1.3	1.5
Official interest rate [2] *(value)*	6.00	5.60	5.60	5.35	4.85	4.60	4.35	4.35
Renminbi per dollar *(value)*	6.1	6.2	6.1	6.2	6.2	6.3	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 · **Domestic demand drives growth in the euro area**

The recovery continues at a moderate but sustained pace. The rate of expansion of the euro area's economy has been maintained, supported by the good performance of domestic demand. Although the ECB pointed to an increase in external risks in its decision to extend QE, the outlook for Europe's economy is favourable and in line with expectations. This is shown by the ECB's own forecasts which hardly varied the scenario for growth and inflation in December. It therefore expects economic growth to increase from 1.5% in 2015 to 1.9% in 2017. The weakness of inflation in 2015 is largely due to lower prices in the energy component, a factor that will disappear in the medium term. In the coming months we expect the economy to still benefit from low oil prices, as well as from accommodative monetary policy, a favourable exchange rate for exports and less fiscal consolidation. However, these are temporary factors and it is therefore necessary to continue with structural reforms, both at this country level and also in the euro area as a whole (economic, fiscal, banking and political union), in order to ensure sustained growth over the long term.

Domestic demand fuels the economy in Q3. GDP continued to grow by 1.6% year-on-year in Q3 in spite of the negative contribution by foreign demand. Behind the good performance of domestic demand lies the growth in consumption, both public and private. At the country level we can see a similar dichotomy between the performance by foreign and domestic demand. Aggregate consumption (private and public) improved its year-on-year growth in Germany (2.3%), Spain (3.3%) and Italy (0.9%), while it slowed up slightly in France (1.4%). Yet, growth in investment slowed up in the euro area (2.2%), although it continued to accelerate in Germany (2.2%), Spain (6.5%) and Italy (0.9%) and stopped hindering growth in France (0.0%). Exports deducted from year-on-year growth although this was due to a larger rise in imports (exports still grew), a natural consequence of the positive tone in domestic demand which is clearly driving the recovery.

Activity continues to grow in Q4. The data available for Q4 indicate that economic expansion continued in the last quarter of the year. The PMI indices are still at their highest level since May 2011, clearly in the expansion zone (above 50 points) and both for the composite index and also for manufacturing and services, suggesting a widespread expansion in activity. Moreover, industrial production once again accelerated its year-on-year growth in October (1.9%) after a slight slowdown in September. Within the EU, Germany's PMI and IFO activity indices still point to an

Euro area: ECB forecasts

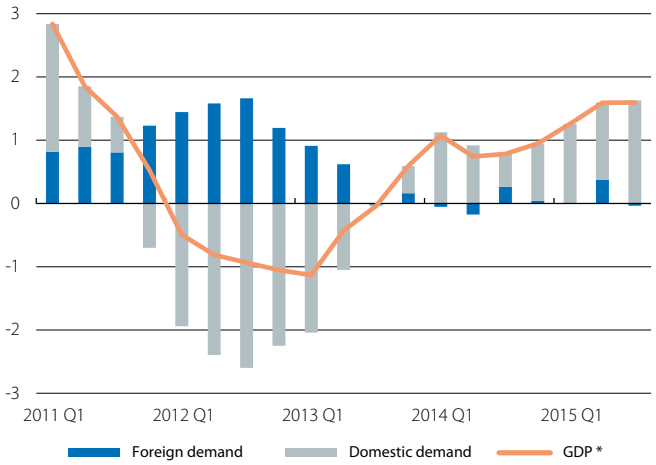
Annual change (%)

	Forecast			Change compared with September 2015 forecast		
	2015	2016	2017	2015	2016	2017
GDP	1.5	1.7	1.9	▲0.1	=	▲0.1
HICP *	0.1	1	1.6	=	▼0.1	▼0.1
HICP without energy or food	0.9	1.3	1.6	=	▼0.1	=

Note: ** Harmonized index of consumer prices.*
Source: *CaixaBank Research, based on data from the ECB (ECB Staff Macroeconomic Projections).*

Euro area: GDP

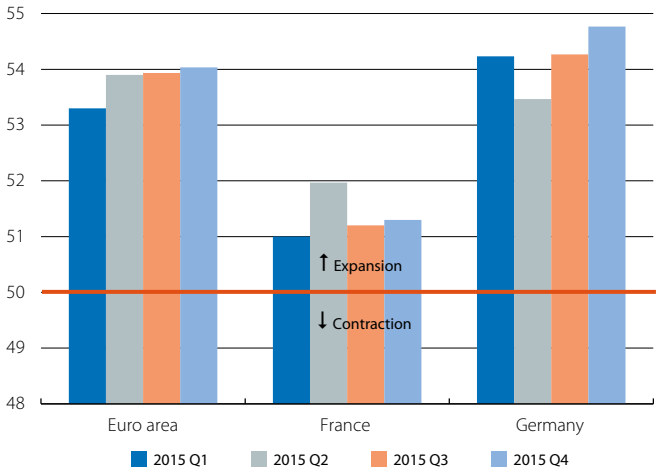
Contribution to year-on-year growth in GDP (pps)



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

Euro area: composite PMI activity indicators

Level



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

acceleration in activity in Q4. However, France seems to be undergoing a weaker expansion in activity with a PMI activity index in December (50.3) that was lower than in previous months and close to stagnation.

Consumption continues to advance. The trend in demand indicators in Q4 is also positive. Consumer confidence improved in November and December, approaching the end of the year with values similar to those of the summer. The latest figure for retail sales indicates that they continued to grow in October, by around 2.5%, bringing the year-on-year rate in line with the average for the year. Another indicator reflecting the good tone in consumption, automobile registrations, grew by 11% year-on-year in November and continues to post record highs not seen since 2010. The industrial production of capital goods speeded up in October with a year-on-year rate of change of 3.4%. On the whole these indicators point to a clearly dynamic recovery, also in demand.

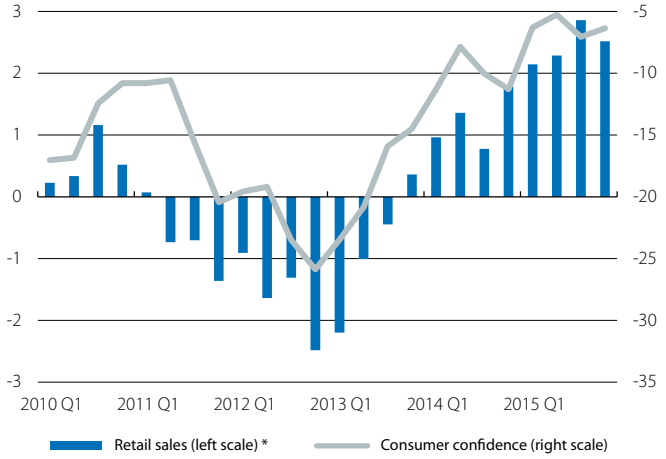
Improved activity stimulates job creation. The euro area's employment grew 11 year-on-year in Q3. Across countries, job creation was also positive. Of note is the high job creation rate in Spain, close to 3% year-on-year in the first three quarters of the year, while Italy also saw an increase in job creation, up to 0.85% in Q3. Moreover, unemployment fell in the euro area in October to 10.7%, 0.8 pps lower than September's figure, although there are still important differences between countries. In the euro area as a whole, labour costs per hour worked reduced their rate of year-on-year growth to 1.1% in Q3 due mainly to the wages component. Of note among the main countries is the rise in labour costs in Germany (2.4%) and their containment in Spain (0.3%) and Italy (–0.4%). Given the conditions of the labour market, Germany's increase is no cause for concern; however, the figure from France (a 1.1% year-on-year rise in labour costs) is more negative given the country's low level of labour capacity utilisation. On the whole these figures show a clearly positive trend in Europe's labour market.

Inflation remains stable. The variation in prices stays stable in spite of continued falls in the energy component, as shown by November's general inflation figure, 0.2% year-on-year, just 0.1 pps higher than October's figure. The increase in prices for services and industrial goods kept core inflation at significantly higher levels in November (0.9% year-on-year). Sustained improvements in domestic demand and the labour market will push up core inflation in 2016, as shown both in our forecasts and those of the ECB. These factors will also strengthen general inflation although its performance will largely depend on the behaviour of oil prices.

Intra-European trade offsets the slowdown in foreign demand. The boost provided by domestic demand is minimising the effect of weaker foreign demand. October saw a break in the year-on-year slowdown of exports from the euro area (1.5%) thanks to an increase in intra-European

Euro area: consumption indicators

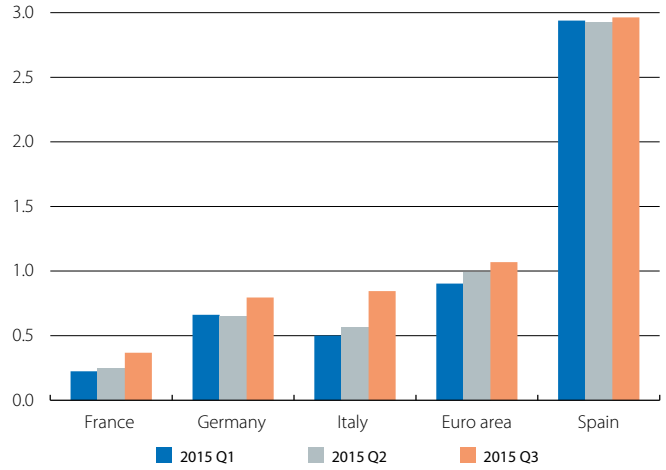
Year-on-year change (%) *Level*



Note: ** 2015 Q4 includes only the figures from October.*
Source: *CaixaBank Research, based on data from Eurostat and the European Commission.*

Employment

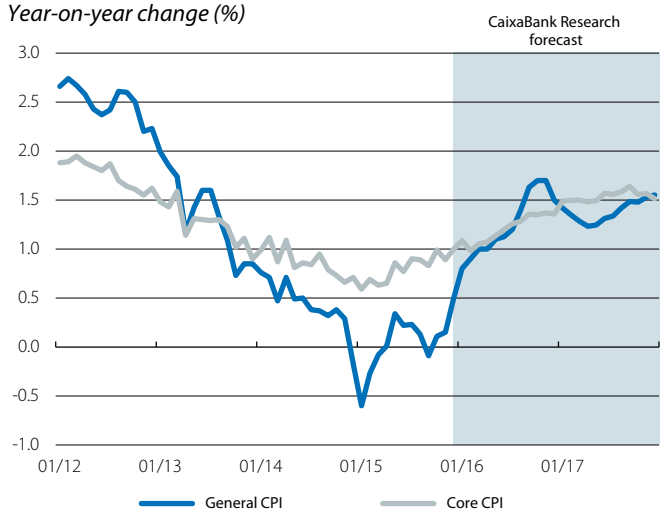
Year-on-year change (%)



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

Euro area: harmonised CPI

Year-on-year change (%)



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

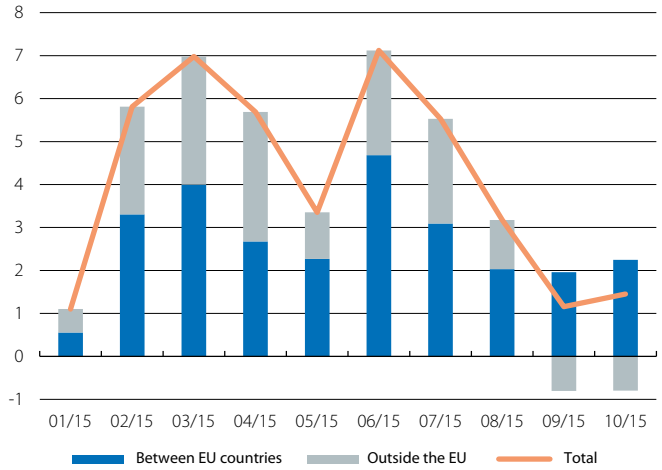
exports (3.6%). This shows how the euro area's recovery is due to strong domestic demand, helping to ease the effects of the slowdown in emerging economies. By country, intra-European exports grew at a good year-on-year rate in Germany (6.4%), Spain (8.9%) and Italy (2.3%), while exports to countries outside the EU shrank (–4.4% in Germany, –3.6% in Spain and –2.1% in Italy). Meanwhile France recorded the opposite performance with a year-on-year change in intra-European exports of –0.7% and an increase in exports towards countries outside the EU of 3.6%. Total exports continued to grow in October in Germany (1.7%), Spain (4.3%), France (1%) and Italy (0.3%).

