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ECONOMIC & FINANCIAL ENVIRONMENT

FINANCIAL MARKETS
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Turkish financial crisis: in stoppage time

SPANISH ECONOMY
Should we be concerned about the slowdown of the Spanish economy?

PORTUGUESE ECONOMY
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Regulation more appropriate to the nature of the banking sector

On music, risks and leverage 10 years after Lehman

CaixaBank Research

MONTHLY REPORT - ECONOMIC AND FINANCIAL MARKET OUTLOOK
October 2018

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The next great crisis

The tenth anniversary of the bankruptcy of Lehman Brothers, the event which, in the collective imagination, marked the beginning of the biggest global financial crisis since 1929, has served as an opportunity for us to consider the causes of the financial crisis and the remedies that have been implemented to try to prevent it from reoccurring.

With regards to the causes, there is broad consensus that several factors played an important role. These include an excessively accommodative monetary policy that fuelled the US housing bubble, the banking sector's limited capacity to absorb losses (due to a lack of capital), excess short-term borrowing, corporate governance issues, banking supervision mistakes and the creation of highly complex financial products that concealed their real risk.

As for the remedies, there is also broad agreement that much has been done to correct the deficiencies that were identified. In particular, banks must meet higher capital, liquidity and transparency requirements, and the role of the management bodies and supervisors has been strengthened. New requirements (resolution plans) have also been introduced, which should facilitate the restructuring of banks experiencing difficulties and minimise the risks to the system as a whole. Some still think that not enough has been done, but perhaps they are ignoring the fact that aspiring to achieve zero risk would entail a huge cost (capital requirements and the cost of complying with regulation make financial intermediation more expensive). A balance must be struck. To judge whether we have achieved this, we must give the new regulatory framework some stability and give ourselves time to analyse how it operates.

In any case, the next great crisis – which we hope will not come anytime soon – will no doubt be different to the previous one. In fact, the European sovereign debt crisis, which was not as severe as the Great Recession of 2009 but caused the euro area to relapse, had very different causes: excessively loose fiscal policies (particularly in Greece), large differences in competitiveness between countries and the institutional weaknesses of the euro area. Europe has also introduced major reforms in order not to repeat another similar crisis, but there is still a lot of work remaining to shore up the Economic and Monetary Union (among other things, the Banking Union still needs to be completed and fiscal capacity needs to be created at a European level).

Looking to the future, what could cause the next great financial crisis? Two pockets of risk stand out on the radar – although the likelihood of them materialising is low.

China is a usual suspect due to its high debt, which has practically doubled in the last 10 years and now stands above the levels of the US prior to the 2008 financial crisis. Given its relevance in the global economy and its extensive trade and financial connections with the rest of the world, a crisis in China would be felt throughout the global economy. The good news is that the Chinese authorities are well aware of the risks and have begun to take measures to reduce the levels of debt.

The other candidate is the rise of populism and its consequences. One example of this is very close to home: Italy, where massive public debt, anaemic economic growth and a populist government make up a high-risk cocktail that could feed doubts over the country's continuity in the euro area. The good news is that the majority of the population wishes to keep the euro. What remains to be seen is whether this desire is compatible with the above combination or whether it will prove essential to change one of the ingredients of this cocktail.

Enric Fernández
Chief Economist
30 September 2018

Chronology

SEPTEMBER 2018

24 The US implements a new tariff rise on 200 billion dollars of Chinese imports. China applies a new tariff rise on 60 billion dollars of US imports.
26 The Fed raises the official rate by 25 bps, bringing it up to the 2.00%-2.25% range.
30 Canada is incorporated into the preliminary trade agreement between the US and Mexico to replace the North American Free Trade Agreement (NAFTA).

JULY 2018

6 The first phase of tariff hikes between the US and China enters into force (on 34 billion dollars of imports, out of the total of 50 billion).

MAY 2018

8 The US abandons the Iran nuclear deal reached in 2015 and announces the restoration of sanctions. Argentina requests financial aid from the IMF to deal with the country's significant macroeconomic imbalances.
31 The US imposes tariffs on imports of steel and aluminium from Europe, Mexico and Canada.

AUGUST 2018

20 Greece completes the third bailout programme after eight years of supervision by the EU, the ECB and the IMF.
23 The second phase of tariff hikes between the US and China enters into force (on 16 billion dollars of imports, out of the total of 50 billion).
27 The US and Mexico announce a preliminary trade agreement to replace the North American Free Trade Agreement (NAFTA).

JUNE 2018

13 The Fed raises the official rate by 25 bps, placing it within the range of 1.75%-2.00%.
14 The ECB announces that the net purchases of assets will decrease to 15 billion euros per month starting in October, before being brought to an end in December 2018.

APRIL 2018

13 The credit rating agency Moody's raises Spain's credit rating from Baa2 to Baa1.

Agenda

OCTOBER 2018

2 Spain: registration with Social Security and registered unemployment (September).
11 Portugal: CPI (September).
15 Spain: financial accounts (Q2).
18 Spain: loans, deposits and NPL ratio (August).
22 Portugal: loans and deposits (August).
25 Governing Council of the European Central Bank meeting.
Spain: labour force survey (Q3).
Portugal: state budget execution (September).
26 US: GDP (Q3).
30 Euro area: economic sentiment index (October).
Euro area: GDP (Q3).
Spain: CPI flash estimate (October).
Portugal: employment and unemployment (September).
31 Spain: GDP flash estimate (Q3).

NOVEMBER 2018

5 Spain: registration with Social Security and registered unemployment (October).
7 Portugal: employment (Q3).
7-8 Federal Open Market Committee meeting.
13 Portugal: CPI (October).
14 Spain: CPI (October).
Portugal: GDP flash estimate (Q3).
Japan: GDP (Q3)
19 Spain: loans, deposits and NPL ratio (September).
22 Portugal: loans and deposits (September).
27 Spain: state budget execution (October).
Portugal: state budget execution (October).
29 Spain: CPI flash estimate (November).
Portugal: employment and unemployment (October).
Euro area: economic sentiment index (November).

Sobriety following the end of summer

The global economy is operating in an environment of downside risks. The economic indicators of recent months reflect a slight slowdown in global growth, particularly across emerging countries, which are feeling the effects of the gradual tightening of global financial conditions and the climate of greater political and economic uncertainty (accentuated in the last month by the imposition of new tariffs between the US and China). Economies that have long been considered fragile, such as Turkey and Argentina, are starting to tackle an adjustment process to correct the high imbalances that have accumulated over the past few years. There is also a second and larger tier of countries (including Malaysia, Brazil, Russia and India) with generally solid macroeconomic fundamentals which should, in principle, enable them to weather the change of environment. However, they have idiosyncratic sources of weakness that place them under investor scrutiny (in some cases it is the sustainability of the public finances, while in others it is their dependence on external financing or their sensitivity to the global financial conditions, etc.). On top of all this is the central role of the Chinese economy, which continues to decelerate, as the latest indicators confirm. In this context, in September, emerging financial markets began the month by continuing the erratic tone seen in August, when they had suffered significant turmoil, although they regained some ground as the weeks went by.

The Fed and the ECB reinforce their respective roadmaps. One of the main driving forces behind the tightening of the global financial conditions is that of the monetary policy of the US Federal Reserve (Fed). Indeed, in the US, the indicators paint the picture of an economy with full employment (an unemployment rate as low as 3.9%), dynamic growth and steady inflationary trends consistent with the Fed's objective. Thus, in September, the Fed carried out the third rate hike of the year (25 bps, bringing it up to the 2.00%-2.25% range) and reaffirmed its intention to continue with gradual increases to the reference rates over the coming quarters. In the euro area, the European Central Bank (ECB) made a positive reading of the macroeconomic scenario at its September meeting and reiterated its intention to continue with the gradual withdrawal of monetary stimulus (an end to net asset purchases in December 2018 and the reference rates unchanged at their current levels at least through the summer of 2019). In fact, the slowdown in the growth of the euro area so far this year is largely due to a tempering of external demand, whereas consumption and investment continue to display a positive tone. Therefore, over the next few quarters, the economic expansion of the euro area is likely to continue at a slightly slower rate than last year, due to a less favourable external environment. That said, it will continue to be well supported by domestic demand and will have growth rates more in line with the historical average.

Slight slowdown of growth in Spain. The Spanish economy is gradually moderating its growth rate. This trend is expected and reflects the fading of the factors that temporarily stimulated the economy over the last few years (such as low oil prices, interest rates at historical lows and the depreciation of the euro). This is well reflected in the revision of the historical GDP series conducted by the National Statistics Institute every year, which shows that growth in 2015 stood at 3.6% (slightly higher than originally estimated) and slowed to 3.2% in 2016 and 3.0% in 2017 (both 1 decimal point lower than previously published). In any case, this trend does not tarnish the economy's continued good performance, which is well reflected in the latest data on the labour market, where job creation continues at a vigorous pace (2.9% in August and September). Thus, over the coming quarters, we expect the gentle deceleration of growth to continue, mostly driven by the slowdown of the foreign sector (held back by the reduced momentum of the euro area and the strength of imports). With regards to domestic demand, although we expect it to lose some steam, everything indicates that it will continue to show healthy growth.

Signs of moderation in Portugal. The economy continues to grow at a healthy rate (0.6% quarter-on-quarter and 2.4% year-on-year in Q2, both 1 decimal point higher than initially estimated), with a strong contribution from private consumption and net exports. However, the indicators in the Portuguese economy are also sending signals of a more tempered growth over the coming quarters. Like in Spain, this trend will reflect the loss of momentum among the factors that temporarily benefited the economy in recent years (as in the case of Spain, low oil prices, interest rates at historical lows and the depreciation of the euro).

Average for the last month in the period, unless otherwise specified

Financial markets

	Average 2000-2007	Average 2008-2015	2016	2017	2018	2019	2020
INTEREST RATES							
Dollar							
Fed funds	3.43	0.48	0.64	1.39	2.50	3.00	3.25
3-month Libor	3.62	0.69	0.98	1.61	2.80	3.29	3.20
12-month Libor	3.86	1.18	1.67	2.05	3.10	3.41	3.25
2-year government bonds	3.70	0.72	1.18	1.84	2.90	3.20	3.15
10-year government bonds	4.70	2.70	2.49	2.41	3.10	3.50	3.40
Euro							
ECB depo	2.05	0.50	–0.40	–0.40	–0.40	–0.20	0.25
ECB refi	3.05	1.13	0.00	0.00	0.00	0.25	0.75
Eonia	3.12	0.77	–0.35	–0.34	–0.35	–0.10	0.40
1-month Euribor	3.18	0.93	–0.37	–0.37	–0.34	–0.08	0.42
3-month Euribor	3.24	1.13	–0.32	–0.33	–0.32	–0.04	0.44
6-month Euribor	3.29	1.30	–0.22	–0.27	–0.22	0.12	0.62
12-month Euribor	3.40	1.51	–0.08	–0.19	–0.12	0.27	0.79
Germany							
2-year government bonds	3.41	0.85	–0.76	–0.69	–0.45	0.08	0.73
10-year government bonds	4.30	2.21	0.29	0.35	0.65	1.26	1.96
Spain							
3-year government bonds	3.62	2.59	–0.13	–0.04	0.06	0.68	1.35
5-year government bonds	3.91	3.16	0.30	0.31	0.48	1.11	1.77
10-year government bonds	4.42	4.13	1.43	1.46	1.50	2.06	2.66
Risk premium	11	192	114	110	85	80	70
Portugal							
3-year government bonds	3.68	4.85	0.76	–0.05	0.08	0.85	1.68
5-year government bonds	3.96	5.42	2.05	0.46	0.72	1.44	2.20
10-year government bonds	4.49	5.90	3.75	1.84	1.95	2.51	3.11
Risk premium	19	369	346	149	130	125	115
EXCHANGE RATES							
EUR/USD (dollars per euro)	1.13	1.33	1.05	1.18	1.19	1.23	1.24
EUR/JPY (yen per euro)	129.50	127.13	122.41	133.70	132.09	129.15	131.44
USD/JPY (yen per dollar)	115.34	96.09	116.06	113.02	111.00	105.00	106.00
EUR/GBP (pounds per euro)	0.66	0.83	0.85	0.88	0.89	0.87	0.86
USD/GBP (pounds per dollar)	0.59	0.62	0.80	0.75	0.75	0.71	0.69
OIL PRICE							
Brent ($/barrel)	42.32	90.70	54.92	64.09	73.00	69.00	66.00
Brent (euros/barrel)	36.35	67.78	52.10	54.17	61.34	56.10	53.23

Forecasts

Percentage change versus the same period of the previous year, unless otherwise indicated