Access to credit continues to improve for companies. SMEs are following in the wake of large firms in the recovery. According to the latest data from the Survey on the Access to Finance of Enterprises (SAFE) in the euro area, SMEs are improving their performance in terms of earnings and, between April and September 2015, only 1% reported lower earnings compared with 10% between October and March 2014. Moreover, for the first time since 2009 SMEs believe that the supply of credit is enough to meet their financing needs. Specifically the percentage of small and medium-sized enterprises perceiving that credit is more readily available continues to grow. This shows that credit conditions have improved during the implementation of QE and underlines the good tone of the recovery.

Political uncertainty hinders the recovery in Portugal. The good tone suggested by the country's activity has been marred over the last few months. Portugal's economy continued to grow in Q3 compared with the previous year (1.4% year-on-year) but stalled compared with Q2 (0.0% quarter-on-quarter). By component, in quarter-on-quarter terms public consumption and investment fell but were offset by private consumption and the foreign sector. However, this positive contribution by the foreign sector masks a slump in activity as the increase was due to a larger drop in imports (–3.0%) than in exports (–2.1%). These data occur within a context of political uncertainty with a fragmented parliament after the elections on 4 October which has led to a coalition government of Socialists, the Communist Party and a left-wing bloc. There are doubts regarding the commitment of this new government to carrying out reforms and the presidential elections on 24 January will be the next political test. The country's high level of public debt (129% of GDP) and unemployment at 12.4% indicate that it needs to continue implementing reforms. Moreover, its close ties with Brazil and Angola, which have been a source of growth over the last few years, could now represent a risk factor due to the recession both countries are experiencing.

Euro area: exports

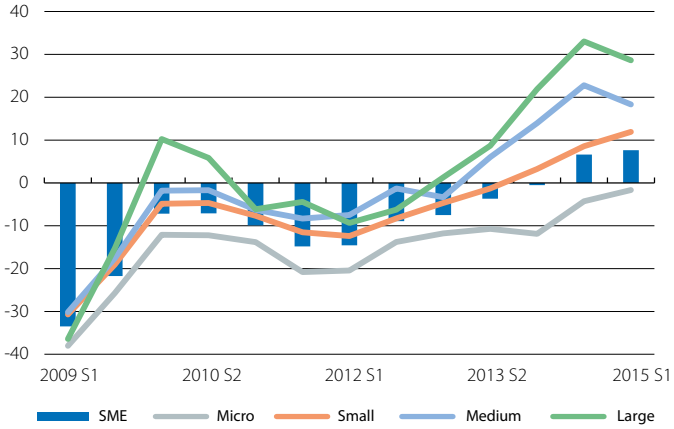
Contribution to year-on-year growth (pps)



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

Euro area: access of enterprises to external financing by company size

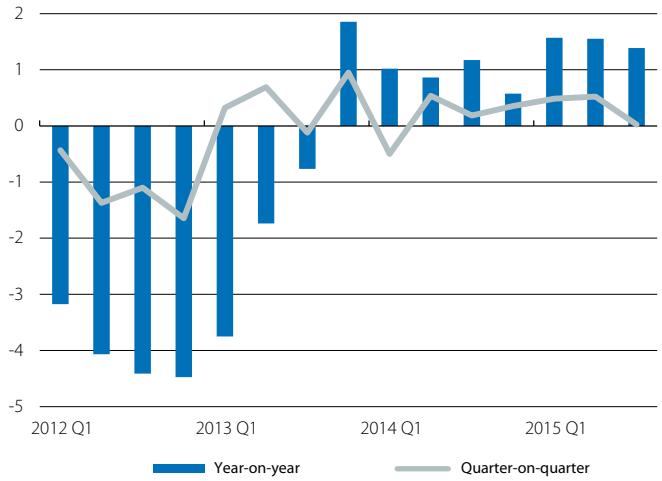
(% of enterprises reporting improvements compared with the previous period)



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

Portugal: GDP

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



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

FOCUS · The role of labour rigidity in the euro area's low productivity

Limited improvement in total factor productivity (TFP)[1] is one of the main reasons behind the euro area's low growth.[2] A more efficient allocation of input factors (capital and labour) is one of the keys to increasing TFP and something which various economic policies can act on, such as changes in the regulatory framework to help increase competition, reducing the fragmentation of the products and services market and measures to encourage labour market efficiency. This Focus deals with the last of these areas.

Labour legislation and, in particular, the rules governing dismissal is vital to regulate relations between companies and workers. However, excessive labour rigidity makes the hiring and separation of workers less efficient. Firstly, high dismissal costs prevent some companies from hiring workers whose productivity might be greater than their wages, while making it difficult to terminate the contracts of other, less productive workers, which could be counterproductive for gross employment.[3] However, an increase in the flexibility of permanent contracts (lower dismissal costs, greater legal security in the process) promotes in- and outflows of the labour market. Reducing the euro area's average degree of protection (2.6) to the level of, for example, the United Kingdom (1.59) would lead to a significant increase in new contracts, both job-to-job and also jobless-to-job. Moreover, in gross terms, job-to-jobless flows would not increase significantly in non-recessionary periods but job-to-job flows would.[4] It should also be noted that a strongly two-tier labour market with marked differences between insiders (workers on a permanent contract) and outsiders (workers on a temporary contract or the unemployed) leads to bigger fluctuations in the unemployment of the second group, while reducing this difference by making permanent contracts more flexible would benefit them.[5]

Secondly, it is important to point out that the reallocation of factors (both labour and capital) towards more productive sectors is positive for productivity. In the case of employment, greater flexibility leads to the labour factor being allocated more efficiently. Less productive firms destroy more jobs and more productive ones create more jobs, so reallocating labour from the former to the latter increases gross productivity. According to the IMF, the potential of euro area countries to improve their factor reallocation is high and the elimination of distortions preventing such reallocation could increase the rate of growth of TFP, especially if a solution could be found to the poor matching between individuals and jobs,[6] which would boost growth considerably. For example, according to the IMF, the rate of growth in Italy and Portugal would increase by 1.8% and by 1.3% annually, respectively, if all such distortions were eliminated. In summary, less protection for permanent workers increases labour mobility and the reallocation of labour at the level of sector, thereby improving productivity.[7]

Thirdly, rigid legislation governing permanent contracts ends up encouraging labour flexibility based on the repeated use of temporary contracts, as has occurred in most of the countries in the euro area. Replacing permanent jobs with temporary ones is counterproductive because it discourages individuals' investment in human capital and firms' investment in training. This kind of labour flexibility ends up reducing productivity at the level of company and harms those people who, after losing their job, cannot find any better job opportunities (thereby suffering from a reduction in income or worse labour conditions in their next job).[8]

In conclusion, euro area countries can increase the productivity of their economies via labour legislation that makes permanent contracts more flexible and avoids the abuse of temporary contracts while effectively protecting participants. To achieve this goal, a favourable environment would be that of «flexicurity», combining the labour flexibility required by companies with employee security via stable contracts, unemployment benefits that allow claimants to look for a suitable job and active policies that improve employability.

1. TFP is calculated as the difference between the economy's growth and the contribution to this growth of the labour factor and capital factor.
2. See an analysis of the euro area's low growth in the Focus «Why is the euro area growing less than the US?» in MR12/2015.
3. Lazear (1990), «Job security provisions and employment», The Quarterly Journal of Economics.
4. OECD (2010), «Institutional and Policy Determinants of Labour Market Flows», OECD Employment Outlook 2010, OECD Publishing, Paris.
5. Bentolila et al. (2012), «Two-tier labour markets in the Great Recession: France vs. Spain», Economic Journal, 122.
6. Moreover, individuals will be more inclined to improve their qualifications and acquire more skills if there is a greater chance of them finding a well-matched job.
7. Among others, Autor et al. (2007), «Does employment protection reduce productivity? Evidence from US states», The Economic Journal, 117 (June); Bassanini et al. (2009), «Job protection legislation and productivity growth in OECD countries»; Martin, J. and Scapetta, S. (2011), «Setting it right: employment protection, labour reallocation and productivity», IZA Policy paper no. 27.
8. OECD, op. cit.

FOCUS · Towards the completion of banking union

Completing banking union is essential for strong and prosperous economic and monetary union. This is the premise that underlies the new proposal by the European Commission to create a European Deposit Insurance Scheme (EDIS) for all members of the euro area. The communication starts the arduous task of raising the third and last pillar required to complete European banking union. This Focus analyses the main aspects of the Commission's proposal.

The aim of this third pillar is to guarantee that all banking union deposits enjoy the same degree of protection irrespective of the institution they are deposited with and the country of origin. Although there is some standardisation at present in the coverage provided by national deposit guarantee schemes (DGS), up to 100,000 euros, this protection depends on the financial strength of the member States, responsible for covering any losses as a last resort. Breaking this vicious circle between sovereign risk and bank risk is the main aim pursued by the EDIS, which would reduce the vulnerability of national DGSs to local shocks by sharing the risk among the different member countries of the banking union. All this would help to reinforce the region's financial stability and reduce its fragmentation.

Should the European Commission's proposal be accepted, the EDIS would be introduced gradually in three phases. The first phase, planned for up to 2020, would establish a re-insurance system for national DGSs so that national systems could access the European fund after exhausting their own resources, with a limit of 20% of the European funds or 10 times the resources of the national fund. During this phase the funds accumulated by the national systems would also start to be transferred to the European fund (see the graph). In the second phase, risk-sharing would gradually be implemented via co-insurance, achieving a greater degree of distribution of risk among the national systems. In this phase both funds would become responsible for the costs as from the time when depositors would have to be reimbursed, with a progressively larger share of the European system, from 20% in 2019 to 100% in 2024. This would then reach the third phase, when mutual responsibility is complete and the EDIS would fully insure all European depositors.

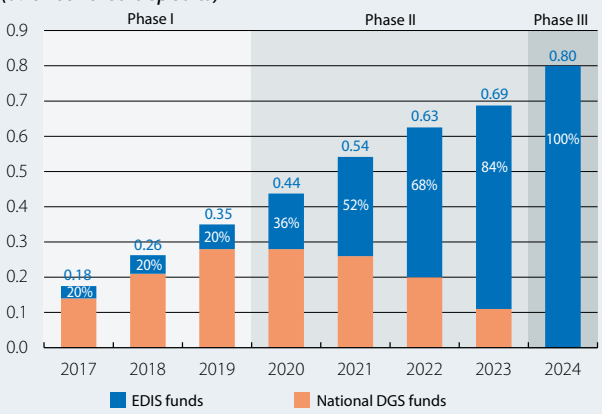
Although one relative aspect of the proposal is its gradual implementation, others such as its scope or funding are also crucial for all countries to accept it. Regarding its scope, participation in the EDIS would be obligatory for all members of the economic and monetary union, whose banks are subject to the single supervisory mechanism. It would also be open to other members of the European Union wanting to join banking union. With regard to its financing, the fund would be financed via *ex ante* contributions from participating banks and would cover 0.8% of the region's deposits by 2024. This fund would therefore be financed completely by private means and with limited funds as the euro area does not have a single treasury offering any kind of implicit guarantee.

In principle, this new system should not involve any additional cost for banks but simply a transfer from one fund to another. However, given the possible changes in how contributions are calculated, this might not be case. At present, bank contributions to national DGSs are calculated based on the volume of insured deposits and the risk profile of each institution compared with the rest of the banks in the same country. According to the Commission's proposal, in the first phase this calculation will remain unchanged but, as from the second phase, the benchmark to compare risk profiles will be all banks in the euro area. The banks of a country whose risk profile is lower than the euro area average would therefore have to contribute less to the EDIS. The effect of this methodological change can only be quantified once more details have been announced.