International economy

	Average 2000-2007	Average 2008-2015	2016	2017	2018	2019	2020
GDP GROWTH							
Global	4.5	3.3	3.2	3.7	3.8	3.7	3.6
Developed countries	*2.6*	*1.1*	*1.7*	*2.4*	*2.3*	*2.1*	*1.8*
United States	2.7	1.4	1.6	2.2	2.8	2.3	1.9
Euro area	2.3	0.2	1.9	2.5	2.1	1.9	1.7
Germany	1.7	0.9	1.9	2.5	2.1	2.0	1.8
France	2.0	0.5	1.1	2.3	1.7	1.9	1.6
Italy	1.5	–1.0	1.0	1.6	1.1	1.0	1.0
Portugal	1.5	–0.6	1.9	2.8	2.1	1.9	1.9
Spain	3.8	–0.4	3.2	3.0	2.5	2.1	2.0
Japan	1.5	0.3	1.0	1.7	1.1	1.2	0.6
United Kingdom	2.8	1.0	1.8	1.7	1.3	1.7	1.9
Emerging countries	*6.6*	*5.2*	*4.4*	*4.7*	*4.9*	*4.9*	*4.7*
China	11.7	8.6	6.7	6.9	6.5	6.2	6.0
India	9.7	6.7	7.9	6.2	7.4	6.9	6.2
Indonesia	5.5	5.8	5.0	5.1	5.1	4.9	4.8
Brazil	3.6	2.3	–3.5	1.0	1.5	2.1	2.0
Mexico	2.4	2.0	2.9	2.0	2.1	2.3	2.3
Chile	5.0	3.4	1.3	1.5	3.7	3.0	2.7
Russia	7.2	1.2	–0.2	1.5	1.8	2.1	2.0
Turkey	5.4	5.0	3.2	7.3	4.0	2.5	3.3
Poland	4.0	3.2	3.0	4.7	4.7	3.0	2.7
South Africa	4.4	2.0	0.7	1.3	1.1	1.3	1.6
INFLATION							
Global	4.1	3.9	2.8	3.0	3.4	3.3	3.2
Developed countries	*2.1*	*1.6*	*0.8*	*1.7*	*2.2*	*2.1*	*1.9*
United States	2.8	1.7	1.3	2.1	2.5	2.1	2.1
Euro area	2.1	1.5	0.2	1.5	1.7	1.7	1.8
Germany	1.7	1.4	0.4	1.7	1.8	1.8	1.9
France	1.8	1.3	0.3	1.2	2.1	1.7	1.8
Italy	1.8	1.4	0.0	1.3	1.2	1.5	1.6
Portugal	3.0	1.3	0.6	1.6	1.4	1.5	1.8
Spain	3.2	1.5	–0.2	2.0	1.7	1.8	2.0
Japan	–0.3	0.4	–0.1	0.5	0.8	0.8	1.2
United Kingdom	1.9	2.6	0.7	2.7	2.6	2.2	2.0
Emerging countries	*6.7*	*6.0*	*4.3*	*4.0*	*4.2*	*4.3*	*4.0*
China	1.7	2.7	2.0	1.6	2.0	2.4	2.4
India	4.5	9.0	4.9	3.3	4.3	4.3	4.6
Indonesia	8.7	6.0	3.5	3.8	3.4	3.5	2.7
Brazil	7.3	6.2	8.8	3.5	3.6	4.1	4.1
Mexico	5.2	4.1	2.8	6.0	4.5	3.8	3.4
Chile	3.1	3.5	3.8	2.2	2.5	2.9	3.0
Russia	14.2	9.5	7.1	3.7	2.9	3.9	4.0
Turkey	27.2	8.1	7.8	11.1	13.4	12.0	8.1
Poland	3.5	2.3	–0.2	1.6	1.4	2.7	2.5
South Africa	5.3	6.1	6.3	5.3	5.0	5.5	5.1

Forecasts

Percentage change versus the same period of the previous year, unless otherwise indicated

Spanish economy

	Average 2000-2007	Average 2008-2015	2016	2017	2018	2019	2020
Macroeconomic aggregates							
Household consumption	3.6	–1.1	2.8	2.5	2.4	2.2	2.2
Government consumption	5.0	0.8	1.0	1.9	1.8	0.9	0.8
Gross fixed capital formation	6.0	–4.1	2.9	4.8	6.0	3.8	2.8
Capital goods	5.4	–0.2	5.2	5.7	7.0	4.4	2.8
Construction	6.2	–7.0	1.1	4.6	6.2	3.5	2.9
Domestic demand (vs. GDP Δ)	4.6	–1.6	2.4	2.9	3.0	2.2	2.0
Exports of goods and services	4.8	2.4	5.2	5.2	2.9	3.7	3.9
Imports of goods and services	7.1	–1.5	2.9	5.6	4.8	4.2	4.1
Gross domestic product	**3.8**	**–0.4**	**3.2**	**3.0**	**2.5**	**2.1**	**2.0**
Other variables							
Employment	3.4	–1.9	3.0	2.8	2.5	2.0	2.0
Unemployment rate (% of labour force)	10.5	21.0	19.6	17.2	15.4	13.7	12.0
Consumer price index	3.2	1.5	–0.2	2.0	1.7	1.8	2.0
Unit labour costs	3.3	0.4	–0.6	–0.1	0.7	1.9	2.4
Current account balance (cum. % GDP)[1]	–6.0	–2.1	1.9	1.9	1.1	1.1	1.1
External funding capacity/needs (cum., % GDP)[1]	–5.3	–1.7	2.2	2.1	1.3	1.3	1.3
Fiscal balance (cum., % GDP)[2]	0.4	–7.3	–4.3	–3.1	–2.7	–2.0	–1.4

Notes: *1. Four-quarter cumulative total. 2. Four-quarter cumulative total. Excludes losses for assistance provided to financial institutions.*

Forecasts

Portuguese economy

	Average 2000-2007	Average 2008-2015	2016	2017	2018	2019	2020
Macroeconomic aggregates							
Household consumption	1.7	–0.5	2.4	2.3	2.3	2.0	1.8
Government consumption	2.3	–0.8	0.8	0.2	0.8	0.6	0.2
Gross fixed capital formation	–0.3	–4.2	2.4	9.2	4.2	4.7	4.5
Capital goods	1.3	–1.0	7.6	13.7	6.6	6.5	5.5
Construction	–1.6	–7.0	–1.3	8.3	4.6	6.2	5.5
Domestic demand (vs. GDP Δ)	1.5	–1.4	2.1	3.1	2.4	2.2	2.1
Exports of goods and services	5.2	3.4	4.4	7.8	6.8	5.2	4.3
Imports of goods and services	3.6	1.2	4.7	8.1	7.1	6.0	4.5
Gross domestic product	**1.5**	**–0.6**	**1.9**	**2.8**	**2.1**	**1.9**	**1.9**
Other variables							
Employment	0.4	–1.4	1.2	3.3	2.5	0.8	0.6
Unemployment rate (% of labour force)	6.1	12.3	11.1	8.9	7.0	6.6	6.3
Consumer price index	3.0	1.3	0.6	1.6	1.4	1.5	1.8
Current account balance (cum. % GDP)[1]	–9.4	–4.9	0.6	0.5	0.2	0.2	0.2
External funding capacity/needs (cum., % GDP)[1]	–7.9	–3.4	1.6	1.4	1.1	1.0	0.9
Fiscal balance (cum., % GDP)[2]	–4.4	–6.8	–2.0	–3.0	–0.9	–1.0	–0.9

Notes: *1. Four-quarter cumulative total. 2. Four-quarter cumulative total. Excludes losses for assistance provided to financial institutions.*

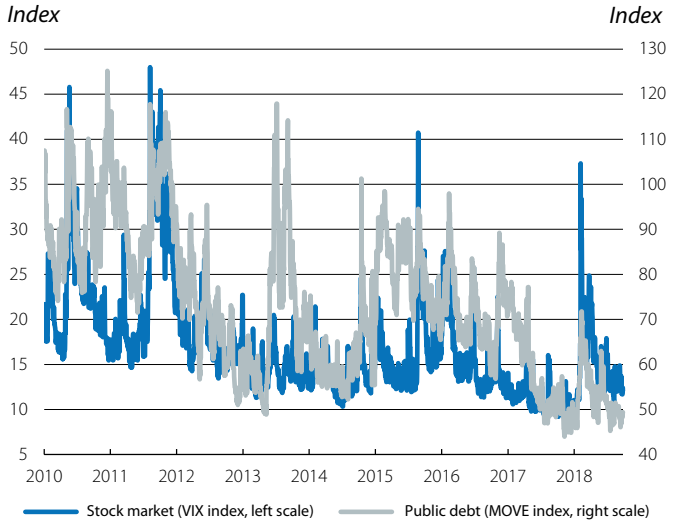
Forecasts

Fickleness prevails in the financial markets

The erratic trend of the summer persists in the early stages of the month. Following a summer where financial turmoil in the emerging economies was at the spotlight, the financial markets in these countries and in Europe maintained the erratic tone seen in August. However, as the weeks progressed, they managed to regain some of the lost ground. The US stock market indices, meanwhile, continued to break records and reach all-time highs, although some indicators cast doubt over the sustainability of these high valuations. The month was also marked by the central banks' meetings in the euro area and in the US. Both remained positive on the macroeconomic scenario in their respective regions and reiterated their monetary policy strategies announced at previous meetings: a gradual rise of rates in the US and a gradual withdrawal of the monetary stimulus in the euro area. As such, over the next few quarters, the financial environment will continue to be marked by a gradual tightening of the global financial conditions. This factor, together with the uncertainty regarding the extent of the slowdown of China's economy and fears of a resurgence of protectionism at the global level, is eroding performance in the markets, particularly in the emerging economies.

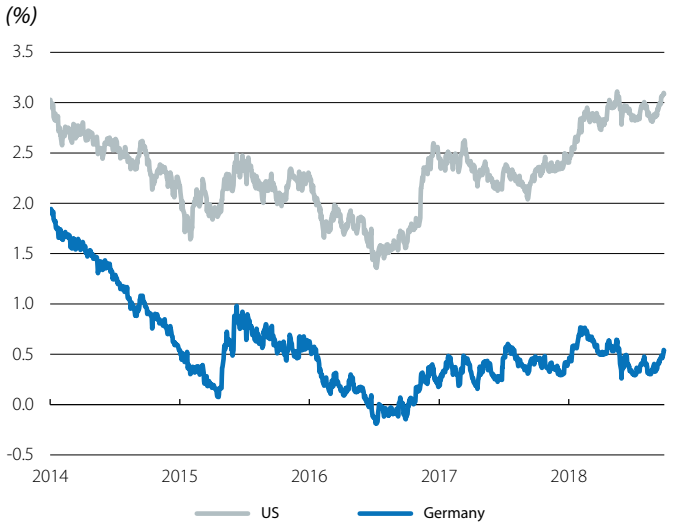
The major central banks continue along their intended paths. In the euro area, the European Central Bank (ECB) maintained a positive view of the macroeconomic scenario at its meeting on 13 September. In doing so, it reiterated its intention to continue with the roadmap announced last June (a reduction of net asset purchases to 15 billion euros a month starting this October, bringing them to an end in December, and without any changes to the reference rates at least through the summer of 2018). Meanwhile, at its meeting held on 25 and 26 September, the US Federal Reserve Bank (Fed) hiked interest rates for the third time this year (25 bps, up to the 2.00%-2.25% range). This decision was anticipated by investors and analysts, and it was based on the strength of the economy reflected by the US activity, labour market and inflation data. In the weeks leading up to the meeting, various members of the Fed hardened the tone of their discourse and indicated a faster pace of rate hikes. This led to an upward revision of expectations among investors, who now anticipate two rate increases in 2019 (in line with our scenario). This movement was transmitted on to the sovereign interest rates, with the 10-year rate increasing by more than 20 bps to over 3%. Similarly, the rate of the German bund climbed to over 0.5% (a level not reached since May), while in Europe's periphery, Italy's risk premium managed to fall by more than 60 bps from the high levels reached in August. However, at the end of the month, the country's risk premium rebounded more than 35 bps, following the news indicating that the Italian Government will set a substantially

Implicit volatility in the financial markets



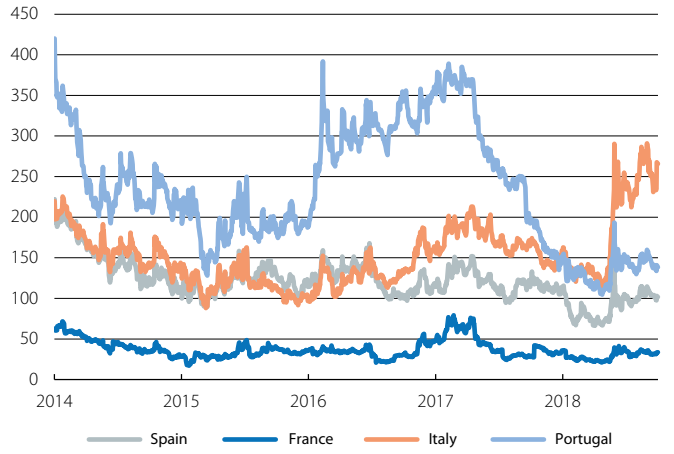
Source: *CaixaBank Research, based on data from Bloomberg.*

10-year public debt yield



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

Euro area: risk premiums of 10-year public debt



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

higher fiscal deficit target for next year than that originally agreed with the European Commission.

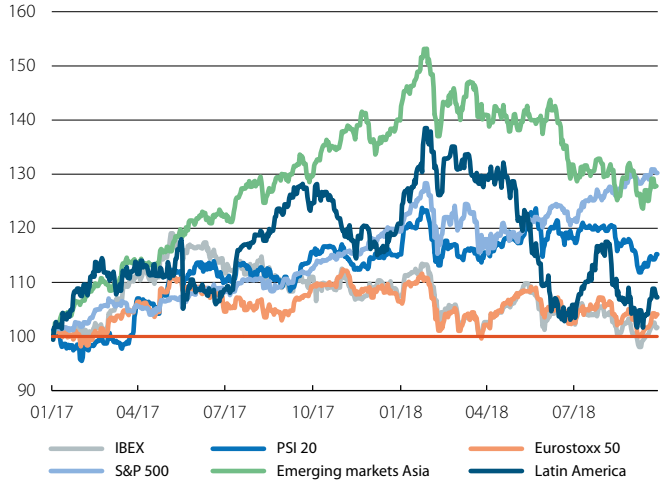
The hesitancy of the summer returns to the European stock markets, while in the US they remain at all-time highs. In an environment marked by fears of a global escalation of protectionism, stock markets in the euro area began the month of September with the same erratic tone as they had shown during the holiday period. However, after this faulty start, the European stock markets began to recover, and the majority of indices managed to end the month at levels similar to those of September's first sessions. On the other hand, the US stock market continued its bullish trend and exceeded the all-time high reached in August. As such, the current valuations of US equities continue to cause high levels in some overvaluation indicators, such as the CAPE and PER ratios. This calls into question their sustainability, especially in an environment of higher interest rates.