In summary, this proposal by the European Commission is a step in the right direction but there is still room for improvement in some aspects, such as the harmonisation of national DGSs and specifying the method that will be used to calculate risk-weighted contributions to the fund. Negotiations will be long and controversial but this is a necessary step for us to approach full banking union.

Accumulation of funds in the European Deposit Insurance Scheme (EDIS)

(% of covered deposits)



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

KEY INDICATORS

Activity and employment indicators

Values, unless otherwise specified

	2013	2014	2014 Q4	2015 Q1	2015 Q2	2015 Q3	10/15	11/15	12/15
Retail sales *(year-on-year change)*	–0.8	1.2	1.8	2.1	2.3	2.9	2.5	...	...
Industrial production *(year-on-year change)*	–0.7	0.8	0.3	1.6	1.3	1.8	1.9	...	...
Consumer confidence	–18.5	–10.0	–11.2	–6.2	–5.1	–6.9	–7.5	–5.9	–5.7
Economic sentiment	93.8	101.6	100.9	102.6	103.7	104.6	106.1	106.1	...
Manufacturing PMI	49.6	51.8	50.4	51.4	52.2	52.2	52.3	52.8	53.1
Services PMI	49.3	52.5	51.7	53.5	54.1	54.0	54.1	54.2	53.9
Labour market									
Employment (people) *(year-on-year change)*	–0.7	0.6	0.8	0.9	1.0	1.1	–	...	–
Unemployment rate: euro area *(% labour force)*	12.0	11.6	11.5	11.2	11.0	10.8	10.7	...	...
Germany *(% labour force)*	5.2	5.0	4.9	4.8	4.7	4.5	4.5	...	...
France *(% labour force)*	10.3	10.3	10.5	10.4	10.4	10.8	10.8	...	...
Italy *(% labour force)*	12.2	12.7	12.8	12.3	12.3	11.7	11.5	...	...
Spain *(% labour force)*	26.1	24.5	23.7	23.1	22.5	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	2015 Q3	10/15	11/15
Current balance: euro area	**2.0**	**2.5**	**2.5**	**2.7**	**3.0**	**3.1**	**3.1**	**...**
Germany	6.5	7.3	7.3	7.5	7.8	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	1.6	...
Nominal effective exchange rate[1] *(value)*	**101.2**	**101.8**	**99.0**	**93.0**	**91.1**	**92.7**	**93.6**	**91.1**

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	2015 Q3	10/15	11/15
Private sector financing								
Credit to non-financial firms[1]	–2.6	–2.6	–1.7	–0.8	–0.4	0.1	0.6	0.9
Credit to households[1, 2]	–0.2	–0.1	0.1	0.2	0.5	1.0	1.2	1.4
Interest rate on loans to non-financial firms[3] *(%)*	2.2	2.0	1.8	1.7	1.6	1.5	1.5	...
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	7.9	6.1	7.3	9.8	11.8	12.5	12.5	11.8
Other short-term deposits	–0.1	–2.0	–2.0	–3.1	–4.0	–4.7	–4.3	–4.1
Marketable instruments	–14.9	–7.2	1.2	3.8	5.6	1.9	3.1	2.6
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 · **Strong advances made in economic activity**

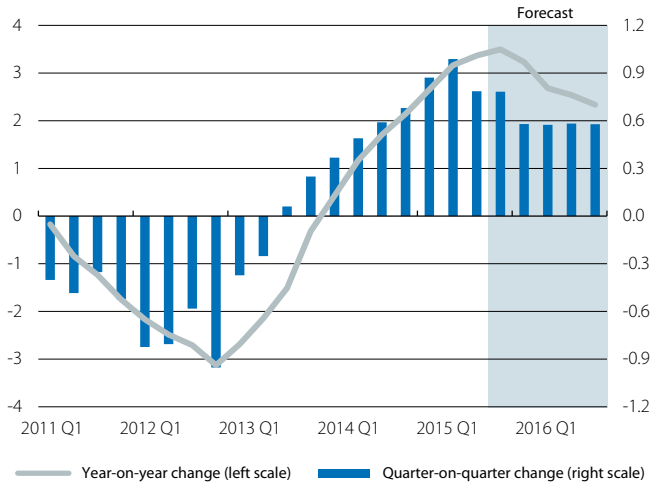
The rate of growth continued high in Q4. The most recent figures show the good expansionary tone of economic activity, slightly above the forecasts from some months ago. For this reason we have revised upwards our forecast for growth in GDP in Q4 by 0.1 pps to 0.8% quarter-on-quarter (in line with the Bank of Spain's estimate), bringing the annual figure for 2015 to 3.2% (compared with 3.1% previously). After a very notable year in terms of GDP growth, in 2016 we expect the rate of increase to dip slightly to 2.7% as the impact from the temporary support received throughout 2015 disappears, such as tax cuts and low oil prices. However, some elements will gradually come to the fore that will help to sustain more balanced growth in the long term. Specifically we expect the improvement in financing conditions to consolidate, the real estate sector to once again make a positive contribution and structural reforms to continue producing results, especially in the labour market where the rate of job creation could exceed 400,000 jobs. Nonetheless there are considerable risks regarding this scenario, especially from outside the country due to a possible slowdown in the emerging economies, so it is vital to continue reinforcing the foundations to be prepared for any eventuality. In this respect the outcome of the recent elections which, as expected, have led to considerable parliamentary fragmentation, is increasing uncertainty regarding the political panorama and, in particular, the country's capacity to continue implementing reforms. The speed with which a new government is formed and its solidity will be key to maintaining this scenario of a robust recovery.

Business indicators suggest the economy remains in a comfortable zone of expansion. According to the business sentiment index (PMI) for November there was solid growth in activity in the last part of the year and other data also verify this improvement. Specifically, the number of businesses in the services sector increased sharply by 5.8% year-on-year in October, confirming that services are leading the recovery. The industrial sector, lagging behind somewhat, is nevertheless posting increasingly positive data: this index, for example, rose by 3.1% year-on-year in the same month. Moreover, the good trend in new industrial orders, especially those from abroad, suggests this sector will continue to perform well in the future.

Bank credit is still flowing at a good rate, helping to underpin the economy's recovery. On the one hand demand for credit is being supported by the good progress being made by household and company deleveraging (see the Focus «The deleveraging of the Spanish economy: a long way to go» in this Report). On the supply side banks are now in a better position to grant loans after thoroughly sorting out their balance sheets (the NPL ratio fell by 0.1 pps, to 10.6%, in

GDP growth

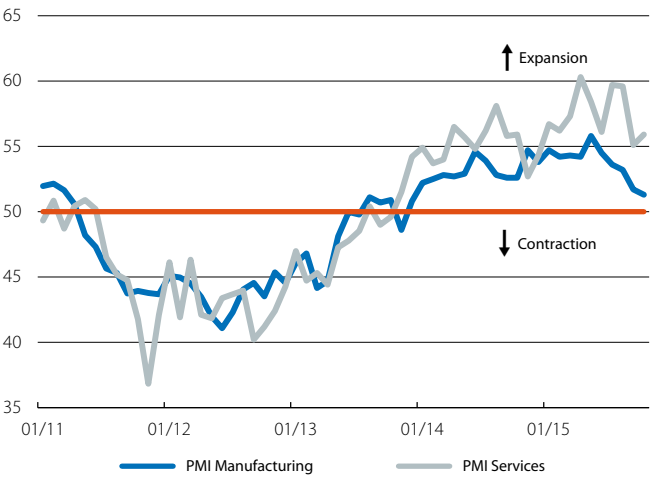
Year-on-year change (%) *Quarter-on-quarter change (%)*



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

PMI activity indicators

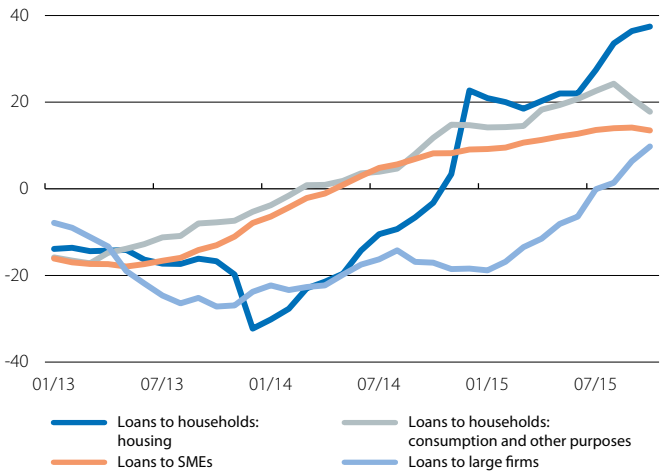
Level



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

New loans granted

Year-on-year change, cumulative over 12 months (%)



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

October) and the restructuring they have carried out. As a result, from the beginning of the year to October the flow of new loans to households and SMEs grew at a rate of 17%, a trend we expect to speed up in 2016. Of note is the strong growth in mortgage loans, boosted by the recovery in the real estate sector.

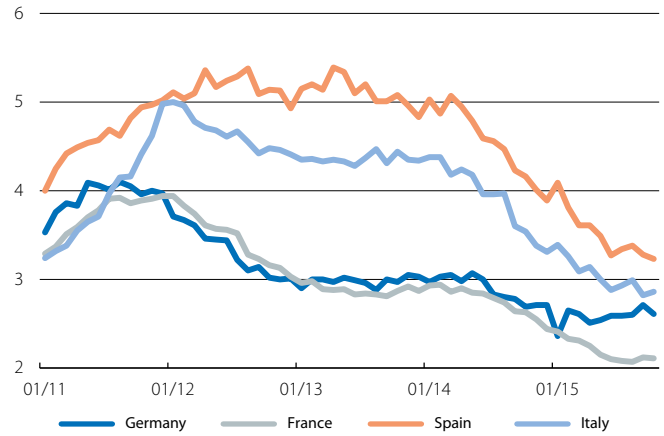
Financing conditions are still improving. Little by little, the interest rate spread is narrowing for new loans of under one million euros (those most widely used by SMEs) between Spain and the main European countries. According to the most recent data, from October, this interest rate was, on average, 3.2% in Spain compared with 2.6% and 2.1% in Germany and France, respectively. Although the Spanish rate is still higher than that of other countries, the spread compared with the German rate, for example, has decreased by 0.9 pps since October 2014. To ensure this process of financial defragmentation does not stop next year, it will be important, at a national level, for uncertainty surrounding the formation of a new government to diminish, helping the short and medium-term risk premium to remain low. At a European level it will be vital to continue reinforcing banking union (see the Focus «Towards the completion of banking union» in this Report).

The recovery in the real estate sector is consolidating. Lower financing costs are helping to stimulate house purchases, up by 11.7% year-on-year in October (cumulative over 12 months). In the short term we expect a rise in the purchase of residential properties by individuals who have been waiting for the real estate market to stabilise (retained demand) and by investors thanks to the higher returns from rents compared with other assets. This strength in demand suggests that the upward trend in prices will continue in the coming quarters although performance will be very heterogeneous as price increases will be concentrated in those regions with a lower stock of new housing for sale.