Emerging economies' financial markets recovered from the summer's turmoil, although they remain volatile. In the early stages of the month, both the currencies and the main stock market indices of the emerging economies continued the bearish trend of the summer, with broad-based declines. Nevertheless, as the weeks progressed, these assets benefited from the positive trend of the global financial markets and were able to regain some of the ground lost in the preceding days. Thus, in the cumulative month to date, the stock market index for the whole of the emerging Asian economies recovered some of the losses, although it failed to close up overall. In Latin America, meanwhile, the advances in the Brazilian stock market pushed the region's MSCI index into positive territory. However, the underlying reasons for this financial turmoil remain dormant: doubts surrounding the strength of growth in China, the tightening of global financial conditions, increased trade tensions between the US and various regions, the increase in oil prices, as well as the idiosyncrasies of some countries and the possible contagion effect they could have on the rest of the emerging economies, are all factors that could continue to threaten emerging assets.

The price of oil surpasses 80 dollars. Following the relative stability it showed in the summer, in September Brent oil prices rose to over 80 dollars per barrel. A number of causes lie behind this spike, most of them related to factors restricting the global oil supply. On the one hand, the entry into force in November of the sanctions imposed by the US on Iran is weakening this country's oil exports. On the other hand, several countries are cutting their oil production by more than the reduction agreed by the OPEC and its partners, while those with a greater productive capacity (such as Saudi Arabia) are not compensating for this excessive reduction. In addition, the production of shale in the US is proving to be lower than expected, due to the existence of bottlenecks.

Main international stock markets

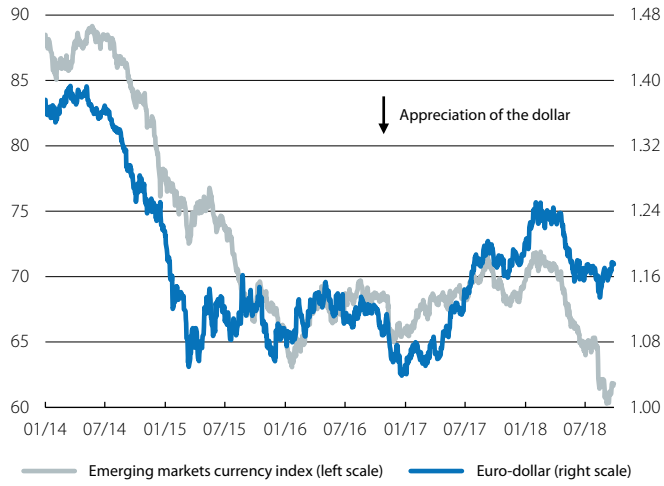
Index (100 = January 2017)



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

International currencies against the US dollar

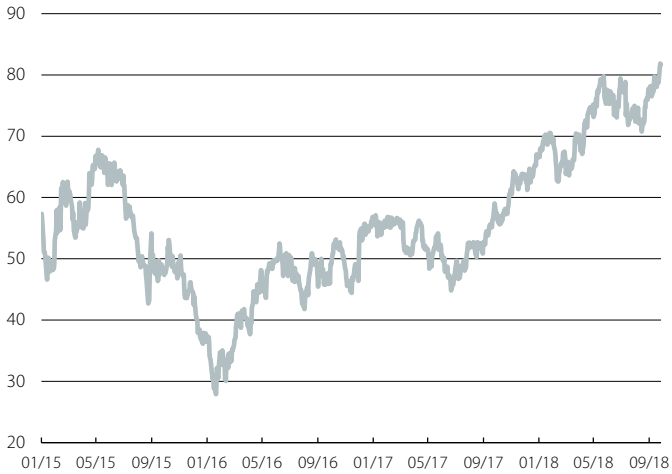
(Index) *(Dollars per euro)*



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

Brent oil price

(Dollars per barrel)



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

Financial upheaval in the emerging economies: a prelude to something else?

2018 is not proving to be a good year for financial assets of the emerging economies. Following a 2017 in which they offered high returns, 2018 has seen a return of volatility. This has been brought about by stock market losses, higher risk premiums and currency depreciations in not insignificant quantities: so far this year, the MSCI stock market index for the emerging economies as a whole has amassed losses of around 10%, the emerging markets bond index (EMBI) is showing an upturn in credit spreads of more than 50 bps, and the emerging currency indices reflect a depreciation of slightly more than 10% (much higher in the currencies of countries such as Turkey and Argentina, with depreciations of 37% and 55%, respectively).

This instability has not been the result of chance. In the last decade, the growth of the emerging economies has been favoured both by accommodative global monetary conditions (with which they obtained cheap and abundant financing from abroad) and by the expansion of international trade, supported by China's growing central role. But the tables have turned and the markets are beginning to operate in an environment of tightening financial conditions (with US interest rate rises and a stronger dollar) and greater trade tensions and uncertainty (both political and over the slowdown in China's economy). These drivers, coupled with the high idiosyncratic vulnerabilities of some countries like Turkey and Argentina, have triggered attitudes of greater risk aversion towards the emerging economies. Will this be a prelude to something else?

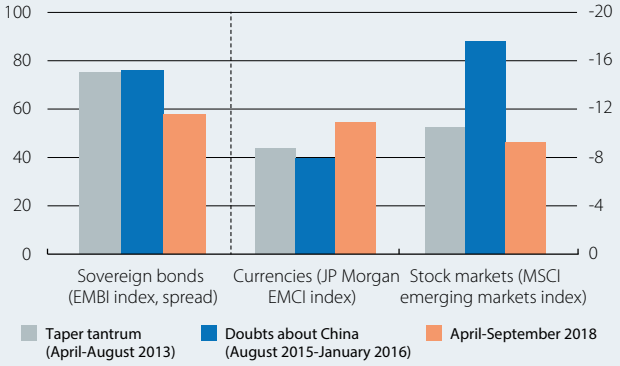
Characteristics of the recent upheaval

The poor performance of emerging financial assets became particularly stark starting in April 2018, when the impact of political uncertainty, trade tensions (especially between the US and China) and the tightening of US monetary policy began to be felt in investor sentiment towards the emerging economies. Since then, although most of the emerging countries have been affected by the instability, there has been a certain degree of discrimination between economies with more and less solid macroeconomic fundamentals. In fact, as can be seen in the second chart, there is a strong parallel between the depreciation of the exchange rate that each country has suffered and the perception of the risk of default on their sovereign debt.

Thus, the currencies that have suffered the most have been those of economies with significant external vulnerabilities (greater external financing needs, few international foreign exchange reserves and/or large numbers of foreign investors participating in the local

Upheaval in emerging economies: reaction of the markets

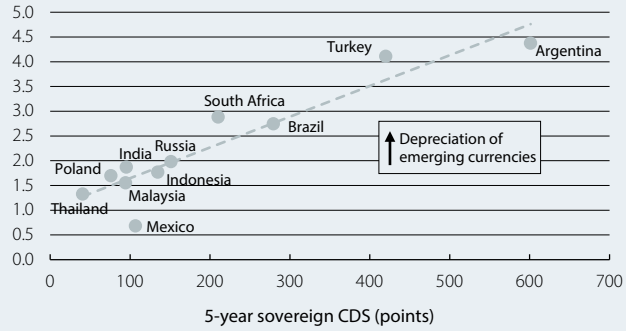
Change (bps) — *Depreciation of currencies and stock market losses (%)*



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

Emerging currencies: depreciation and sovereign default risk

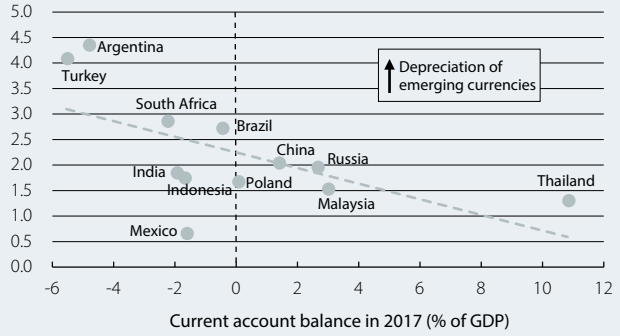
Change in exchange rate (logarithmic scale)



Note: *Each point represents the cumulative depreciation of an emerging currency against the US dollar between the end of April and the beginning of September 2018. Given the significant depreciations in Argentina and Turkey, we use a logarithmic transformation.*
Source: *CaixaBank Research, based on data from Bloomberg.*

Emerging currencies: depreciation and external imbalances

Change in the exchange rate (logarithmic scale)



Note: *Depreciation against the US dollar between the end of April and the beginning of September 2018. Given the significant depreciations in Argentina and Turkey, we use a logarithmic transformation.*
Source: *CaixaBank Research, based on data from Bloomberg and the IMF.*

bond market), as illustrated in the third chart. Meanwhile, stock prices in the Asian economies, which are deeply involved in international trade and especially in trade with China, have been particularly affected. Lastly, and in the same vein, throughout this period there has been a slowdown in portfolio capital inflows and there have even been investment fund withdrawals, which have particularly affected Asian economies such as Indonesia and Malaysia.[1]

Overall, the scale of the turmoil has been similar to that of other past episodes, such as the so-called taper tantrum of 2013 or China's stock market corrections in 2015 (see the first chart). However, up to now there has been one key difference: investors are showing a greater degree of discrimination and are raising doubts about certain emerging economies (those known to be fragile), while showing less concern about many others.

How is the macroeconomic health of the emerging economies?

As we have seen, this discrimination appears to act on external imbalances in the emerging economies. But the tightening of global financial conditions, trade tensions and the economic slowdown in China mean that investors may begin to question the very sources of growth in the emerging markets in the last decade.

In other exercises,[2] we have already identified the emerging economies that are most vulnerable to changes in global investor sentiment based on their macroeconomic imbalances (Argentina, Turkey and South Africa), as well as a secondary group (Brazil, Colombia, Hungary, Indonesia, Malaysia and Poland) where the focal points of risk are less widespread and are concentrated in the accumulation of debt (mainly corporate debt, but also public debt, as in the case of Brazil). It is the first group that has been punished the most by the current episode of financial stress, while some countries in the second have been affected more sporadically and to a lesser extent.

The cases of Turkey (discussed in the Focus «Turkish financial crisis: in stoppage time» in this *Monthly Report*) and Argentina can be explained by the bad combination of a delicate external position, the presence of internal imbalances (such as high inflation) and economic policy mistakes. However, in other cases the reasons for the weak financial asset valuations are less easy to pin down, as is the case for Russia, India and Brazil, which are particularly relevant because of their greater systemic role. Therefore, we must look beyond the conventional concept of imbalances, which may be too generic.

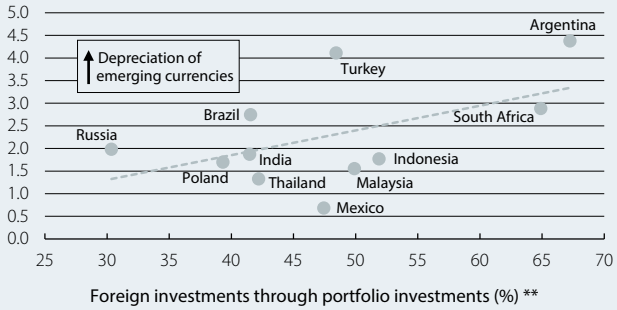
1. For more details, see IMF (2018), «External sector report».
2. See the Focus «Fragile emerging countries: Argentina and Turkey, neither exceptional cases, nor the first of many others» in the MR06/2018.

On the one hand, with regards to external financing needs, not only is their scale important but so is their composition. In particular, as various authors[3] have pointed out, portfolio debt and the loans and deposits of foreign banks are especially sensitive to global volatility spikes. In fact, the analysis of the current episode appears to confirm that the currencies of those countries with a higher proportion of foreign investment conveyed through portfolio flows (and a lower proportion of foreign direct investment) are enduring greater downward pressures (see the fourth chart). This helps to explain, at least partially, why economies like India are under scrutiny, despite having a current account deficit that does not appear to be excessive.

On the other hand, external vulnerabilities do not deplete existing risks. Even though the direct link that is becoming apparent is broadly between exchange rate crises and doubts arising over external financing, in a

Emerging currencies: depreciation and composition of foreign investment

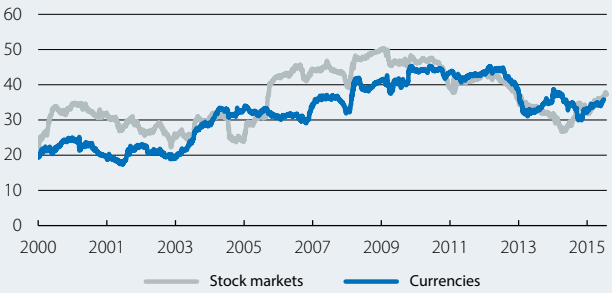
*Change in the exchange rate (logarithmic scale)**



Notes: ** Depreciation against the US dollar between the end of April and the beginning of September 2018. Given the significant depreciations in Argentina and Turkey, we use a logarithmic transformation. ** Fraction in relation to the sum of direct foreign investments and portfolio investments (liabilities of the international investment position). Data relating to 2017.*
Source: *CaixaBank Research, based on data from Bloomberg and the IMF.*

Financial externalities: impact of emerging economies on advanced economies

(pps)



Note: *Financial externalities are defined as the fraction of the 12-day forecast error of the financial asset valuations of the economies receiving the externality that can be explained by the change in the financial asset valuations of the economy emitting the externality.*
Source: *CaixaBank Research, based on data from the IMF's Global Financial Stability Report for April 2016.*

3. See, for example, G. Hoggarth *et al.* (2017), «Assessing the riskiness of capital inflows based on lender and currency», VoxEU.org.

situation with global debt at an all-time high, we must also pay attention to the total level of indebtedness. If we take a step back, we see that most of the above discussion stems from an increase in the cost of external financing due to the combined impact of an appreciation of the dollar and higher interest rates in the US. But the impact of less accommodative financial conditions in advanced economies also translates to the emerging countries' local currency interest rates: in a way, it generates an externality. In fact, various analyses confirm that these externalities vary considerably from country to country. However, they tend to agree that, based on historical data, they are more pronounced in some of the emerging markets that have been affected by the current episode of financial stress, such as Brazil, Mexico, Indonesia, Hungary, South Africa and Turkey.