Wage containment is helping to regain competitiveness. In Q3 hourly wage costs rose by a moderate 0.6% year-on-year in Spain (compared with 2.3% in Germany and 1.6% in France). In Q4 wages will grow slightly above this figure as, in October, almost 25% of the extraordinary pay from 2012 was refunded to civil servants, as happened in Q1. This temporary increase in wages in this sector will be repeated in 2016 when the remaining 50% is returned. Apart from these fluctuations, wage increases will remain contained given the high unemployment rate and low inflation. The support for domestic demand provided by wage rises will therefore continue to be limited. However, what will particularly support consumption will be the high rate of job creation which, although we expect a modest slowdown, will still be at a considerable level. In November the year-on-year rate of change of registered workers affiliated to Social Security held steady at 3.2%. The robust performance by services (not only those related to tourism), industry and construction have

*Interest rates on new loans to SMEs **

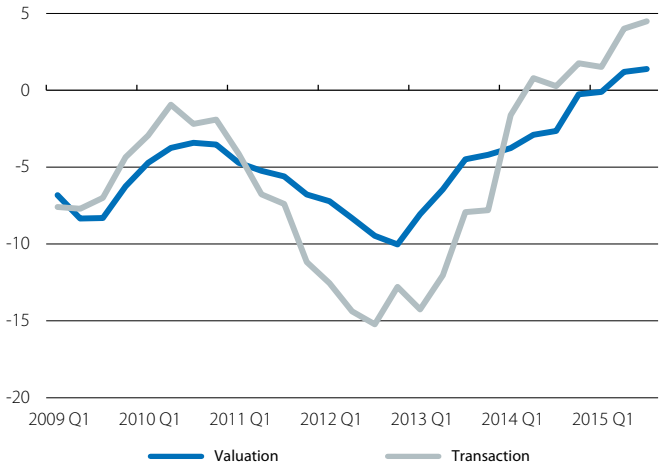
(%)



Note: ** Loans under one million euros.*
Source: *CaixaBank Research, based on data from the ECB.*

Housing prices

Year-on-year change (%)



Source: *CaixaBank Research, based on data from the Ministry of Public Works (valuation) and INE (transaction).*

*Hourly wage costs **

Change (%)

Note: ** Data adjusted for calendar and seasonal effects.*
Source: *CaixaBank Research, based on data from the INE (ICLA).*

offset the lower contribution by public administration in the second half of the year.

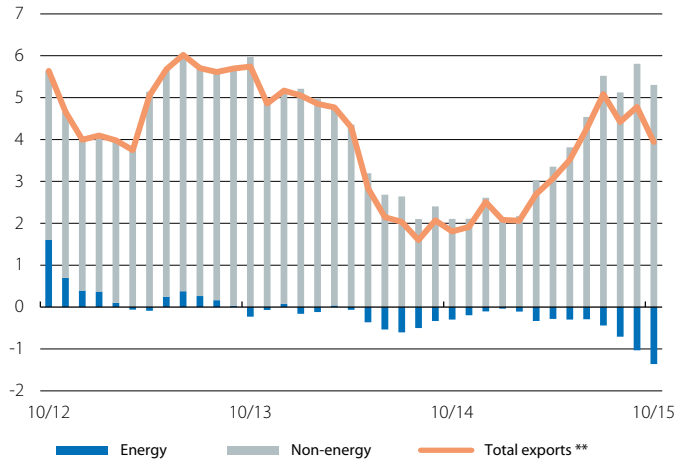
Adjustment of the external balance continues. Improved competitiveness, thanks partly to wage moderation but also to the efforts made by Spanish firms to internationalise, has been crucial to boosting exports. Consequently, from the beginning of the year up to October, exports of non-energy goods increased, on average, by 5.9% year-on-year compared with 2.1% in the same period of 2014. Of note is the excellent performance by exports of consumer goods whose share of all exports is 38% and which posted an increase of 13.5% year-on-year, on average, from January to October. Foreign sales of cars, which represent one third of all consumer goods, have played a very important role, up by 24.8% year-on-year on average. However, energy exports continued to contribute negatively to growth as a result of the sharp fall in oil prices. This year so far imports have grown at a slower rate than exports (3.2% year-on-year on average), so the external balance is likely to continue improving.

Inflation returns to positive figures. According to the CPI flash estimate for December, inflation stood at 0.0%, 0.3 pps above the rate of the previous month due to the smaller drop in energy prices (in year-on-year terms). We expect core inflation, not influenced by the fluctuations in energy or fresh foods, to have risen very gradually thanks to stronger household consumption, which continues to be supported by ongoing improvements in the labour market and in conditions to access credit. The annual average for inflation in 2015 would therefore be –0.5%. We expect inflation to continue to rise in 2016 and reach 1.2% on average, backed by a scenario of a gradual recovery in oil prices.

The public sector continues with its fiscal consolidation but adjustment has yet to be completed. The budget execution up to October indicates that the central government may have some margin to offset part of the deviation from the deficit target by the autonomous communities and Social Security, although it will not be enough to avoid a deviation by public administration as a whole. The correction of the structural deficit is one of the main focuses of attention by the European Commission. Specifically, the follow-up report on the agenda of reforms planned for the Spanish economy published by this public body every six months endorses the progress made to improve public administration efficiency such the simplification of public bodies. However, the European Commission repeats that fiscal consolidation must continue in order to underpin growth and keep the risk premium low.

Exports of goods *

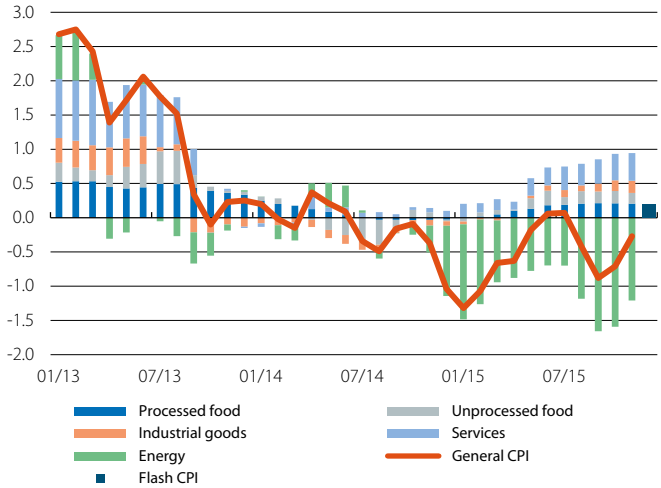
Contribution to year-on-year growth of the 12-month cumulative figure (pps)



Notes: ** Nominal data. ** Year-on-year change.*
Source: *CaixaBank Research, based on data from the Customs Dept.*

CPI

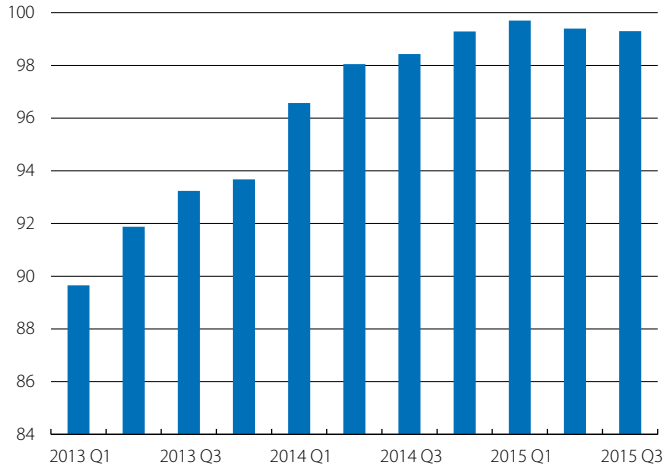
Contribution to year-on-year growth (pps)



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

Public debt

(% of GDP)



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

FOCUS · Labour productivity in Spain: it is not a problem of the model of production

Production per hour of work (or apparent labour productivity)[1] is substantially lower in Spain than in Germany and, moreover, the gap has not narrowed in the last few years. But before we look at the cause of this disparity we need to note some limitations to this indicator. Growth in apparent labour productivity is not necessarily attributable to greater efficiency of the labour factor but can also be due, for example, to higher growth in more capital-intensive sectors. However, this problem diminishes to some extent when the analysis is carried out at the level of sector as the relative intensity of use of the input factors (capital and labour) in each sector should be similar between countries.

The general opinion is that the economy's overall production per hour worked is lower in Spain because it tends to specialise in more labour-intensive sectors. For example, while the sectors of trade, transport and hotels and restaurants account for 24.5% of the gross value added (GVA) in Spain as a whole, in Germany this percentage is just 15.5%. However, if we break down this gap between Spain and Germany's apparent labour productivity into the difference between each sector's apparent productivity for the two countries and the difference in the share of various sectors in each country's overall employment we can see that former, and not the latter, is the main reason for this divergence.[2]

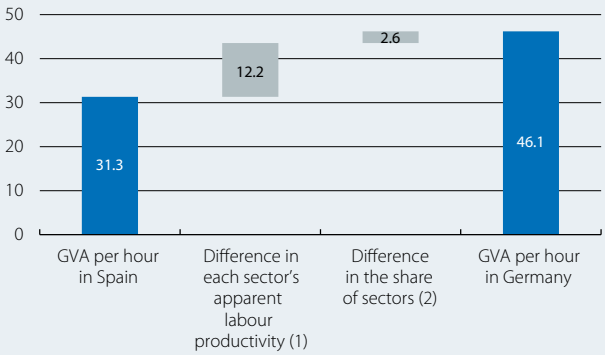
In Spain, apparent labour productivity was 31.3 euros of GVA per hour worked in 2015 Q3 compared with Germany's 46.1 euros, a difference of 14.8 euros per hour (see the graph). Spain's larger share of more labour-intensive sectors lies behind part of this difference (2.6 euros per hour, equivalent to 17.6% of the total) but its lower apparent productivity per sector is actually the determining factor (12.2 euros per hour). Although the kind of activities carried out in the same sector in each country might differ, since the degree of disaggregation (10 sectors) is limited, the significantly higher contribution of this second effect suggests that, certainly, lower apparent productivity per sector is a notable aspect.

Lastly, has this pattern altered recently? After the recession a change could be observed in the composition of the Spanish economy in sector terms: on average the relative weight of construction in Spain, a highly labour-intensive industry, fell from 10.3% in the period 2001-2007 to 5.5% in 2015 Q3 whereas in Germany the relative weight of different sectors has remained stable. Nevertheless the contribution of the difference between the relative weights of the different sectors to the total difference in apparent labour productivity has decreased little compared with the pre-crisis figure. Between 2001 and 2007, on average, the differing share of sectors was responsible for 3.7 euros of the 15.2 euros, 24.3% of the total (compared with 17.6% in 2015 Q3, as mentioned above). Therefore, although Spanish labour is gradually being reallocated towards less labour-intensive sectors, most of the country's difference with Germany is still the result of lower apparent labour productivity in its different sectors.

In summary, to increase labour productivity in Spain it is vital to insits on factors such as company size and internationalisation. We should learn a lesson from the German model.

Breakdown of the difference in GVA per hour worked between Spain and Germany

(Euros)



Note: *GVA: gross value added. The difference between the apparent labour productivity in both countries is broken down into: (1) each sector's difference in apparent labour productivity between countries and (2) the difference in the relative share of employment in the different sectors in each country. Data for 2015 Q3.*
Source: *CaixaBank Research, based on Eurostat data.*

1. In this Focus we analyse apparent labour productivity by sector, defined as the gross value added (GVA) of the sector per hour worked.
2. For the analysis, the production per hour and the relative share of employment for 10 sectors were calculated. These sectors are: Agriculture (A); Industry (B-E); Construction (F); Trade, transport and hotels and restaurants (G-I); Information and communication (J); Financial and insurance activities (K); Real estate activities (L); Professional, scientific, technical and administrative (M-N); Public administration, education and healthcare (O-Q); Artistic activities and other services (R-U). Based on these data, the difference in apparent productivity was broken down into two effects.
$p^g - p^s = \sum_{i=1}^{n=10} w_i^s (p_i^g - p_i^s) + \sum_{i=1}^{n=10} p_i^g (w_i^g - w_i^s)$ were i denotes the sector; $p^g = (\frac{VAB^g}{H^g})$ is the apparent productivity per hour worked in Germany and $p^s = (\frac{VAB^s}{H^s})$ in Spain; w_i^g is the relative share of employment in hours of sector i out of Germany's total and w_i^s in Spain; p_i^g is the apparent productivity per hour worked in sector i in Germany and p_i^s in Spain.

FOCUS · Will the slowdown in Latin America affect Spanish foreign direct investment?

The slowdown in the emerging economies has led to doubts regarding the impact this might have on the returns expected from foreign direct investment (FDI) in these countries. In the case of Spain, the deterioration in Latin America's growth prospects has set alarm bells ringing. Although it is true that the share of Spanish exports to Latin America did not exceed 7% in 2014, the stock of Spanish FDI in the region is considerable, accounting for more than one third of the total. As FDI is more difficult to transfer from one country to another than portfolio investment, it is useful to analyse the geographical distribution of Spanish FDI in order to determine to what extent the slowdown in the emerging economies, and especially Latin America, could represent a risk for the expected returns from such investment.

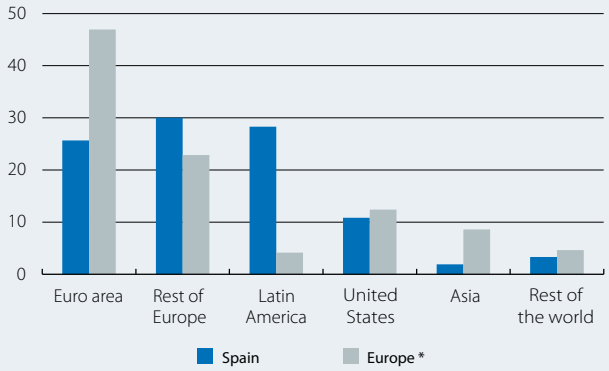
The three main blocs receiving Spanish FDI in 2013[1] were, by order of importance, the European continent, Latin America and the United States. It should be noted that Spanish FDI was greater in Latin America than in the euro area, unlike the situation with portfolio investment, for example.[2] In comparison, the percentage of European FDI was higher in Europe and Asia but much lower in Latin America (see the first graph). Nevertheless, although Spain is more exposed to the emerging countries than the rest of the European states, there are factors that mitigate this risk.

Firstly, although the main receiver of Spanish FDI in Latin America is Brazil, a country currently immersed in a deep recession, other countries with much better prospects also receive considerable amounts, such as Mexico and Chile. Consequently, if we classify all the countries according to their growth forecast for 2016 instead of by their location, the distribution of Spanish FDI is not so different from European FDI (see the second graph). Although it is true that the countries with negative growth concentrate a larger proportion of Spanish FDI, so do those with higher growth. In this respect, the expected return of Spanish FDI compared with European FDI is more volatile but on average they should be similar. Secondly, Latin America was one of the most profitable regions for Spanish FDI between 2008 and 2013 (perhaps influenced by the strong cultural ties): it almost doubled the return from investments in the euro area and was four times more profitable than investments in the US. Moreover, the relative stability of historical returns indicates that the latter is not so volatile throughout the economic cycle. The yields obtained historically therefore help us to understand why this geographical area has a higher proportion of Spanish FDI.

Although Spain could be more exposed to the slowdown in the emerging economies and a consequent deterioration in asset value, since it concentrates more FDI in Latin America than the rest of the European countries, an analysis provides arguments to suggest that this potential deterioration will be minor. Moreover, since this slowdown is expected to be temporary in most countries as they return to higher growth rates as from 2017, Spanish assets abroad are likely to continue generating considerable returns, as has happened in the past. For these reason, we do not expect the slowdown in the emerging countries in 2016 to excessively deteriorate the assets of Spanish FDI and, as a consequence, the net debt position.

Foreign direct investment by geographical destination in 2013

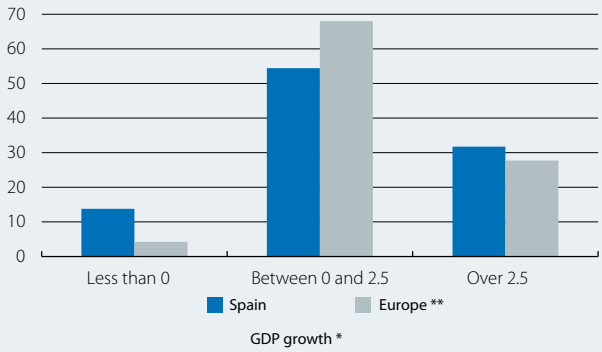
(% of the total)



Note: ** Weighted average of Germany, France, Italy, Netherlands and Greece.*
Source: *CaixaBank Research, based on Eurostat data.*

Foreign direct investment by growth in the receiving country in 2013

(% of the total)



Notes: ** Countries ordered according to the IMF growth forecast for 2016.*
*** Weighted average of Germany, France, Italy, Netherlands and Greece.*
Source: *CaixaBank Research, based on data from Eurostat and the IMF.*

1. Latest figures from Eurostat. As Spanish investments abroad accounted for a stock of approximately 50% of GDP in 2014, the geographical distribution is relatively stable over time.
2. More than 70% of the portfolio investment is in the euro area.

FOCUS · The deleveraging of the Spanish economy: a long way to go

One of the main macroeconomic imbalances of the Spanish economy is its high levels of public and private borrowing, and a notable proportion of this debt is in foreign hands. Bringing debt down to sustainable levels is vital to improve growth capacity and reduce external vulnerability. Although the economy's total debt has started to fall in the last three years, it is still very high. A detailed analysis of the trend in debt by institutional sector, however, reveals very different situations.

In 2015 Q1,[1] the non-consolidated debt of households and firms represented 70.6% and 108.1% of GDP, respectively, 14.2 and 25.0 pps lower than the peaks reached in 2010 Q2. Therefore, after five years of deleveraging, the private sector would approach more sustainable levels. If we take the euro area as our benchmark, Spanish firms reached the level of debt of its European peers in 2015 Q2. Households, however, are deleveraging somewhat more slowly as most of their debt is long-term and fewer options are available to them to deleverage. Although this debt is still 10 pps above the level of European households, if the last year's rate of reduction continues, Spanish households will reach the level of the euro area in just two years. Moreover, in a context of GDP growth and low interest rates, reducing the indebtedness ratio is compatible with positive flows of credit to the sector. Therefore excessive debt, which limited the performance of the private sector at the beginning of the recovery, is now starting to lose its role as a burden for growth.

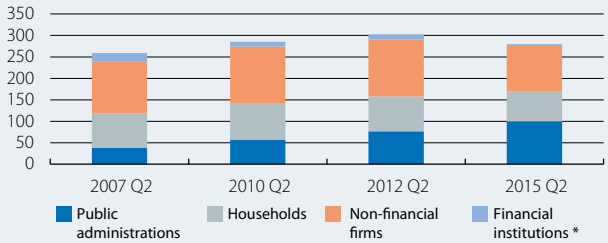
Unlike what is happening in the private sector, public debt is still growing although it is showing some signs of stabilising. According to the excessive deficit procedure,[2] this stood at 99.3% of GDP in 2015 Q3, just 0.4 percentage points below of maximum level, as a percentage of GDP, reached in 2015 Q1. In fact the increase in public debt over the last five years, namely 42.9 pps, has more than offset the fall in private debt over the same period (39.2 pps). However, this situation is likely to change very soon: in the coming quarters public debt will stabilise at around 100% of GDP and, should the expected path of deficit reduction be realised, will gradually fall.

Lastly the sector of financial institutions completes the economy as a whole. Their debt is generally not taken into account since their main function is financial intermediation and, consequently, if all their debt were included, it would be counted twice. We have therefore adjusted the level of bank debt and have only taken into account debt not used to finance the rest of the resident sectors or, in other words, debt taken out to finance other activities such as buying the shares of other companies. According to our calculations,[3] the adjusted debt of financial institutions has fallen to almost zero, with a cumulative drop of 17.1 pps since the real estate bubble burst in 2007. In any case it is important to note that, from the perspective of financial institutions, total debt is relevant for the purposes of the obligations imposed on the sector.

The Spanish economy has therefore started to deleverage as a whole, albeit at a different rate in each sector. In 2015 Q2 total debt represented 279.8% of GDP, only 22.4 pps below the peak of 2012 (302.2%). Moreover, a large part of the loans and debt securities are held by non-residents, so the economy is still vulnerable to potential changes in sentiment among international investors. Specifically, in 2015 Q2 external debt represented 169.2% of GDP and, unlike total debt, shows no signs of falling. On the one hand financial institutions have reduced their direct external dependency but this has almost entirely been offset by an increase in the Bank of Spain's external debt, which channels Eurosystem funding towards the Spanish banking sector. On the other hand external public debt has increased rapidly: from less than 20.6 pps in 2007 Q2 to 50.8 pps currently. In summary, the Spanish economy is still very much in debt, especially with external lenders. The process of private sector deleveraging has almost been completed; now that there is a tail wind, the public sector should also follow suit.

Total debt by institutional sector

(% of GDP)



Note: ** Debt of the financial institutions adjusted to avoid counting the same debt twice. Specifically, deposits from the rest of world and resident deposits have been added to the loans and debt securities of the liabilities of financial institutions, deducting resident loans and debt securities.*
Source: *CaixaBank Research, based on data from the Bank of Spain.*

1. Data from the financial accounts published by the Bank of Spain.
2. The non-consolidated debt of the public administration, according to the financial accounts, stood at 128.0% of GDP in 2015 Q2. However, it is necessary to consolidate public sector debt as, in practice, it comes from a single treasury.
3. Deposits from the rest of world and resident deposits have been added to the loans and debt securities of the liabilities of financial institutions, deducting resident loans and debt securities.

KEY INDICATORS

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

Activity indicators

	2013	2014	2014 Q4	2015 Q1	2015 Q2	2015 Q3	10/15	11/15
Industry								
Electricity consumption	–2.1	–0.1	–1.6	1.2	–0.2	2.4	3.6	1.4
Industrial production index	–1.5	1.3	0.3	1.5	3.5	4.0	4.1	...
Indicator of confidence in industry *(value)*	–13.9	–7.1	–5.3	–3.2	0.9	0.7	–0.7	–1.5
Manufacturing PMI *(value)*	48.5	53.2	53.7	54.4	54.8	52.8	51.3	53.1
Construction								
Building permits *(cumulative over 12 months)*	–36.3	–7.7	4.0	12.1	17.0	19.6	21.1	...
House sales *(cumulative over 12 months)*	0.4	–5.6	0.3	8.9	10.2	12.2	11.7	...
Services								
Foreign tourists *(cumulative over 12 months)*	3.2	7.2	7.5	6.6	5.9	4.9	4.4	4.8
Services PMI *(value)*	48.3	55.2	54.3	56.7	58.3	58.1	55.9	56.7
Consumption								
Retail sales	–3.7	1.0	2.8	2.5	2.9	3.3	5.6	2.7
Car registrations	5.6	18.4	21.7	31.4	13.6	23.1	5.2	25.4
Consumer confidence index *(value)*	–25.3	–8.9	–9.6	–0.6	1.6	–1.3	–1.2	0.6

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	2015 Q3	10/15	11/15
Registered as employed with Social Security [1]								
Employment by industry sector								
Manufacturing	–4.3	0.1	0.9	1.5	2.2	2.4	2.6	2.7
Construction	–12.1	–1.6	1.6	4.6	5.6	4.6	4.3	4.2
Services	–2.0	2.2	2.8	3.5	3.7	3.5	3.4	3.3
Employment by professional status								
Employees	–3.8	1.4	2.3	3.0	3.8	3.6	3.6	3.6
Self-employed and others	–0.6	2.2	2.5	2.4	2.2	1.7	1.5	1.5
TOTAL	**–3.2**	**1.6**	**2.3**	**2.9**	**3.5**	**3.3**	**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	9.7	1.9	13.0
Temporary	6.4	13.1	7.7	12.2	11.2	9.7	3.6	16.1
TOTAL	**4.0**	**13.4**	**8.8**	**13.2**	**10.9**	**9.7**	**3.4**	**15.8**
Unemployment claimant count [3]								
Under 25	–6.2	–8.2	–6.9	–9.8	–9.3	–13.4	–11.3	–11.9
All aged 25 and over	3.7	–5.3	–5.7	–6.1	–7.4	–7.7	–7.4	–7.6
TOTAL	**2.7**	**–5.6**	**–5.8**	**–6.5**	**–7.6**	**–8.2**	**–7.7**	**–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	2015 Q3	10/15	11/15	12/15
General	**1.4**	**–0.1**	**–0.5**	**–1.0**	**–0.3**	**–0.4**	**–0.7**	**–0.3**	**0.0**
Core	1.5	0.0	0.0	0.2	0.5	0.8	0.9	1.0	...
Unprocessed foods	3.6	–1.2	0.8	0.3	1.9	2.3	2.7	2.4	...
Energy products	0.1	–0.8	–4.3	–9.7	–6.4	–9.7	–13.1	–9.9	...