In short, the current episode appears to validate three basic premises. Firstly, the situation among the emerging economies is clearly varied and the exchange rate crisis is primarily affecting to the so-called «fragile» countries. As a logical counterpart of the first premise, a second one is that many other emerging economies have reasonably satisfactory fundamentals. Finally, the third premise is that investors are pointing out a wide variety of vulnerabilities, and this can provide a clue as to what to expect in the future (watch out for debt!). In particular, this raises the question as to whether or not the current trend of moderate contagion is likely to persist in the near future.

Moderate contagion... but with risks

The conclusion that many emerging economies are built on reasonably solid economic fundamentals could offer a good explanation for why the contagion so far has been limited. Nevertheless, there are elements that suggest caution.

Firstly, various authors have warned of an increase in the influence that asset valuations in emerging economies have on the rest of the international financial markets, due to their greater integration into global trade and the international capital markets.[4] As an example, this trend, which is clearly reflected in the fifth and sixth charts, led to the fluctuations in certain emerging market financial assets in 2016 explaining around 30% of the variability of the returns in the stock markets and currencies of the advanced economies, and 40% for those of other emerging markets. Secondly, and related to the previous point, it has been documented that there is a greater likelihood of contagion when sectors with a high dependency on external financing and companies with less liquidity and higher leverage play an important role.

4. See G. Gelos and J. Surti (2016), «The growing importance of financial spillovers from emerging market economies», VoxEU.org.

Financial externalities: impact of emerging economies on other emerging economies

(pps)

Note: *Financial externalities are defined as the fraction of the 12-day forecast error of the financial asset valuations of the economies receiving the externality that can be explained by the change in the financial asset valuations of the economy emitting the externality.*
Source: *CaixaBank Research, based on data from the IMF's Global Financial Stability Report for April 2016.*

Thirdly, the strong growth of global intermediaries to channel capital flows means that the financial structure has become more prone to contagion: by operating in different jurisdictions, adjustments in an economy's portfolio mean that these intermediaries are likely to trigger adjustments in the portfolios they hold in other economies. Finally, and in the same vein, in recent decades, passively managed investment funds (including exchange-traded funds, or ETFs) have grown significantly, achieving a prominent market share as conduits for investments in emerging economy assets.[5] According to various authors,[6] this increasing importance of passive investment instruments as vehicles for channelling capital inflows into emerging economies has consequences for their ability to withstand upheaval and for the level of contagion they can generate. In particular, empirical analysis indicates that passive investment funds are relatively more likely to adjust their portfolios in response to global developments than in reaction to local factors specific to the countries in which they have invested assets. Thus, the emergence of passive investment funds would contribute to reducing the containment role that more solid macroeconomic fundamentals can play in the event of financial turbulences in emerging markets (at least in the short term). Similarly, indices like the one presented in the seventh chart show that the emerging economies have received increased levels of investment from investors with a greater propensity to withdraw their capital at short notice.

What does the future hold?

Very fragile economies, such as Argentina and Turkey, must undertake an agenda of economic adjustments to correct their large macroeconomic imbalances, while in the other cases we generally find differing combinations

5. Some estimates put their market share at 20%. See N. Converse *et al.* (2018), «How exchange-traded funds amplify the global financial cycle in emerging markets».
6. See the reference in the previous note.

of macroeconomic fundamentals and some idiosyncratic weaknesses.[7] However, in a less favourable international context, emerging market financial assets are likely to continue to suffer moderately over the coming months, which will have a small but significant effect on these countries' growth rates.

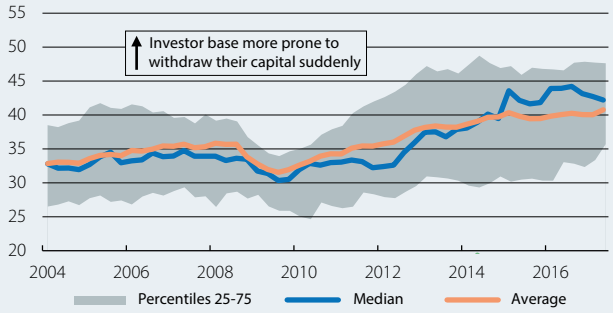
Among the factors that will determine the scale of this burden, we highlight the following ones: the tightening of global financial conditions, the scope of the slowdown in China and the evolution of oil prices. The latter factor is particularly difficult to predict, but there is some consensus among analysts that the tightening of financial conditions and the slowdown in China will both be gradual processes. As such, the growth slowdown in emerging countries is likely to be limited. Nevertheless, it is necessary to analyse what could happen if the dynamics of these three factors end up being different to those considered in this central scenario.

Firstly, a surge in inflation in the US and/or clear indications of overheating could cause a higher-than-expected tightening of monetary policy by the Fed and, consequently, of global financial conditions. In this scenario, economies with high levels of debt denominated in foreign currency, such as Malaysia, as well as those with significant external financing needs, such as Indonesia, India and South Africa, could be particularly affected. Secondly, with regards to China, a very gradual slowdown is expected due to the authorities' extensive margin for manoeuvre (such as the large buffer of reserves and the possibility to implement more expansive monetary and fiscal policies). Nevertheless, estimates suggest that an accentuation of trade tensions with the US could detract 1 pp from Chinese growth. In this scenario, the impact on the emerging bloc would be varied, but it would have a clear and adverse effect on producers of industrial metals (such as Brazil, Chile and South Africa) and on the East Asian countries most closely connected to the global supply chains that are centred around China (such as Malaysia, Taiwan and South Korea). Finally, if the price of oil continues to steadily increase, we would find ourselves in a scenario with winners (net exporters that are now included on the list of fragile economies, such as Brazil and Colombia) and losers (importers of crude oil, such as India, which would see an increase in their current account deficits).[8]

According to the estimates presented in the analyses we have published previously,[9] these scenarios could

Emerging economies: investor base risk index

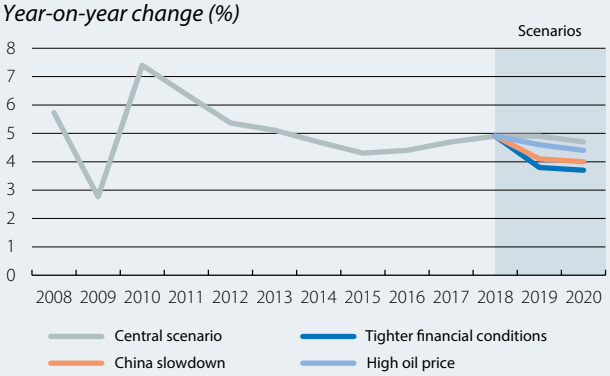
Index (0 -100)



Note: *The investor base risk index produced by S. Arslanalp and T. Tsuda (2012), in «Tracking Global Demand for Advanced Economy Sovereign Debt», captures the likelihood of sudden outflows of capital according to the type of investor.*
Source: *CaixaBank Research, based on data from the IMF's Global Financial Stability Report for April 2018.*

Emerging economies: GDP

Year-on-year change (%)



Note: *Scenarios built based on the sensitivities estimated in the articles «What is behind the rise in oil prices?» in the MR07/2018, «China: in prosperity and in adversity» in the MR06/2018 and «Growth in the emerging economies and global financial conditions: a close relationship» in the MR05/2018.*
Source: *CaixaBank Research.*

subtract between 0.3 and 1 pps from the growth of the emerging bloc over the next two years (see the last chart). These figures are significant enough to give us reason to remain alert, although they are apparently not sufficient to put the expansion of the global economy at risk. This reflects the view that, as a whole, the emerging countries are in a better position now than they were 10 years ago, and particularly than they were in the fateful 1990s. There are some pathological exceptions, made worse by bad economic policy decisions (Turkey and Argentina) and, in a more complex global context, it is likely that the financial assets of emerging economies will continue to be adversely affected. Nevertheless, their foundations and the discrimination shown by investors so far should prevent a situation of severe and widespread turmoil.

7. For instance, the majority of them have adequate reserves, whereas there is greater diversity in terms of fiscal policy margin (ranging from a relatively delicate situation in Brazil to more comfortable positions in emerging Asian economies).
8. In this scenario, the situation in India deserves a separate mention. Its current account is very sensitive to fluctuations in oil prices and, in addition, the rise in the cost of imports could lead to social unrest in 2019, a year in which President Modi will be seeking re-election.

9. See the Focus «Growth in the emerging economies and global financial conditions: a close relationship» in the MR05/2018, «China: in prosperity and in adversity» in the MR06/2018 and «What is behind the rise in oil prices?» in the MR07/2018.

Interest rates (%)

	28-Sep	31-Aug	Monthly change (bp)	Year-to-date (bp)	Year-on-year change (bp)
Euro area					
ECB Refi	0.00	0.00	0	0.0	0.0
3-month Euribor	–0.32	–0.32	0	1.1	1.1
1-year Euribor	–0.16	–0.17	1	2.6	1.2
1-year government bonds (Germany)	–0.59	–0.62	3	4.8	12.8
2-year government bonds (Germany)	–0.52	–0.61	9	10.7	17.7
10-year government bonds (Germany)	0.47	0.33	14	4.3	–0.9
10-year government bonds (Spain)	1.50	1.47	3	–6.7	–12.6
10-year government bonds (Portugal)	1.88	1.92	–4	–6.3	–53.9
US					
Fed funds	2.25	2.00	25	75.0	100.0
3-month Libor	2.40	2.32	8	70.6	106.5
12-month Libor	2.92	2.84	8	81.3	113.3
1-year government bonds	2.56	2.45	11	82.8	127.3
2-year government bonds	2.82	2.63	19	93.7	136.9
10-year government bonds	3.06	2.86	20	65.5	75.2

Spreads corporate bonds (bps)

	28-Sep	31-Aug	Monthly change (bp)	Year-to-date (bp)	Year-on-year change (bp)
Itraxx Corporate	69	68	1	24.0	11.0
Itraxx Financials Senior	84	85	–1	40.5	24.3
Itraxx Subordinated Financials	171	177	–6	66.6	33.4

Exchange rates

	28-Sep	31-Aug	Monthly change (bp)	Year-to-date (bp)	Year-on-year change (bp)
EUR/USD (dollars per euro)	1.160	1.160	0.0	–3.3	–1.5
EUR/JPY (yen per euro)	131.930	128.840	2.4	–2.5	–0.4
EUR/GBP (pounds per euro)	0.890	0.896	–0.6	0.3	1.5
USD/JPY (yen per dollar)	113.700	111.030	2.4	0.9	1.2

Commodities

	28-Sep	31-Aug	Monthly change (bp)	Year-to-date (bp)	Year-on-year change (bp)
CRB Commodity Index	415.0	411.4	0.9	–4.0	–3.0
Brent ($/barrel)	82.7	77.4	6.8	23.7	44.1
Gold ($/ounce)	1,192.5	1,201.4	–0.7	–8.5	–7.4

Equity

	28-Sep	31-Aug	Monthly change (bp)	Year-to-date (bp)	Year-on-year change (bp)
S&P 500 (USA)	2,914.0	2,901.5	0.4	9.0	16.1
Eurostoxx 50 (euro area)	3,399.2	3,392.9	0.2	–3.0	–4.6
Ibex 35 (Spain)	9,389.2	9,399.1	–0.1	–6.5	–9.1
PSI 20 (Portugal)	5,359.3	5,422.6	–1.2	–0.5	–0.3
Nikkei 225 (Japan)	24,120.0	22,201.8	8.6	6.0	18.4
MSCI Emerging	1,047.9	1,056.0	–0.8	–9.5	–2.3

Growth remains strong, despite the increase in downside risks

Global activity indicators remain high, albeit they point towards a slight moderation of growth, especially in emerging markets. In particular, the global composite business sentiment index (PMI) remains in clearly expansionary territory (above 50 points), although in August it declined for the second consecutive month, to 53.4 points, its lowest level since March. This reduction in the index was more pronounced in emerging countries, which are feeling the effects of the heightened political and economic uncertainty and the gradual tightening of global financial conditions. Over the next few quarters, we expect growth in emerging economies to continue to gradually slow down, which will imply a slightly more contained global growth rate.

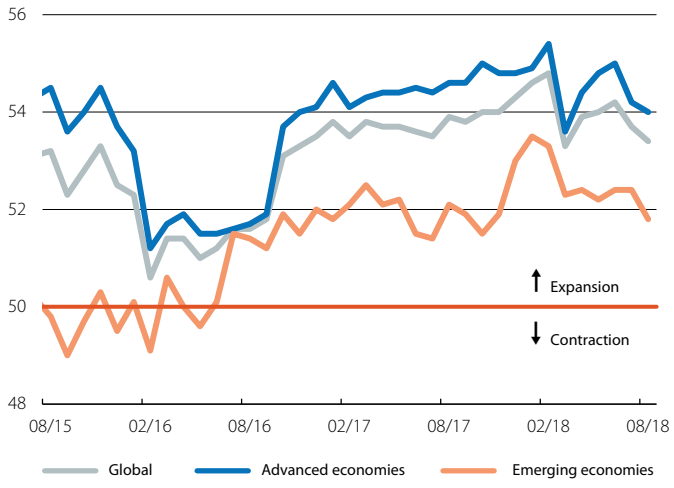
Recent geopolitical events have led to an increase of downside risks. In particular, despite having entered into negotiations with China to steer the trade tensions, the US announced another round of tariffs on Chinese imports (this time, 10% on a value of 200 billion dollars). This is in addition to the 25% tariff package on Chinese products valued at 50 billion dollars that was already implemented this summer. On the other hand, at the European policy level, the United Kingdom and the EU are hoping to reach an exit agreement over the next few weeks that will make effective, from March 29, the transition agreement previously reached. According to this agreement, the United Kingdom will remain in the single market and the customs union until the end of 2020. However, there are still important elements to be resolved – such as finding a solution to the issue of the border between Ireland and Northern Ireland – and the ratification process in the United Kingdom could prove complicated and end up delaying the agreement. It is therefore likely that the uncertainty surrounding Brexit will regain prominence over the next few weeks (or even months) until the final exit agreement is announced. This announcement could be accompanied by a statement setting out the basis for the future relationship between the United Kingdom and the EU. Finally, in Italy, everything suggests that the coalition Government will propose a significant deviation from the deficit target agreed in May in Brussels (possibly increasing it from the 0.8% agreed to 2.4%, which would make it difficult to correct the country's high level of public debt). Although official details on the final scale and composition of the fiscal measures remain uncertain, the new plans could create tensions in the financial markets and with European partners.