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 Q4	2015 Q1	2015 Q2	2015 Q3	09/15	10/15
Trade of goods								
Exports *(year-on-year change)*	5.2	2.5	4.3	4.4	5.4	3.4	1.1	–0.8
Imports *(year-on-year change)*	–1.3	5.7	5.0	2.5	5.8	3.3	1.8	–2.2
Current balance	**15.6**	**10.2**	**10.2**	**12.1**	**14.9**	**15.8**	**15.8**	**17.0**
Goods and services	33.5	26.0	26.0	27.4	27.5	27.2	27.2	27.6
Primary and secondary income	–17.9	–15.7	–15.7	–15.3	–12.6	–11.4	–11.4	–10.7
Net lending (+) / borrowing (–) capacity	**22.3**	**14.7**	**14.7**	**15.6**	**19.0**	**21.5**	**21.5**	**22.5**

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	2015 Q3	10/15	11/15
Net lending (+) / borrowing (–) capacity	**–6.9**	**–5.9**	**–5.9**	**–0.7**	**–3.0**	**–3.1**	**–**	**...**
Central government [1]	–4.9	–3.9	–3.9	–1.0	–2.1	–2.4	–2.2	–2.6
Autonomous regions	–1.6	–1.7	–1.7	–0.2	–0.9	–1.0	–1.2	...
Local government	0.6	0.6	0.6	0.1	0.2	0.3	–	...
Social Security	–1.1	–1.0	–1.1	0.3	–0.4	–0.3	–0.3	...
Public debt *(% GDP)*	**93.7**	**99.3**	**99.3**	**99.7**	**99.3**	**99.3**	**–**	**...**

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 Q4	2015 Q1	2015 Q2	2015 Q3	09/15	10/15	Balance 10/15 [1]
Financing of non-financial sectors [2]									
Private sector	–7.5	–6.2	–5.9	–4.8	–4.2	–4.3	–4.4	–3.6	1,653.9
Non-financial firms	–9.3	–7.0	–6.9	–5.4	–4.6	–4.8	–4.9	–3.7	926.3
Households [3]	–5.0	–5.1	–4.6	–4.1	–3.7	–3.6	–3.7	–3.4	727.6
General government [4]	16.8	6.9	6.7	5.0	4.0	3.8	4.1	3.9	1,056.7
TOTAL	**–0.5**	**–1.8**	**–1.5**	**–1.3**	**–1.2**	**–1.3**	**–1.2**	**–0.8**	**2,710.6**
Liabilities of financial institutions due to firms and households									
Total deposits	2.1	–0.9	–1.7	–1.3	–1.2	–1.1	–1.1	–0.4	1,151.3
On demand deposits	4.2	10.8	14.8	17.9	19.5	18.8	19.2	19.4	371.7
Savings deposits	–0.1	5.8	6.8	10.5	12.3	13.7	14.4	16.1	245.2
Term deposits	1.7	–7.6	–11.3	–13.5	–15.5	–16.3	–16.8	–16.0	514.1
Deposits in foreign currency	16.8	1.1	5.2	8.9	10.5	5.1	4.4	–4.1	20.3
Rest of liabilities [5]	–16.8	–8.2	–6.8	–11.4	–11.5	–14.0	–9.6	–12.8	102.0
TOTAL	**–0.2**	**–1.7**	**–2.2**	**–2.3**	**–2.2**	**–2.3**	**–1.8**	**–1.5**	**1,253.2**
NPL ratio *(%)* [6]	**13.6**	**12.5**	**12.5**	**12.1**	**11.0**	**10.7**	**10.7**	**10.6**	**–**
Coverage ratio *(%)* [6]	**58.0**	**58.1**	**58.1**	**58.5**	**60.0**	**60.6**	**60.6**	**60.2**	**–**

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.*

INDIA: THE NEW ASIAN STAR?

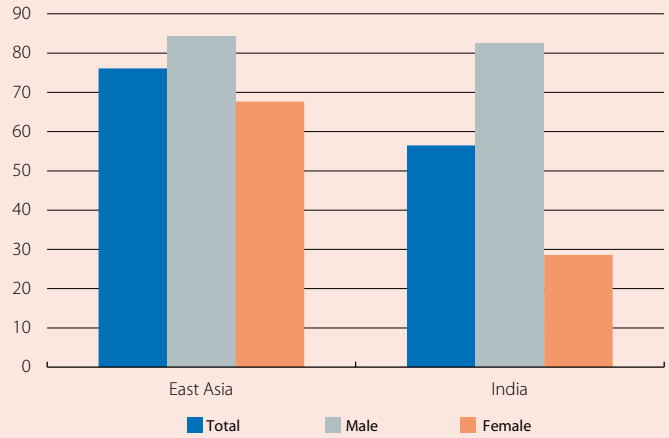
India: favourable prospects in the long term

India is increasingly important for the global economy as a whole. The second largest emerging economy, after China, with a population of 1,292 million, is also large in economic terms: India accounts for 7.1% of the world's GDP (in purchasing power parity), behind only the United States and China.

This importance has recently increased thanks to India remaining on the margins of the slowdown occurring in the emerging economies with the country being proposed as a replacement for China, which is now growing more slowly. While the emerging economies as a whole have gone from growth of 5.2% in 2012 to the 4.0% forecast for 2015, India's growth has accelerated from 5.1% to 7.3% according to the IMF. It has also managed to improve its macroeconomic environment thanks to the anti-inflationary approach of the country's central bank, the Reserve Bank of India which, with its governor, Raghuram Rajan, has helped inflation to fall from 10.2% to 5.4% and the current deficit to drop from 4.8% to 1.2% of GDP (see the article «India, the star emerging economy: a glow from the past or the light of the future?» in this Dossier).

Participation rate *

(%)



Note: ** Percentage of economically active people out of the total population aged between 15 and 64.*
Source: *CaixaBank Research, based on data from the World Bank.*

Beyond its size and improved macroeconomic situation, India is also an economy with huge potential. In addition to its favourable demographics it also has abundant natural resources, a widespread use of English and an undeniable entrepreneurial spirit. A good example of the country's dynamic business environment is provided by the 14 Indian companies included on the FT 500 in 2015.[1] By comparison China has 37 firms on the FT 500 but one significant difference is that India has four companies in sectors considered to be high tech (Infosys Technologies and Tata Consultancy Services in software and computing, Bharti Airtel in mobile telephones and Sun Pharmaceutical in pharmaceuticals), while China has none. Adding to this favourable analysis, in its *World Economic Outlook* for October 2015 the IMF estimates that India will grow on average by 7.7% in 2017-2020, more than the 6.2% forecast for China (for a more detailed comparison see the article «India and China: so close yet so far» in this Dossier).

India therefore appears destined to become a leading contender in the world order but aren't we perhaps being overly optimistic? Will the IMF's forecasts really come about? Could India replace China as the engine of the emerging economies? The answer to all these questions lies in the country's own hands and, so far, it is on the right track, a path which includes taking the first steps in a series of reforms: firstly in public administration and the labour market, as well as reforms in tax, land and banking.

In spite of these favourable projections, however, India is suffering from two serious problems: poverty and under-investment in infrastructures. India has the largest number of poor people on the planet. According to the World Bank, 706 million Indians (58% of the population) survive on 3.1 dollars a day (measured in purchasing power parity) compared with 365 million Chinese, which means that a large proportion of the population is excluded from basic services such as healthcare, drinking water, housing, energy and education.

India's second problem is its deficient infrastructure. Between 2000 and 2012 India's cumulative gross fixed capital formation totalled 25% of China's (although perhaps investment has been excessive in the latter). The consequence of this situation is outdated logistics and production bottlenecks responsible for the manufacturing sector contributing relatively little to GDP growth, namely 17%, which also makes India's economy more closed than China's in trade terms.

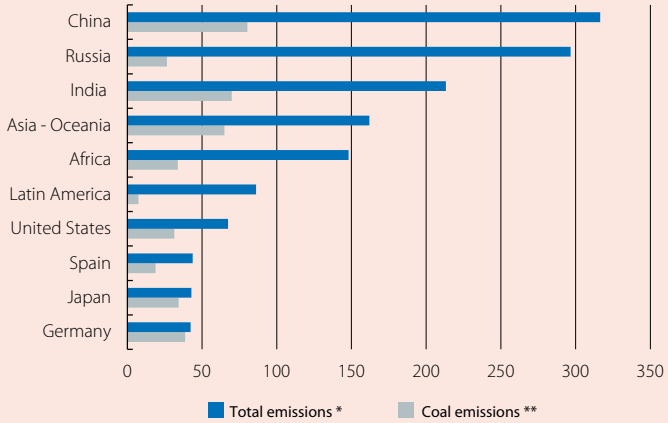
Reforms are vital in public administration and the labour market in order to tackle these problems of poverty and deficient infrastructure. In 2014 the newly elected Prime Minister, Narendra Modi, received a clear reformist mandate from the election proving that such reforms, in addition to being necessary, also enjoy considerable support among the population.

1. The FT 500 is a ranking of the world's largest companies, produced by the London newspaper, the *Financial Times*.

The eradication of the country's widespread poverty involves a substantial increase in public spending on basic services (food, healthcare, education). By way of example, in 2014 expenditure on public healthcare in India totalled 1.3% of GDP, far below China's figure of 3.7%, Brazil's 4.7% and the figure of 8.0% in the United States. India's economic growth means it can finance an increase in social spending but the true obstacle is government inefficiency, resulting in aid being lost along the way and not reaching those who need it. That is why the main objective of public administration reform is to put an end to red tape. Such government reform needs to set up supervisory mechanisms, improve the implementation of projects, pass legislation to boost transparency, rationalise ministries (some areas of responsibility are shared by five different ministries), empower local government to bring administration closer to its beneficiaries and simplify the judicial system.

CO_2 emissions

(%)



Notes: *CO_2 emissions in mt/1,000 dollars of GDP (2005 prices) as a percentage of the global average.*
*** Percentage of CO_2 emissions from coal.*
Source: *CaixaBank Research, based on data from the Energy Information Administration.*

The second focus of public administration reform is to reduce state conglomerates. Modi's government plans to reduce state participation in these conglomerates by at least 25% and this would free up capital to invest in infrastructures. Coal mining warrants particular attention among such conglomerates as it is highly inefficient and is creating a serious problem of pollution. To produce one dollar of GDP, India consumes 3.4 times the energy consumed by Europe, 2.4 times that consumed by the United States and 1.7 times the world's average consumption. The situation is even worse in terms of emissions as, for every dollar of GDP, India emits 4.8 times more carbon dioxide than Europe, 3.2 times the emissions of the United States and 2.1 times the global average. India's serious environmental problem is concentrated on coal as the country, together with China, is the world's largest producer and consumer. 70% of India's emissions come from coal, in line with the fact that 71% of the country's electricity comes from coal and only 11% from hydroelectric facilities.

In addition to social expenditure, a sustainable eradication of poverty also depends on an improved labour market. India's participation rate for people aged between 15 and 64 was 56.5% in 2014, below the 76.0% for East Asia as a whole. At constant levels of productivity and wages, if India had East Asia's participation rate, which is 20 pps higher, poverty would be significantly reduced. The main reason for such low participation in the labour market is related to gender. India's male participation rate is 82.5%, just 1.7 pps lower than the figure of 84.2% for East Asia as a whole, but its female participation rate is only 28.6%, 40 pps lower than the 67.7% for East Asia. This gender gap, only comparable with Middle Eastern countries, is due to cultural factors and requires legislation to encourage women to join the labour market. For the time being, however, this point has not been included on Modi's reformist agenda.