US

The indicators continue to suggest solid growth. In particular, following the encouraging GDP growth figure for

Activity indicators: composite PMI

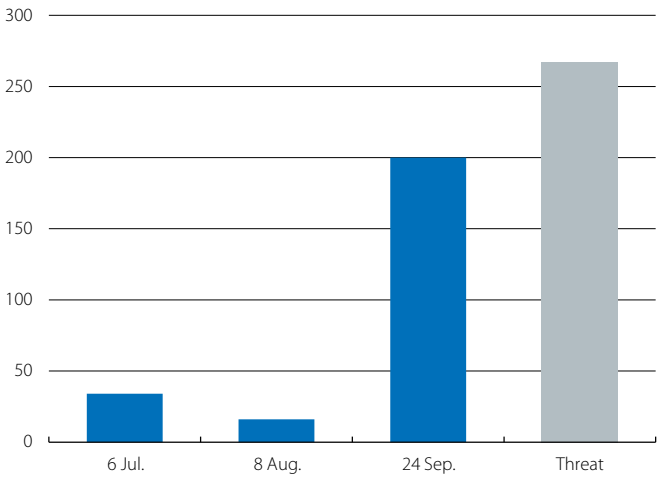
Level



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

US: tariffs on Chinese imports

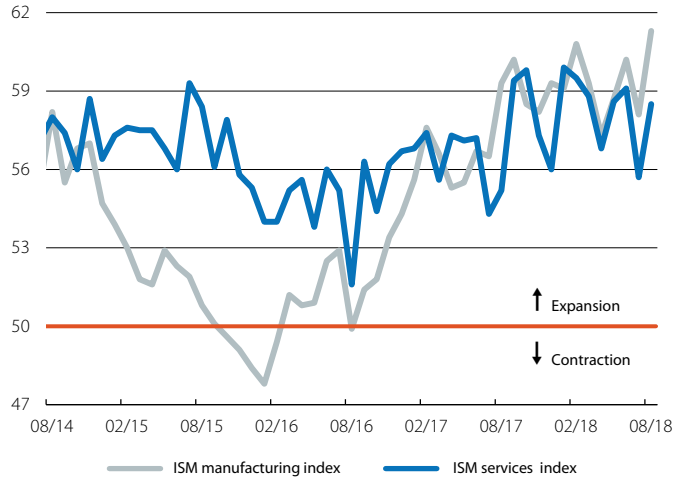
USD billions



Source: *CaixaBank Research, based on data from the US Trade Representative Office.*

US: activity indicators

Level



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

Q2 (1.0% quarter-on-quarter and 2.9% year-on-year), the indicators available for Q3 – some of which have been higher than expected – confirm that the US economy continues to grow at a rapid rate. As an example, nowcasting GDP models of the Federal Reserve Banks of Atlanta and New York predict an activity rate for Q3 that is well above the US economy's growth potential (which we consider it to be around 2%). In addition, the manufacturing and services business sentiment indices (ISM) increased significantly in August, reaching 61.3 and 58.5 points, respectively, and well above the threshold that separates the expansionary and recessive territories (50 points).

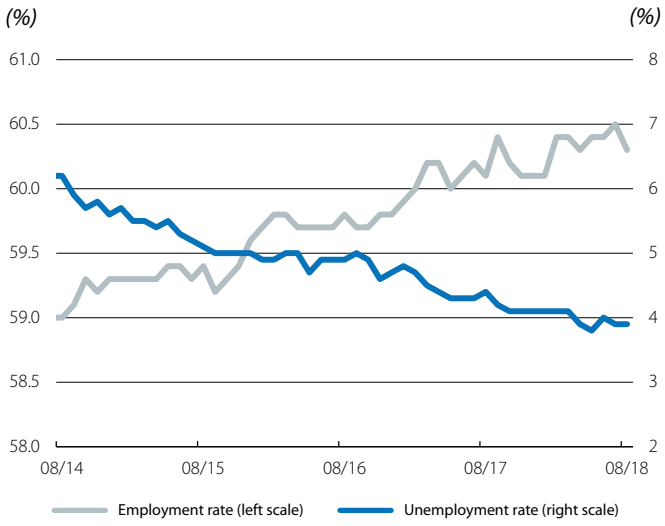
The labour market and domestic demand produce strong results. In particular, in August, 201.000 jobs were created, a considerable figure for an economy experiencing virtually full employment. In addition, the unemployment rate remained at a low 3.9%, while wages continued to rise at a steady rate (2.9%). In this context, household confidence remains high, as demonstrated by the consumer confidence index developed by the Conference Board in August, which rose to levels not seen since 2000 (133.4 points). All of this reinforces our positive growth outlook for the US economy in 2018 (2.8%, according to CaixaBank Research).

The upward trend in inflation of recent months slows, but it remains at strong levels. Specifically, headline inflation stood at 2.5% in August, 2 decimal points below the figure for the previous month, but clearly above the 2017 average (2.1%). On the other hand, core inflation, which excludes the most volatile components of energy and food, stood at 2.2% (2.4% in July). This slight moderation in the growth of prices was in part due to the expected dissipation of temporary factors, such as the base effects caused by the sharp decline in wireless telephony prices during 2017. Over the coming months, we expect that the strength of US economic activity will continue to support firm inflationary pressures, which in turn will support the Federal Reserve's intention to continue with its rate hikes (one more before the end of the year, according to CaixaBank Research).

EUROPE

The outlook for the euro area remains positive, despite the moderation in the pace of economic activity. The growth slowdown of the first half of the year was largely due to a weakening of external demand, following a very positive 2017. This reflects the weakening of global demand for goods and services, as well as the appreciation of the euro in 2017. For this reason, in its quarterly update of the macroeconomic forecasts, the ECB moderated its growth forecasts for the euro area by 1 decimal point, to 2.0% for 2018 and 1.8% for 2019 (a scenario that is very similar to CaixaBank Research's). However, over the coming quarters, we expect the economic expansion of the euro area to remain steady, with a growth rate slightly above potential,

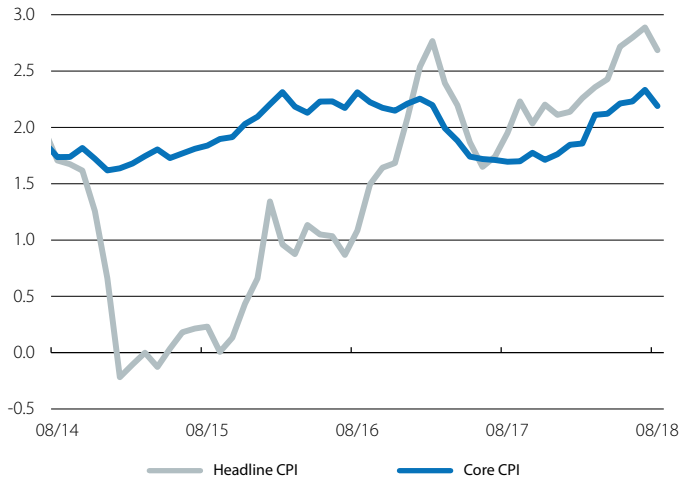
US: labour market



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

US: CPI

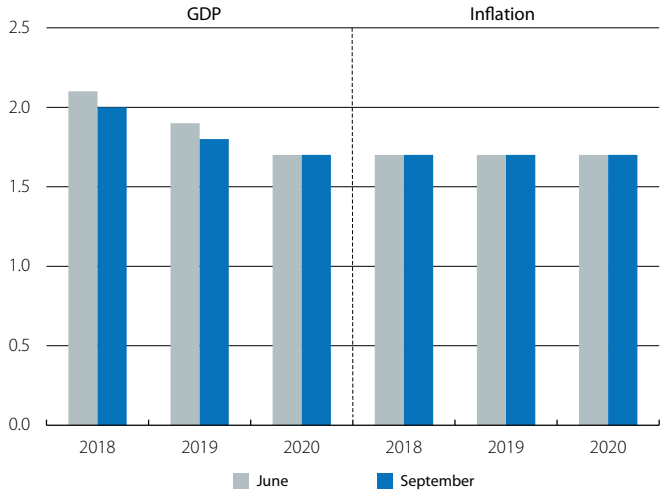
Year-on-year change (%)



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

Euro area: ECB forecasts of GDP and inflation

Annual change (%)



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

supported by very favourable financial conditions and a good performance of the labour market.

Domestic demand remains the main driver of growth in Q2. The breakdown of GDP in the euro area shows that Q2 growth (2.1% yoy) was driven by a 1.7 pp. contribution from domestic demand (1.8 pp. in Q1). This came as a result of growing investment, and despite the slight moderation of private consumption. On the other hand, external demand faltered again and reduced its contribution to 0.4 pps (0.6 pp. in Q1), due to modest growth in exports of goods and services.

Activity indicators suggest that growth in Q3 remains at similar levels to those seen in the first half of the year. The composite PMI index for the whole of the euro area – which measures business sentiment – stood at 54.2 points in September, 3 decimal points below the August figure but in clearly expansionary territory. Furthermore, the economic sentiment index (ESI) stood at 110.9 points in September, similar to the average for 2017 (110.7). On the other hand, and despite falling in September for the second consecutive month, down to –2.9 points, consumer confidence remains at levels similar to the average for 2017 (–2.5 points). In this regard, private consumption will continue to be supported by the labour market, which continues to perform well (in July, the unemployment rate remained at 8.2%, its lowest since November 2008).

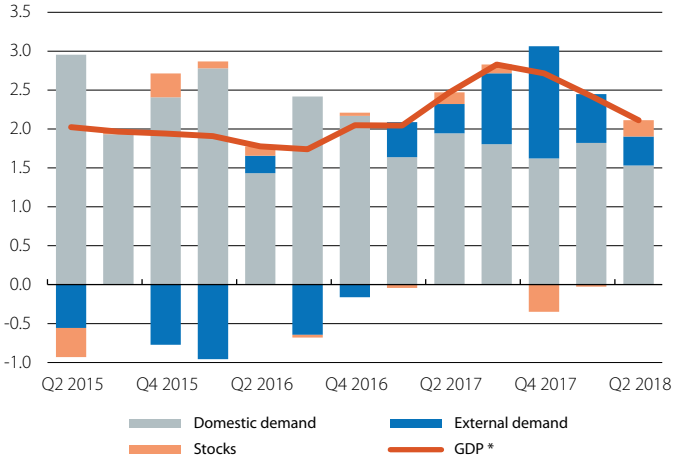
EMERGING MARKETS

In China, the economic indicators point towards a slowdown in activity over the coming months. In particular, industrial production increased by 6.1% year-on-year in August (6.0% in July), an encouraging figure, albeit below the 2017 average (6.5%). Something similar occurred with retail and consumer goods, which grew by 9.0%, 2 decimal points above the figure for July but clearly below the average for 2017 (10.2%). Also, based on available data, CaixaBank Research's activity indicator suggests a slightly lower growth rate in Q3. All this suggests that, over the coming months, the country's growth will continue to gradually slow down, despite the Government's recent policies aimed at supporting investment and credit.

In Brazil, political uncertainty continues to hold back growth. The Brazilian economy grew by 1.0% year-on-year (0.2% quarter-on-quarter) in Q2, below the Q1 figure (1.2%). This confirms that the economic recovery is yet to be consolidated, as is being held back by the significant political uncertainty in a context of presidential and legislative elections. In this regard, even after Lula's withdrawal as a candidate for the Workers Party, we expect that political uncertainty will continue to weigh down economic activity, given that none of the presidential candidates seem to have the electoral support nor the will to implement the reforms that the economy needs.

Euro area: GDP

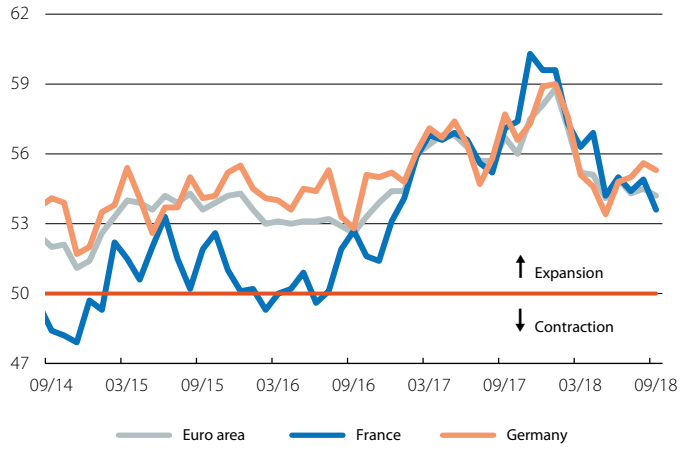
Contribution to year-on-year growth (pps)



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

Euro area: composite PMI activity indicator

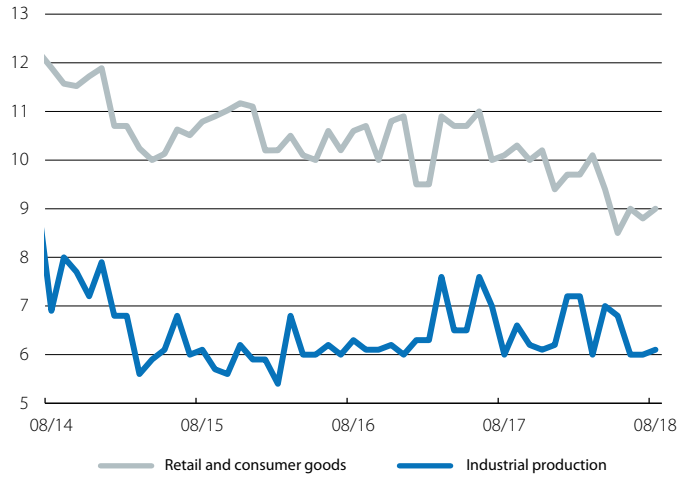
Level



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

China: activity indicators

Year-on-year change (%)



Source: *CaixaBank Research, based on data from the National Statistics Office of China.*

Turkish financial crisis: in stoppage time

Since 1 August, the Turkish lira has depreciated by around 20%, making it the second worst-performing emerging currency after the Argentine peso. So far this year, its accumulated depreciation amounts to approximately 40%, again second only to the peso. The interest rate on 10-year bonds has also risen by about 900 bps since the start of the year, bringing it to 20.3%. In short, we are witnessing a fully-fledged foreign exchange crisis, with an uncertain outcome. How did Turkey reach this point? What alternatives are there for the future?

On the surface, this selling frenzy of the Turkish currency in recent months appears to have been triggered by a diplomatic escalation between the US and Turkey, which led to the US announcing the establishment of tariffs on steel and aluminium imported from Turkey. However, this is only a superficial reading. While it is true that these two countries have had disagreements on foreign policy over the last few years, the root cause of the Turkish currency crisis is of an economic nature: it is a sign that we are probably looking at quite a classic case of overheating of the economy.

In recent years, but particularly since late 2016, Turkey has experienced a phase of strong growth (average GDP growth of 6.6% since Q4 2016). Inflation over the same period, meanwhile, stood at 11% on average (but with a tendency to spike, as shown in the first chart) and the current account deficit stood at 6.5% of GDP.

Thus, the essential traits of a pattern of unsustainable growth remain clear: the strong increase in the growth of economic activity has been achieved at the price of accumulating very high internal and external macroeconomic imbalances. The rise in prices points towards the inability of the Turkish economy to grow without exacerbating bottlenecks, and the inflated current account deficit indicates an overuse of external financing. The latter trend also presents an aspect that is a particularly delicate in the current context of a gradual tightening of global financial conditions: Turkish companies have taken advantage of an environment of abundant and cheap foreign financing in order to borrow in foreign currency (dollars and euros, mostly), to the point that this debt represents 36.3% of GDP, one of the highest rates among the major emerging economies. The end result is that, while most emerging economies are showing growth rates commensurate with their potential (or even slightly lower), in Turkey the output gap is estimated to be between +2% and +3%.

The overheating of the Turkish economy has been compounded by the economic policy that has been followed. Far from tackling the imbalances with a decisive counter-cyclical policy, the general approach has been to deny the very existence of excessive growth.

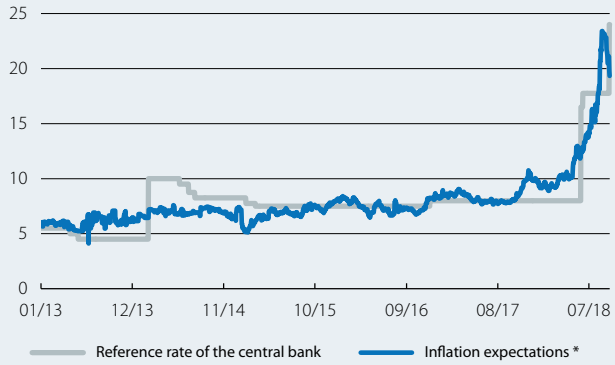
Turkey: GDP growth and inflation

Year-on-year change (%)

Note: ** The figure for Q3 2018 is the average of July and August.*
Source: *CaixaBank Research, based on data from the Turkish Statistics Institute (Turkstat).*

Turkey: reference rate and inflation expectations

(%)



Note: ** Break-even of five-year inflation rate.*
Source: *CaixaBank Research, based on data from the National Central Bank and Bloomberg.*

In particular, and despite the accumulation of pressures on prices, the monetary policy kept the reference rate at 8.0% between late 2016 and May this year (i.e. a negative real rate for an economy that was growing above 7% for much of this period). The result, predictably, is that investors have begun to question the credibility of Turkey's monetary policy: while medium-term inflation expectations were less than 8% a year ago, they are currently touching on 20%. The measures adopted in the monetary policy since May (among other minor decisions, to adopt different macroprudential measures, to raise the reference rate from 8.0% to 24.0% and to limit companies' ability to operate in foreign currencies) have been viewed as being too little too late, given the scale of the imbalances that have accumulated. In addition to this, the fiscal policy, which is traditionally a strong point of economic policy, has also failed to act decisively (only now are there indications of a primary

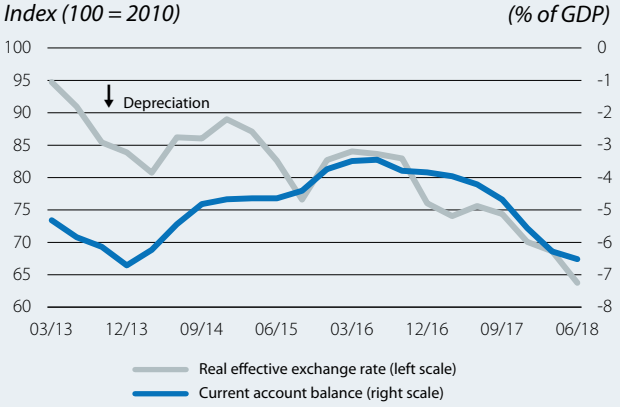
surplus being achieved in the future, after several years in which there have even been significant increases in public salaries). As a result, the lack of credibility is not only limited to the monetary policy but extends across the entire economic policy.

For those familiar with the country's economic history, this sequence of events remains somewhat paradoxical. Turkey seemed to have taken ownership of the lessons of the strong macroeconomic adjustment experienced in 2001 and the radical changes to the economic system that followed (with the consolidation of the banking system, a new and stricter approach to public finances and the reinvention of the central bank as a truly independent entity). This was a highly-successful experience which helped the country to achieve a modern market economy for the first time, with an institutional basis comparable to that of the best emerging economies.

Although the straying from orthodox policies may be due to many factors, the exceptional political situation in the country in recent years appears to have been an essential ingredient. In the space of just a few years, Turkey has undergone substantial changes in its external and internal political context, and managing these changes has posed a challenge for the Government, just as it would have for any other country subjected to similar situations. First of all, from an external perspective, the seismic change in the Middle East, with conflicts as brutal as the Syrian civil war and the fight against ISIS, has had a significant impact. National policy has had to manage everything from military and internal security challenges to those brought about by the flow of refugees. However, there have been a number of other factors in addition to this. There was an attempted coup in July 2016, which led to an increase in internal intervention, Turkey has taken on a difficult reinvention of its constitution (which involved shifting towards a presidential model, far removed from that which has been in place since 1923, when the republic was established) and there have been key presidential and legislative elections in 2018, already under the new rules of play. In this situation, a macroeconomic adjustment, which would have led to inevitable social costs, would have eroded the political capital available. This option, which perhaps could be forgiven in 2016 when investors generally had a more complacent view of the emerging risks, has been unsustainable in 2018, when the impact of global uncertainty and the tightening of the Fed's monetary policy on emerging economies with greater imbalances has become virulent.

Now, Turkey has to simultaneously confront strong pressure on both the real and financial sectors of its economy. First and foremost, the current situation, with a *de facto* sudden stop to capital flows, is going to lead to an inevitable adjustment in economic activity. In this regard, the slowdown seen in Q2, when growth stood at 5.2% compared to 7.3% in Q1, can only be the prelude to greater economic weakness to come. Although the

Turkey: current account balance and exchange rate



Source: *CaixaBank Research, based on data from the Bank for International Settlements and the Turkish Statistics Institute (Turkstat).*

exercise of predicting forecasts during a period of fully-fledged financial turbulence is especially uncertain, CaixaBank Research predicts a rapid decline in growth, which could end up being the lowest since the Great Recession of 2008-2009. This loss of momentum will be accompanied by the maintenance of double-digit inflation over the coming quarters. Despite the lower pressure on the demand side, over the next few months we will see the knock-on effect of the currency's depreciation in the prices of imported goods. As for the financial aspects, the difficulties are even greater. Given the high level of foreign-currency debt that the Turkish economy has accumulated, covering payments and renewing this debt, in a context of a heavily depreciated lira and with international interest rates expected to rise, represents a particular challenge. In this situation, companies' financial difficulties are likely to lead to a rise in non-performing loans in the banking sector.

Against this background, what are the options that remain open? In essence, the economic policy decision-makers have several options at their disposal to stabilise the situation. The least orthodox option, and the one with the highest risk of proving insufficient, and perhaps even counter-productive, is to establish capital controls. The most conventional option would be to extend the adjustment programme, combining a fiscal adjustment with a tightening of monetary policy. The decisions taken in the last few weeks, with the increase in the reference rate and the announcement of a fiscal adjustment equivalent to 1.3% of GDP, are steps in this direction. These measures would have a greater chance of success if they were accompanied by financial aid from the IMF, a possibility that has been repeatedly rejected by the Turkish authorities but which would help the economic policy to regain credibility more quickly. In the absence of IMF funding, the adjustment could end up being less gradual and more intense. Turkey, in short, has virtually run out of time and is left with little margin to react. The match is far from lost, but stoppage time is almost over and a way out must be found urgently.

UNITED STATES

	2016	2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	07/18	08/18
Activity								
Real GDP	1.6	2.2	2.3	2.5	2.6	2.9	–	...
Retail sales (excluding cars and petrol)	3.4	4.1	4.0	5.3	4.4	5.2	6.1	5.9
Consumer confidence *(value)*	99.8	120.5	120.3	126.0	127.1	127.2	127.9	134.7
Industrial production	–1.9	1.6	1.3	3.0	3.4	3.4	4.0	4.9
Manufacturing activity index (ISM) *(value)*	51.4	57.4	58.7	58.7	59.7	58.7	58.1	61.3
Housing starts *(thousands)*	1,177	1,208	1,172	1,259	1,317	1,261	1,174	1,282
Case-Shiller home price index *(value)*	189	200	200	205	209	211	212	...
Unemployment rate *(% lab. force)*	4.9	4.4	4.3	4.1	4.1	3.9	3.9	3.9
Employment-population ratio *(% pop. > 16 years)*	59.7	60.1	60.2	60.1	60.3	60.4	60.5	60.3
Trade balance [1] *(% GDP)*	–2.7	–2.8	–2.8	–2.8	–2.9	–2.8	–2.9	...
Prices								
Consumer prices	1.3	2.1	2.0	2.1	2.2	2.7	2.9	2.7
Core consumer prices	2.2	1.8	1.7	1.8	1.9	2.2	2.4	2.2

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

JAPAN

	2016	2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	07/18	08/18
Activity								
Real GDP	1.0	1.7	2.0	2.0	1.1	1.3	–	...
Consumer confidence *(value)*	41.7	43.8	43.8	44.5	44.4	43.7	43.5	43.3
Industrial production	–0.2	4.5	4.4	4.1	2.5	2.0	0.7	0.1
Business activity index (Tankan) *(value)*	7.0	19.0	22.0	25.0	24.0	21.0	–	19.0
Unemployment rate *(% lab. force)*	3.1	2.8	2.8	2.7	2.5	2.4	2.5	2.4
Trade balance [1] *(% GDP)*	0.7	0.5	0.6	0.5	0.4	0.4	0.5	0.3
Prices								
Consumer prices	–0.1	0.5	0.6	0.6	1.3	0.6	0.9	1.3
Core consumer prices	0.6	0.1	0.2	0.3	0.4	0.3	0.3	0.4

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

	2016	2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	08/18
Activity							
Real GDP	6.7	6.9	6.8	6.8	6.8	6.7	–
Retail sales	10.4	10.2	10.3	9.9	9.9	9.0	9.0
Industrial production	6.1	6.6	6.3	6.2	6.6	6.6	6.1
PMI manufacturing *(value)*	50.3	51.6	51.8	51.7	51.0	51.6	51.3
Foreign sector							
Trade balance [1] *(value)*	512	435	435	435	420	395	362
Exports	–8.4	8.5	6.9	10.1	13.6	11.3	9.1
Imports	–5.7	16.1	14.7	13.2	19.2	20.1	20.5
Prices							
Consumer prices	2.0	1.6	1.6	1.8	2.2	1.8	2.3
Official interest rate [2] *(value)*	4.35	4.35	4.35	4.35	4.35	4.35	4.35
Renminbi per dollar *(value)*	6.6	6.8	6.7	6.6	6.4	6.4	6.8

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.*

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

EUROPEAN UNION

Activity and employment indicators

Values, unless otherwise specified

	2016	2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	07/18	08/18	09/18
Retail sales *(year-on-year change)*	1.6	2.3	2.6	2.0	1.6	1.6	1.1	...	...
Industrial production *(year-on-year change)*	1.6	3.0	4.1	4.2	3.1	2.2	–0.1	...	...
Consumer confidence	–7.8	–2.5	–1.5	–0.2	0.5	0.0	–0.5	–1.9	–2.9
Economic sentiment	104.2	110.8	111.8	114.3	114.0	112.5	112.1	111.6	110.9
Manufacturing PMI	52.5	57.4	57.4	59.7	58.3	55.5	55.1	54.6	53.3
Services PMI	53.1	55.6	55.3	55.9	56.4	54.6	54.2	54.4	54.7
Labour market									
Employment (people) *(year-on-year change)*	1.4	1.6	1.7	1.6	1.4	1.5	–	...	–
Unemployment rate: euro area *(% labour force)*	10.0	9.1	9.0	8.7	8.6	8.3	8.2	8.1	...
Germany *(% labour force)*	4.2	3.8	3.7	3.6	3.5	3.4	3.4	3.4	...
France *(% labour force)*	10.1	9.4	9.5	9.1	9.2	9.1	9.2	9.3	...
Italy *(% labour force)*	11.7	11.3	11.3	11.0	11.0	10.6	10.2	9.7	...
Spain *(% labour force)*	19.6	17.2	16.8	16.6	16.2	15.4	15.2	15.2	...