Other labour reforms should be aimed at improving productivity. The first step is to achieve market unity by applying common rules. Differing legislation between states makes it difficult for employees to move to geographical areas with higher growth and to technological clusters such as Bangalore, Delhi, Chennai, Hyderabad, Pune, Mumbai and Calcutta, which offer more productive jobs and better wages.

By way of conclusion, we should also remember that, although the most urgent reforms are related to public administration and the labour market, these are not the only ones required. For example, the taxation system needs to reduce the obstacles and regulations facing companies in order to boost foreign investment and the manufacturing industry, which is an area of India's economy that still requires attention. Distorting taxes and fiscal differences between states must also be eliminated as these help to push India down the World Bank's Ease of Doing Business ranking to the 130th position, behind Russia (51), Brazil (116) and China (84).

Considering all these aspects, the bulk of the evidence suggests that India does have a brilliant future in the making which could catapult it to a genuine position of leadership in the world economic order. But achieving this brilliant future also involves the formidable challenge of overcoming the limitations of the past. On its upward journey India will depend on itself and, given what we have already seen, it is making the most of all the cards it has been dealt.

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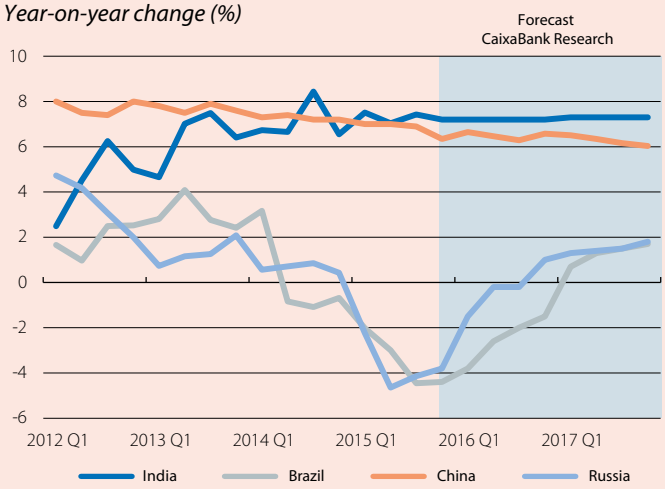
India, the star emerging economy: a glow from the past or the light of the future?

It is well known that the light we see from the stars whenever we look up at night sky left the respective suns millions of years ago. It is therefore impossible to know whether we are seeing the reflection of a sun that died out before humanity even began or a star in full ascendency. India is a glowing economy, almost certainly the current star of the emerging galaxy. But given that 2016 and 2017 are expected to be difficult for the emerging economies due to the tightening up of international financing conditions, will the country's prospects continue to sparkle in a more complicated and demanding context?

Emerging countries: GDP growth

Year-on-year change (%)



Source: *CaixaBank Research, based on data from the national statistics offices.*

First of all let us look at the brilliance of the past. In 2015 India grew by 7.4% year-on-year, much more than any other important emerging economy including the now relatively hesitant China which only advanced by 6.9%. This sorpasso in growth terms has been repeated throughout 2015.[1] The situation becomes even clearer when we compare the positive progress made by India's gross domestic product (GDP) with the recession in other emerging economies such as Russia and Brazil.

And there are more sources of light. Since May 2013, when the Fed announced it was preparing to normalise monetary policy, international investors have paid particularly close attention to the macroeconomic fundamentals of the emerging countries. Whereas financial markets had hardly separated the wheat from the chaff before this moment, since then they have become much more selective. In May 2013 India was one of the hardest hit economies and the rupee depreciated 22% against the dollar, significantly more than the currencies of other emerging countries with shakier economic foundations such as Brazil, South Africa and Turkey. Such market doubts have occurred more than once, the last time due to the upswing in financial volatility last summer. However, since then India has not come under any appreciable pressure from financial investors and now tends not to be included in the «pool» of countries that might face problems due to the tougher international financing conditions that will presumably come about in 2016-2017.

So what lies behind India's brilliant light? How can it sustain growth whilst also reducing the risk profile perceived by investors? The country's good performance is the result of two factors. Firstly, the beneficial effect of the shock of falling commodity prices in an economy which is a strong commodity importer (especially of oil and its derivatives, of which India is the world's fourth largest consumer and whose net imports account for almost 6% of Indian GDP, approximately).[2]

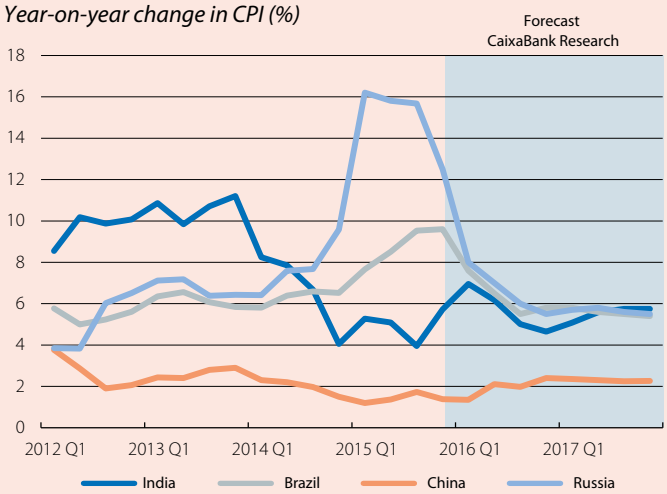
A second factor has been economic policy and, in particular, monetary policy, focusing on containing what was probably the most worrying macroeconomic imbalance, namely inflation. Whereas, in 2012-2013, this threatened to far exceed 10% year-on-year (in 2013 Q4 it reached 11.2% year-on-year), by the end of 2015 growth in consumer prices will have reached the zone of 4% year-on-year. Key to redirecting inflation has been the shift towards tougher monetary policy by India's central bank under the direction of Raghuram Rajan, an economist of great renown who was appointed in September 2013. Rajan raised the reference rate from 7.25% to 8% in just two hikes between the end of 2013 and the beginning of 2014 and kept it at this high rate for almost one year. When inflation started to appear more contained, he slowly reversed this upward trend, down to the current level of 6.75%. Undoubtedly this monetary policy has been helped by the credibility of the central bank's governor in the eyes of investors even before he was appointed, a reputation such management has merely reinforced. As an indication of the appropriateness of this monetary policy, since the last episode of depreciation started among the emerging currencies in August 2015 the Indian rupee has been among those currencies best withstanding the pressure.

1. On the long-term outlook for India and China, see the article «India and China: so close yet so far» in this Dossier.
2. The two critical energy commodities for India are coal and oil and their derivatives. However, being an important importer of crude, the country has the world's fifth largest coal reserves.

However, in spite of this positive performance by economic policy, more could be demanded from the country's fiscal policy. One recurring element in India's most recent fiscal strategy is a stronger focus on privatisation but the results to date appear to be mixed: the privatisation of the state steel industry started off badly while it is believed that the telecom spectrum auctions have been more successful. So far investors do not seem to be particularly concerned about the situation of the country's public accounts. However, a public deficit totalling 7.2% of GDP and public debt at 65.3% of GDP are taking some of the shine off India's brilliance and cannot be dismissed as minor details, particularly with a view to the future.

Emerging countries: inflation

Year-on-year change in CPI (%)



Source: *CaixaBank Research, based on data from the national statistics offices.*

In fact, this will be the area on which India will ultimately be judged: will the light we can see, so brilliant and scarcely dimmed by any shadow, continue to shine in the near future? The predominant diagnosis is positive and our opinion is shared by analysts as a whole. Growth in excess of 7% is expected for 2016 and 2017 as a result of the solid performance by activity, fuelled by a combination of greater investment in infrastructures and a more accommodative monetary policy which started at the end of 2014 and will continue in 2016.[3] Such boosts will be able to counteract the expected rise in commodity prices (presumably moderate) which will occur in 2016 and 2017. On a less tangible note but one we should not ignore, the credibility of two of the visible heads of India's new economic policy, namely Prime Minister Narendra Modi and the governor of the Reserve Bank of India, Raghuram Rajan, is still high and reputation is an asset that is not enjoyed by many emerging countries.

However, such positive prospects need to be qualified by at least two sources of risk. The first comes from the expected rise in commodity prices. Should the scenario of a gentle recovery actually turn out to be more serious with rapid, sharp increases in price, India will be facing a considerable headwind. The second concern comes from the little sensitivity shown by investors to India's relatively high levels of public deficit and debt. Given that these are expected to adjust relatively slowly (in 2016, for example, we forecast a public deficit of 7% of GDP and a public debt of 63.9% of GDP), should this complacence shown by investors regarding the fiscal imbalances of the emerging economies alter, then India would probably be at the heart of the discussion.

In summary, India seems to be a thriving star that will continue to shine in a firmament where the light from some emerging suns of previous years has gone out, if not forever then at least for a considerable period of time.

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3. In addition to increased public investment, the government's strategy regarding infrastructure development also includes a significant change in the legal framework which is expected to encourage public-private involvement in this area.

India and China: so close yet so far

Given the good economic growth figures for India and the Chinese economic slowdown, it is worth wondering about the capacity of the former to replace the impetus lost by the latter. In fact India, with a population close to 1,300 million, is the only emerging economy that could possibly follow in the footsteps of the Asian giant. However, in spite of them sharing notable features such as powerful demographics and a reduction in poverty, affecting hundreds of millions of people in both countries, India's growth is still far from the two-digit figures we had come to expect from China until very recently.

Throughout the last 35 years both countries have gradually moved apart in economic terms. While China grew at an average rate of 10% for three decades, India advanced at a rate of just over 6% and, although these figures seem to be reversing at present (China grew by 6.9% in 2015 Q3 compared with India's 7.4%), India still has a long way to go. At the end of the 1970s both economies were similar in size: India's share in the global economy was close to 3.0% and even exceeded China's share of 2.4%[1] but just over three decades later China accounts for 17.2% of the world economy in economic terms while India's share is less than half its neighbour's (7.1%). A dichotomy that can also be seen in other economic variables such as GDP per capita which, in India, has scarcely increased fourfold (from 1,000 dollars in 1980 to 3,780 currently) while in China it is now 14 times bigger (from close to 750 dollars to 10,538).[2]

India and China: indicators of the past and present

		India	China
Population *(millions)*	*1980*	686	987
	Current	1,296	1,375
Economic weight	*1980*	3.0	2.4
	Current	7.1	17.2
GDP per capita *(2005 dollars)*	*1980*	1,007	747
	Current	3,780	10,538
FDI received *(million dollars)*	*1980*	81	251
	Current	28,937	124,497
Goods exports *(billion dollars)*	*1980*	8	18
	Current	318	2,343

Note: *The relative economic weight is the relative weight of GDP at a global level, in purchasing power parity. The FDI received is the moving average of annual inflows of foreign direct investment for the period 2012-2014. Current refers to the most recently available data.*
Source: *CaixaBank Research, based on data from the IMF, Penn Word Tables, UNCTAD and WTO.*

In order to understand what lies behind this disparity between these two giants, we will analyse the trends in the different factors affecting growth in any economy (in other words physical and human capital, labour and technology), as well as the policies supporting the development of these factors.[3] In this respect there are two factors that particularly stand out as responsible for China's strong growth compared with India's more moderate rate: namely physical capital and technology.[4] The improvement in the knowledge, ability or capacity of workers (human capital) has not been a determining factor as both countries have seen similar significant progress. Moreover, India's more favourable demographics (given China's firm control of its birth rate) has not been able to offset the improved role of physical capital and technology in China.

During the 1980s and 90s, China's investment as a percentage of GDP stood at 37% compared with India's 22% and although this last figure has gradually increased up to its present rate of around 30%, in China the percentage had already passed 45% by 2014. For the period 1990-2014, the contribution of physical capital to India's average annual economic growth was 2.6 pps, far below China's figure of 4.7 pps.[5] The efforts made by the Asian giant to improve its infrastructures over several years have helped the development of omnipresent Chinese manufacturing firms while the Indian model has not supported labour-intensive manufacturing, which would have provided the country with higher growth rates. It is true that it has developed some knowledge and capital-intensive sectors (such as pharmaceuticals and information technologies) but this has not resulted in any significant growth in the country's overall manufacturing or even services. In fact, almost half India's population still works in low-productivity agriculture (compared with one third in China) and only 20% in manufacturing (30% in China).