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

	2016	2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	07/18	08/18	09/18
Current balance: euro area	**3.8**	**3.7**	**3.7**	**3.7**	**3.9**	**3.8**	**3.7**	**...**	**...**
Germany	8.5	7.9	7.9	7.9	7.9	8.1	8.0	...	...
France	–0.8	–0.6	–0.6	–0.6	–0.4	–0.4	–0.4	...	...
Italy	2.6	2.8	2.7	2.8	2.7	2.8	2.8	...	...
Spain	1.9	1.9	1.8	1.9	1.8	1.4	1.3	...	...
Nominal effective exchange rate [1] *(value)*	**94.3**	**96.5**	**98.5**	**98.6**	**99.6**	**98.5**	**99.2**	**99.0**	**99.4**

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

	2016	2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	07/18	08/18	09/18
Private sector financing									
Credit to non-financial firms [1]	1.8	2.5	2.4	3.0	3.3	3.7	4.0	4.2	...
Credit to households [1, 2]	1.7	2.6	2.7	2.8	2.9	2.9	3.0	3.1	...
Interest rate on loans to non-financial firms [3] *(%)*	1.4	1.3	1.3	1.3	1.2	1.2	1.2	...	...
Interest rate on loans to households for house purchases [4] *(%)*	1.8	1.7	1.7	1.7	1.6	1.6	1.6	...	...
Deposits									
On demand deposits	10.0	10.1	10.6	10.1	9.2	8.1	7.5	6.8	...
Other short-term deposits	–1.9	–2.7	–3.0	–2.4	–2.1	–1.5	–1.1	–1.4	...
Marketable instruments	2.7	1.1	–0.4	–1.6	–5.8	–2.8	–3.3	–4.3	...
Interest rate on deposits up to 1 year from households *(%)*	0.5	0.4	0.4	0.4	0.4	0.4	0.3	...	...

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.*

Moderation in the rate of growth, as expected

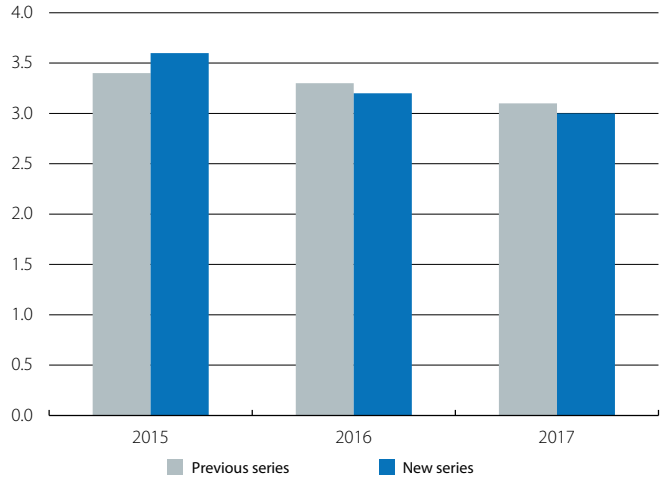
Slight slowdown in growth. The Spanish economy is moderating its growth rate slightly, and the revision of the annual GDP series carried out by the National Statistics Institute every September confirms this trend. While growth in 2015 was 3.6%, slightly higher than expected, in 2016 it was 3.2% and in 2017, 3.0%, both 1 decimal point lower than previously announced. In 2018 and 2019, as foreseen in CaixaBank Research's scenario, this gradual deceleration will continue due to the fading of the tailwinds that have supported the economy over the last few years. Domestic demand continued to grow at a good pace, albeit somewhat lower than in the past, supported by slightly less vigorous private and public consumption, as well as by growth in investment that is expected to accelerate slightly. The foreign sector's contribution to growth, meanwhile, will be close to zero, due to export growth being held back by the reduced activity of the euro area and imports remaining strong due to domestic demand.

The activity indicators for Q3 point towards a moderation of the growth rate. Specifically, the CaixaBank Research's leading GDP indicator for Q3 projects a quarter-on-quarter growth of 0.5%. This is lower than the growth observed in the last six quarters (0.7% on average) although, given the moderate availability of data relating to Q3, it is still a relatively tentative forecast. All in all, the indicators available to date are clearly below those of last year. On the supply side, the composite PMI business sentiment indicator remains in expansive territory (at 53 points in August), but below the 56.2-point average for 2017. Furthermore, industrial production fell by 0.1% in July, following year-on-year growth of 0.9% in Q2. On the demand side, retail sales fell by 0.4% year-on-year in July, continuing the sluggish performance observed in Q2 (0.0%, compared to +0.9% in 2017). Thus, everything seems to indicate that the economy is entering a more mature phase of the cycle in which it will maintain a solid rate of growth, albeit lower than in recent years.

Job creation grew in August by 2.9% year-on-year, a strong rate, albeit 1 decimal point lower than in July. In seasonally-adjusted terms, the number of registered workers affiliated to Social Security fell by 203,000 people. This is a common occurrence in holiday periods, although the decline was somewhat greater than in previous years. In the last 12 months as a whole, however, the number of registered workers has increased by 530,000 people and we expect this encouraging trend to continue, albeit at a slightly slower pace than in the past. Salary costs, meanwhile, saw a moderate rise in Q2. According to the Quarterly Labour Cost Survey, the labour cost per effective hour grew by 0.9% year-on-year (seasonally adjusted and corrected to take account of calendar effects), 1 decimal point higher than the growth registered in the previous quarter. Looking towards the next few quarters,

Spain: revision of the GDP series

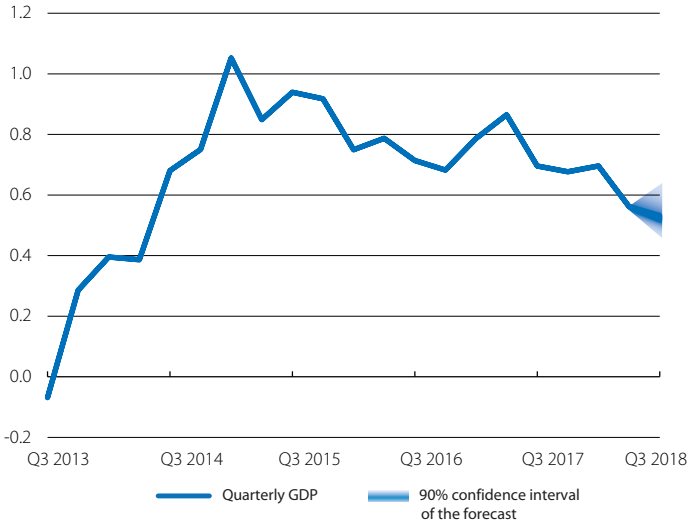
Annual change (%)



Source: *CaixaBank Research, based on data from the National Statistics Institute.*

Spain: GDP

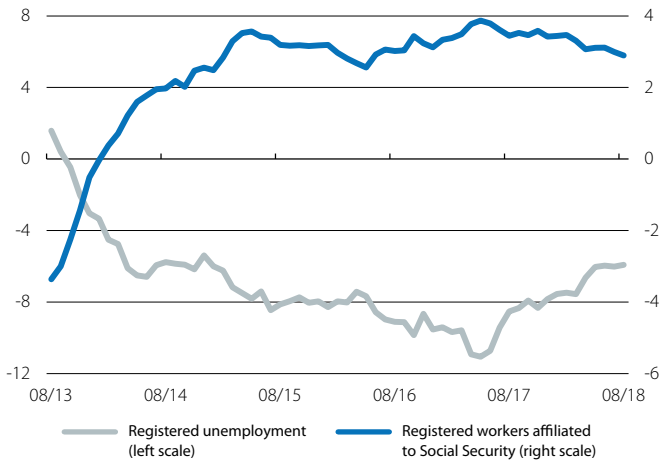
Quarter-on-quarter change (%)



Source: *CaixaBank Research, based on data from the National Statistics Institute.*

Spain: registered workers affiliated to Social Security and registered unemployment

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



Source: *CaixaBank Research, based on data from the Ministry of Employment and the Social Security Institute.*

we expect labour costs to continue to gradually rise, as the recovery in the labour market continues and higher salary increases agreed in collective agreements are applied.

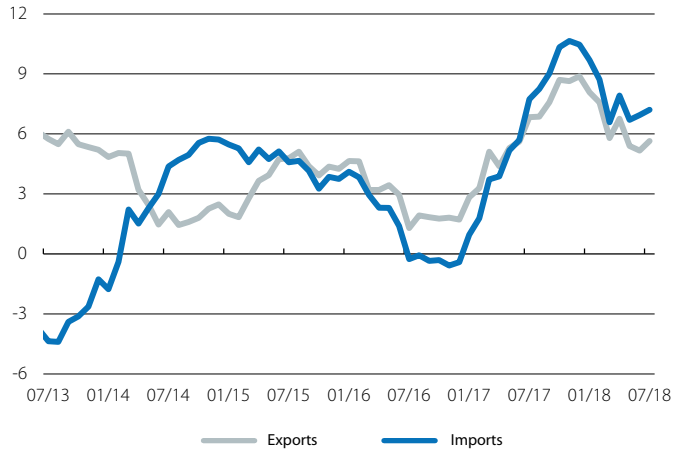
The foreign sector moderates its positive tone. The current account surplus for July stood at 1.3% of GDP (12-month cumulative balance), lower than the 1.9% registered for July 2017. Half of this 6-decimal point decline (i.e. 3 tenths of a percentage point of GDP) can be explained by the non-energy balance, which is slightly negative, while the effect of higher oil prices explains another decimal point. In addition, customs data for the month of July show that total exports of goods grew by 5.6% year-on-year (12-month cumulative figure), while the non-energy subcomponent of exports increased by 4.4%. Imports, meanwhile, also accelerated, driven by domestic demand and higher oil prices, with a growth of 7.2% (5.9% year-on-year in the case of non-energy goods). For the year as a whole, CaixaBank Research predicts a reduction in the current account surplus down to 1.1% in 2018, due to the higher oil prices as well as higher imports of non-energy products.

The fiscal deficit in Q2 stood at 1.8% of GDP, which represents a 0.4-pp reduction compared to the figure for Q2 2017. Thus, in the first half of the year, the deficit would have already reduced by the 0.4 pps needed to achieve the deficit of 2.7% of GDP for 2018 that was agreed with Brussels (compared to the 3.1% deficit in 2017). In the second half of the year, there is likely to be a slight increase in expenditure, notably due to the rise in civil servants' salaries and the revaluation of pensions, both included in this year's budget. By administration, the State deficit, for which data are already available up to August, decreased to 1.6% of GDP (1.9% in August 2017). Also, based on data up to July, the Social Security deficit stood at 0.3% of GDP (0.5% in July 2017) and the Autonomous Communities recorded a surplus of 0.1% of GDP (an improvement on the deficit of –0.1% of GDP in July 2017). The general government debt, on the other hand, stood at 98.1% of GDP in Q2 2018, 1.3 pps lower than in Q2 2017.

The real estate market consolidates its upward trend. Homes prices published by the National Statistics Institute, based on transactions, rose by 6.8% year-on-year in Q2 2018, 6 decimal points higher than the increase observed in Q1 and the average for 2017. On the other hand, the prices published by the Ministry of Public Works, based on valuations, rose by 3.8% year-on-year in Q2 and consolidated the upward trend in home prices that began in 2015. On the demand side, the buoyancy in the number of home purchase and sale transactions continues, increasing by 12% year-on-year in the current year up to July. On the supply side, the granting of planning permission for new developments increased by a significant 24% year-on-year in the current year up to May. As such, the indicators reflect a favourable outlook for the next few quarters.

*Spain: exports and imports of goods **

Year-on-year change (%)



Note: ** 12-month cumulative figures.*
Source: *CaixaBank Research, based on data from the Department of Customs.*

Budgetary implementation by administration

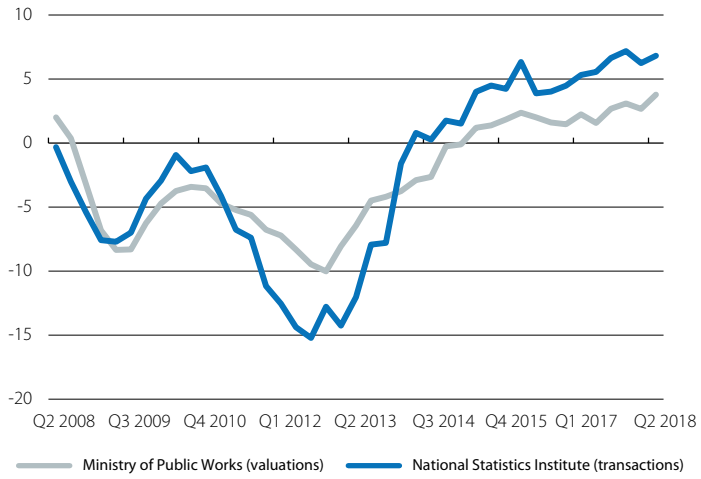
(Cumulative year-to-date figures)

	Latest figure	EUR millions		% of GDP	
		2017	2018	2017	2018
State	August	–21,588	–18,895	–1.9	–1.6
Social Security	July	–5,309	–3,787	–0.5	–0.3
Autonomous Communities	July	–744	681	–0.1	0.1
General Government Total (excl. Local Gov. Corporations) *	July	–27,155	–22,634	–2.3	–1.9
Local Gov. Corporations	June	1,446	615	0.1	0.1
General Government Total	**Q2 2018**	**–25,452**	**–22,083**	**–2.2**	**–1.8**

Note: ** Excluding bank restructuring costs.*
Source: *CaixaBank Research, based on data from the General Comptroller of the State Administration (IGAE).*

Spain: unsubsidised home prices

Year-on-year change (%)



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

Should we be concerned about the slowdown of the Spanish economy?

The latest data on the national accounts published by the National Statistics Institute, which included slight downward revisions in recent quarters, reflected a GDP growth rate that was lower than expected. However, given that there was already an expectation that the Spanish economy's growth rate would moderate, in this article we will see that the latest data are not cause for alarm.[1] In fact, the data available to date suggest that the slowdown the country is currently facing is caused by factors that pose a limited risk and are only moderate in their scale.

A look at the latest data

Let us start by analysing the latest data, which have generated some concern. In the first table we present the data on the national accounts of the Spanish economy for the past four quarters.