Technological improvements have been a second key factor in the widening gap between these two Asian economies. The Conference Board estimates that total factor productivity (a measure of the contribution made by improved technology to growth) would have contributed 1.6 pps to the growth in India's average annual GDP, once again significantly below the 2.5 pps

1. Measured in share of GDP in purchasing power parity.
2. Measured in constant 2005 dollars according to data from the Penn World Tables (see 8.1).
3. Most of the results are based on the Growth Accounting exercise produced by the Conference Board (Total Economy Database) for 1990-2014, and on the exercise carried out by Bosworth, B., and Collins, S. M. (2007). «Accounting for growth: comparing China and India» (No. w12943). National Bureau of Economic Research.
4. In addition to purely technological advances, the term «technology» also refers to the way in which input factors (capital and labour) are assigned in an economy. From the point of view of economic growth we are talking about total factor productivity or TFP.
5. This is the annual average for the period 1990-2014 of the contribution of non-ICT capital as the Conference Board distinguishes between ICT and non-ICT capital.

of China. Of note here are the policies that have helped China to open up its markets, leading to the country's greater technological advances such as the creation of special economic zones early in the 1980s, with special tax conditions and laws designed to attract foreign firms.[6] On the other hand, although India's economy has gradually become more open, it has been (and still is) substantially more closed than China, limited by a large number of measures that restrict both trade flows and foreign investment. By way of example, whereas India and China attracted 0.1% and 1.7% of flows of foreign direct investment (FDI) at a global level respectively at the beginning of the 1980s, by the end of the 1990s China already captured 6.6% of global flows compared with India's share of less than 1%. A gap that continued to widen over the next decade: in the period 2012-2014 China attracted 9.1% of flows of global FDI, placing it second in the world ranking and only behind the United States, while India could only attract 2.1% of the total flows, placing it 13th in the global ranking. Along the same lines, according to the annual FDI index produced by the consulting firm AT Kearney which measures how attractive a country is for international investment, India lost four positions in 2015, falling to 11th and leaving the top ten for the first time since 2002, while China remained in second position for the third year running.

India's restrictions to flows of FDI have been extreme: with upper limits on investment in numerous sectors such as insurance, banking, retail and telecommunications and with the need for government approval for many investments in these sectors. Nonetheless restrictions to this kind of investment have recently been extensively reduced (both in terms of upper limits and approval procedures). Specifically, since the Prime Minister, Narendra Modi, implemented the Made in India campaign in September 2014, which aims to attract foreign investment and technology to develop Indian manufacturing firms, inflows of FDI appear to have increased substantially.[7] Among the most recent measures encouraged by this new initiative is the relaxation, last November, of restrictions on investment in 15 sectors, including banking, insurance, retail and also defence and agriculture, among others.

Lastly, the contrast between the two countries is also evident in terms of international trade. Whereas exports of goods from China and India represented just 1% and 0.5% respectively of the world's exports in 1980, by 2014 China was exporting close to 13% of all global exports compared with 1.7% by India. By 2009 China had already become the world leader in exports, taking over from Germany, while India has been and continues to be a much more closed economy (19th in the world export ranking).

In summary, the gap separating India from China is considerable and has been widening for more than three decades, so it is not logical to assume that India can become the world's new China overnight. However, the country has huge potential for growth, especially if we take into account the reforms it is starting to implement: whether India prospers as much as its neighbour will depend on the success of those reforms.

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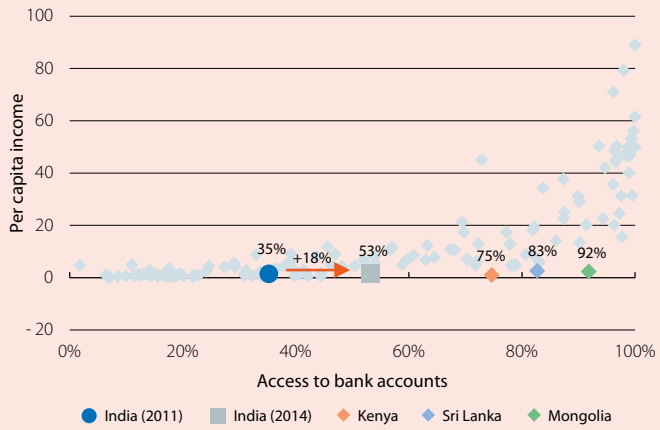
6. For a theoretical analysis of the relationship between openness and innovation and economic growth see Grossman, G. M. and Helpman, J. (1993). «Innovation and growth in the global economy», MIT Press.
7. According to the Financial Times (29 September 2015) «India grabs investment league pole position», India might have reached the top of the FDI ranking in 2015.

Financial inclusion in India and the challenges for the banking industry

Financial inclusion is a critical issue for developing countries and represents a significant challenge for India. In a country where more than 265 million people (21% of its population) live on less than 1.9 dollars a day, poverty reduction and economic equality are one of the most important social goals. In this context, financial inclusion is a fundamental way of achieving this target. Without access to basic financial services, poor people and small businesses have to depend on their savings or other informal sources of resources to invest in education, set up a firm or deal with any accidents or losses. In macroeconomic terms, financial inclusion increases savings, promotes investment and the consumption of durables, ultimately boosting economic growth.[1] In this article we analyse India's degree of financial inclusion and its main challenges.

India: financial inclusion and per capita income

(% population over 15 in 2014 and thousands of dollars at 2011 prices)



Source: *CaixaBank Research, based on data from the World Bank (Global Findex, 2014).*

Financial inclusion in India has improved considerably in the last few years. Between 2011 and 2014, more than 175 million people opened a bank account, representing 18% of the population. As a result of this notable progress, access to financial services in India is high compared with other medium and low-income countries and low compared with just a few countries such as Kenya, where the popularity of mobile banking has encouraged financial inclusion. In spite of this trend more than 600 million Indians (47% of the population) still did not have a bank account in a financial institution in 2014. Similarly, the country also has one of the highest rates of informal financial services in the world as 12% of its adult population borrowed from an informal lender.

To promote even greater financial inclusion, the government implemented in 2014 the Pradhan Mantri Jan Dhan Yojana programme (PMJDY, the Hindi acronym for the Prime Minister's People Money Scheme). Between August 2014 and early December 2015, this programme resulted in more than 194 million accounts being opened.[2] As state banks account for 70% of the banking sector's assets, the government gave them the task of being the main channel for financial inclusion on the supply side, to such an extent that these banks are now responsible for 78% of the accounts created through this programme. This plan also benefitted by the government's initiative to provide every Indian citizen with a unique biometric card (Aadhaar),[3] helping to comply with identification requirements («know your client»). Finally, the Reserve Bank of India, the country's central bank and banking supervisor, granted in April 2014 two banking licences on the condition that 25% of new branches should be located in rural regions, precisely with the aim of promoting financial inclusion. Such promotion of competition is vital for financial inclusion as it encourages traditional (state) banks to innovate so they can offer financial services to new customer segments.

As part of the PMJDY, the authorities are also promoting a number of incentives to stimulate demand for bank accounts. The government has encouraged people to open new accounts by establishing that they should be used for cash transfers of government subsidies and other social aid. Moreover, the state also benefitted from the lower administration costs for these transfers, prevented corruption and increased control of the beneficiaries ultimately receiving these payments as each bank account is associated with a single identity card.[4,5] Other financial products subsidised by the government were also associated with these new bank accounts, such as debit cards, accident and life insurance, and pension plans.

These financial inclusion measures are particularly helping certain social groups that had been traditionally excluded from the financial system such as farmers and day labourers. The programme allows these workers to open joint accounts, making such groups more attractive for banks as they generate more transactions and have a greater financial capacity operating as a

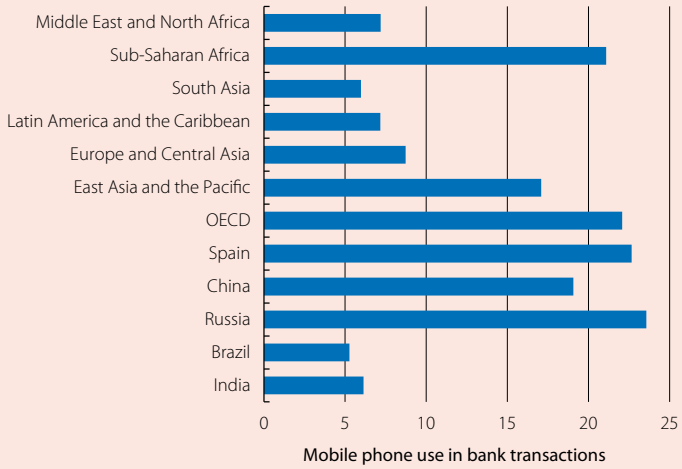
1. See «The Global Findex Database 2014. Measuring Financial Inclusion around the World», World Bank, April 2015.
2. See «Progress Report, Pradhan Mantri Jan Dhan Yojana», Finance Ministry, Indian government, December 2015.
3. The Aadhaar (Hindi for «foundation») is India's national identity document and it contains biometric data on the individual (photograph, finger and iris print), reducing the number of duplicated or false identities.
4. See «The Opportunities of Digitizing Payments», World Bank, August 2014.
5. See «India: Jump-Starting Financial Inclusion», Institute of International Finance, June 2015.

cooperative. Lastly, the financial inclusion programme has also benefitted from the so-called network effect or externality via which the number of individuals with access to financial services increases the value of such services for everyone using them. In this case, the inclusion of certain groups in the financial system creates a critical mass of new customers, making it easier for them to interact with each other and also with other segments of society and increasing both interest and competition on the part of banks as they start to focus on this market segment. This situation encourages the creation of financial products aimed at these new customers and, consequently, they become more interested in obtaining these new financial products.

The leadingchallenge for banking is how to make a profit from millions of new customers with very low incomes. Scale, very low operating costs and a range of financial products specific for these customer segments, based on transactional services and simple savings and insurance products, are all required in order for this business model to be sustainable. At present the new accounts created under the PMJDY programme are not being used very extensively as 34% have a zero balance while deposits total just 4.1 billion dollars (an average of 20 dollars per account).[6]

Mobile phone use for bank transactions

(% population over 15 with a bank account in 2014)



Source: *CaixaBank Research, based on data from the World Bank (Global Findex, 2014).*

The implementation of this new business model and the use of new technologies will be essential for rendering financial inclusion sustainable. Agents or correspondent banking (for example post offices, petrol stations and other establishments) have considerably reduced the costs of the PMJDY as opening an account via these channels costs one fifteenth of what it would cost a bank. According to market estimates, the cost of opening and maintaining each new PMJDY account is 3-4 dollars per year. The State Bank of India, the country's largest state bank, has led the field in using this channel, representing 90% of the accounts opened through the programme.[7] To improve implementation, portable terminals are being distributed to postal staff so that transfers can be authorised using Aadhaar identity cards, eliminating the need for someone to go to an agent or branch. Lastly, digitalisation and the growing use of mobile phones for bank transactions are helping to expand the scale of transactions. Although the penetration of mobiles in India is high, their use for transactions is low compared with other developing countries because of the differences between platforms and the procedures adopted by banks.[8] To promote digitalisation in India, the National Payments Corporation of India is developing a single payment interface based on the Aadhaar biometric card.

In the future greater financial inclusion should also be accompanied by greater financial literacy and the expansion of credit registries to avoid the risks associated with rising indebtness levels. It is particularly important to promote the financial education of new customers, agents and correspondents as a large proportion of them had never accessed formal financial services prior to the PMJDY. Lastly, the use of Aadhaar biometric cards could also help to generate and maintain new credit databases, making it easier to estimate potential losses and to price new financial products.

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6. See note 2.
7. See note 5.
8. See «Report of the Technical Committee on Mobile Banking», Reserve Bank of India, February 2014.

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	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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