As can be seen, GDP growth has slowed down significantly. Although these figures still represent a solid growth rate (higher than most developed countries, for example), there are two elements that raise some concern: the slowdown in private consumption observed in the last quarter and the poor contribution of external demand.

With regards to the first point, a quick reading of the data might suggest that the slowdown is due to a deterioration in household confidence regarding the economic outlook. However, this contrasts with the positive confidence and labour market indicators that are available. In Q2, the economic sentiment index (ESI) developed by the European Commission stood at 109.8 points, above the average for 2017 (108.6). In addition, the consumer confidence index, also elaborated by the European Commission, stood at 0.5 points, 1.2 points above the average for 2017. The composite PMI index developed by Markit, meanwhile, stood at 55.4 points in Q2, a figure compatible with robust growth rates. Finally, the labour market is also producing encouraging data, with a job creation rate of 2.8% year-on-year in Q2 (according to data from the EPA), slightly above the average growth rate of 2.6% for 2017.

In fact, if we look not only at actual consumption but also at the trend in nominal and deflator consumption, the data offer a less negative view. In particular, the second chart shows that, following an initial recovery phase (2014-2015) in which the stability of prices caused real and nominal consumption to follow a similar path, from 2016 the growth of real consumption has remained relatively stable and has shown little sensitivity to the increase in prices reflected by deflator consumption (which follows the CPI very closely). In other words, households chose to offset the price increases with greater expenditure in order to maintain their consumption of goods and services. However, in Q2 2018, the rebound in inflation (due to the oil price increase) did dent real consumption, while the growth in nominal consumption remained stable, at around 4%. This may be

Spain: macroeconomic table

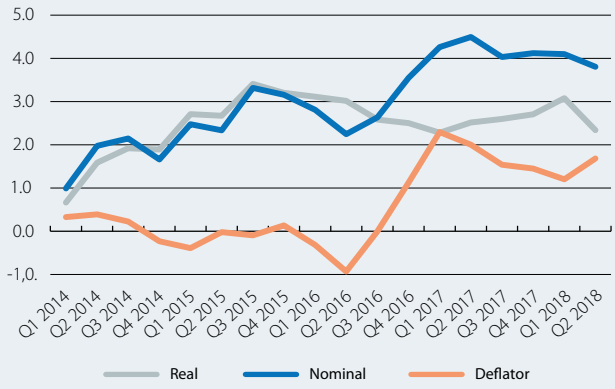
Quarter-on-quarter change (%)

	Q3 2017	Q4 2017	Q1 2018	Q2 2018
Private consumption	0.9	0.4	0.9	0.1
Public consumption	0.6	0.3	0.8	0.1
Gross fixed capital formation	2.3	0.6	1.1	3.5
Investment in capital goods	*3.6*	*0.5*	*–0.1*	*6.5*
Investment in construction	*1.7*	*0.8*	*2.1*	*2.2*
Domestic demand *(contrib.)*	**1.2**	**0.4**	**0.9**	**0.8**
Exports	0.1	1.4	0.6	0.2
Imports	1.9	0.6	1.7	1.0
External demand *(contrib.)*	**–0.5**	**0.3**	**–0.3**	**–0.2**
GDP	**0.64**	**0.73**	**0.56**	**0.56**

Source: *CaixaBank Research, based on data from the National Statistics Institute.*

Trend in nominal, real and deflator private consumption

Year-on-year change (%)



Source: *CaixaBank Research, based on data from the National Statistics Institute.*

1. As an example, see the article «The Spanish economy in 2017: growing with fewer tailwinds» included in the Dossier of the MR12/2016.

partly a result of the low household savings rate, which in Q2 2018 stood at 4.7%, the lowest in the historical series. Thus, the lack of reaction in the nominal consumption when faced with rising prices may be indicative of households' limited margin for manoeuvre to increase their consumption expenditure. However, since the rise in prices is largely due to an increase in energy prices, which is expected to be temporary, actual consumption is likely to recover higher growth rates over the coming quarters as inflation falls.

With regards to the performance of exports, the data available up to July show a deterioration in the trade balance of non-energy goods. This is less surprising if we take into account the current context of deceleration in trade flows at a global level, as well as the gradual appreciation of the euro that took place between early 2017 and April 2018.[2] In addition to these factors is the uncertainty generated by the trade tensions between the US and China, which could damage confidence.

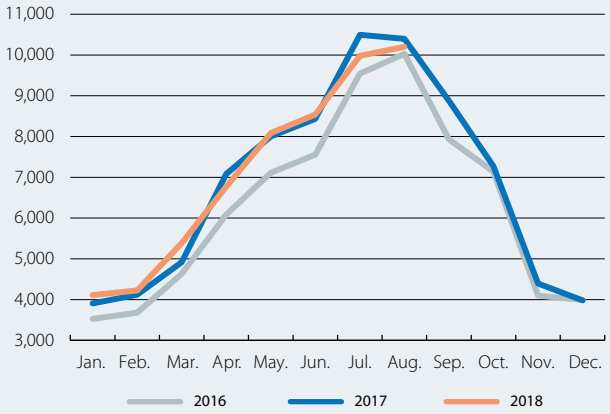
In addition, the tourism sector, which has been one of the cornerstones of the trade surplus in recent years, has also seen a slowdown in its contribution to growth, following an exceptionally good 2017. As can be seen in the third chart, based on data up to July the arrival of tourists has stagnated compared to the previous year. All these factors suggest that exports will perform less favourably over the coming quarters than they have in recent years. In this regard, in the fourth chart we present a table with different estimates of the impact that the slowdown in the tourism sector might have on GDP: in a reasonable scenario, the impact would be around 0.1-0.2 pps.

Winds changing direction

The high growth rates registered in Spain between 2015 and 2016 would not have been possible without a series of factors that gave more impetus to the economic recovery already underway. These tailwinds include the fall in oil prices that occurred at the end of 2014 (the price of crude oil went from 112 dollars in June 2014 to 50 dollars in January 2015), the reduction of interest rates resulting from the policies of the ECB, a fiscal policy that went from reducing growth to making slight contributions, and the depreciation of the euro. All these factors are reflected in the fifth chart, where our estimates show that the tailwinds made a particularly strong contribution in 2015 and 2016.

However, at the current juncture, many of these tailwinds have run out of steam or have even changed direction.

Spain: number of tourists
Thousands of people



Source: *CaixaBank Research, based on data from the Spanish National Statistics Institute.*

Tourism sector: GDP sensitivities table
Year-on-year change (%)

	2017	Cum. July'18	Scenario 1	Scenario 2
Tourism exports	17.1	3.3	2.0	0.0
Impact on GDP (in pps)			0.09	0.16

Note: *The impact on GDP is calculated based on the balance of tourism exports. It does not include indirect effects.*
Source: *CaixaBank Research.*

The most obvious examples include the oil price and the exchange rate. After standing at 48 dollars per barrel in June 2017, the price of oil has been going up and in September 2018 it reached around 80 dollars. Furthermore, the nominal effective exchange rate of the euro has appreciated by 6% since the beginning of 2017. Given this change in the tailwinds, in the last chart we also show our estimates of the impact on GDP forecast for each of the four factors mentioned above (oil prices, interest rates, exchange rate and fiscal policy) for the period 2018-2019.

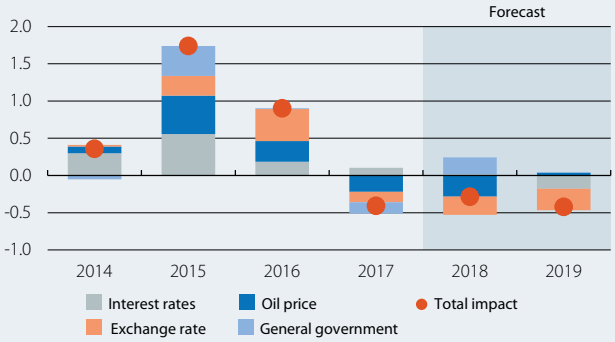
As can be seen, according to CaixaBank Research's estimates, all the factors considered will limit the growth of the Spanish economy, with the exception of fiscal policy, which we predict will continue to have a slightly expansionary effect. In relation to the oil price, the biggest impact is expected to come this year, since we expect the price to curb its upward trend thereafter. On the other hand, the effect of the higher interest rates, brought about both by the ECB's net asset purchases stopping at the end of 2018 and by the increases to the ECB's reference rates at the end of 2019, is expected begin to emerge in 2019. Finally, the appreciation of the

euro that has occurred to date, and which is expected to still have some room to continue, will weigh down on GDP throughout this year and the next. All in all, it should be noted that the negative impact of these factors on GDP growth is not expected to exceed –0.4 pps of GDP in total. This is a much smaller impact than that observed in 2015 and 2016, when these factors made a positive contribution of between 1 and 1.5 pps to GDP growth.

So, should we be alarmed by the economic slowdown indicated by the latest data? Our analysis suggests that, although a slowdown is to be expected and could intensify over the course of this year and the next, the scale of it and the factors that are causing it do not point towards a sudden slowdown. Rather, they support the view that the economy is shifting gears and entering a more advanced phase of the cycle.

Spain: impact of tailwinds and headwinds on growth

(pps)



Notes: *The impact of the different factors is estimated based on the energy balance, interest payments, the depreciation of the real effective exchange rate and the fiscal adjustment. To estimate the impact on the components of demand, a marginal propensity to consume of 60% and a 25% import intensity are assumed. It does not include indirect effects.*
Source: *CaixaBank Research, based on data from the National Statistics Institute, the ECB and the Bank of Spain.*

Activity and employment indicators

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

	2016	2017	Q4 2017	Q1 2018	Q2 2018	07/18	08/18	09/18
Industry								
Industrial production index	1.9	3.2	5.2	2.7	0.9	–0.1	...	...
Indicator of confidence in industry *(value)*	–2.3	1.0	4.3	2.8	1.2	–1.3	–3.5	–3.0
Manufacturing PMI *(value)*	53.2	54.8	55.9	55.3	53.7	52.9	53.0	51.4
Construction								
Building permits *(cumulative over 12 months)*	43.7	22.9	25.1	25.1	28.1	27.1	...	...
House sales *(cumulative over 12 months)*	13.1	13.8	14.4	15.0	15.2	13.7	...	...
House prices	1.9	2.4	3.1	2.7	3.8	–	...	–
Services								
Foreign tourists *(cumulative over 12 months)*	8.2	10.0	9.2	8.2	5.3	2.4	–10.7	–22.7
Services PMI *(value)*	55.0	56.4	54.5	56.8	55.8	52.6	52.7	...
Consumption								
Retail sales	3.8	0.9	0.5	1.8	0.0	–0.5	0.3	...
Car registrations	11.4	7.9	10.8	11.8	9.2	19.3	48.7	–17.0
Consumer confidence index *(value)*	–3.8	–0.7	–1.5	–0.6	0.5	0.6	–2.5	–8.0
Labour market								
Employment [1]	2.7	2.6	2.6	2.4	2.8	–	...	–
Unemployment rate (% labour force)	19.6	17.2	16.5	16.7	15.3	–	...	–
Registered as employed with Social Security [2]	3.0	3.6	3.5	3.4	3.1	3.0	2.9	...
GDP	**3.2**	**3.0**	**3.1**	**2.8**	**2.5**	**–**	**...**	**–**

Prices

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

	2016	2017	Q4 2017	Q1 2018	Q2 2018	07/18	08/18	09/18
General	–0.2	2.0	1.4	1.0	1.8	2.2	2.2	2.2
Core	0.8	1.1	0.8	1.0	1.0	0.9	0.8	...

Foreign sector

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

	2016	2017	Q4 2017	Q1 2018	Q2 2018	07/18	08/18	09/18
Trade of goods								
Exports *(year-on-year change, cumulative over 12 months)*	1.7	8.9	8.9	5.8	5.2	5.6	...	...
Imports *(year-on-year change, cumulative over 12 months)*	–0.4	10.5	10.5	6.6	6.9	7.2	...	...
Current balance	**25.2**	**21.5**	**21.5**	**20.8**	**17.2**	**15.0**	**...**	**...**
Goods and services	36.0	33.6	33.6	33.5	29.5	27.3	...	...
Primary and secondary income	–10.7	–12.1	–12.1	–12.7	–12.3	–12.2	...	...
Net lending (+) / borrowing (–) capacity	**27.8**	**24.2**	**24.2**	**23.8**	**20.4**	**18.1**	**...**	**...**

Credit and deposits in non-financial sectors [3]

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

	2016	2017	Q4 2017	Q1 2018	Q2 2018	07/18	08/18	09/18
Deposits								
Household and company deposits	2.5	2.8	3.2	2.5	3.0	3.4	3.3	...
Sight and savings	16.0	17.6	15.9	12.3	11.0	10.4	10.2	...
Term and notice	–16.0	–24.2	–24.6	–23.1	–20.7	–19.2	–19.1	...
General government deposits	–14.2	–8.7	13.1	16.7	17.6	12.4	8.6	...
TOTAL	**1.2**	**1.9**	**3.7**	**3.2**	**3.8**	**4.0**	**3.6**	**...**
Outstanding balance of credit			...	...	...	...		
Private sector	–3.6	–2.2	–1.9	–2.2	–2.8	–2.4	–2.2	...
Non-financial firms	–5.3	–3.6	–3.3	–4.4	–6.4	–5.8	–5.5	...
Households - housing	–3.7	–2.8	–2.6	–2.4	–2.0	–1.7	–1.6	...
Households - other purposes	2.0	3.7	4.5	4.9	5.0	5.2	5.1	...
General government	–2.9	–9.7	–11.4	–12.5	–9.4	–9.0	–9.6	...
TOTAL	**–3.6**	**–2.8**	**–2.5**	**–2.9**	**–3.2**	**–2.8**	**–2.7**	**...**
NPL ratio *(%)* [4]	**9.1**	**7.8**	**7.8**	**6.8**	**6.4**	**6.4**	**...**	**...**

Notes: *1. Estimate based on the Active Population Survey. 2. Average monthly figures. 3. Aggregate figures for the Spanish banking sector and residents in Spain. 4. Period-end figure.*

Source: *CaixaBank Research, based on data from the Ministry of Economy, the Ministry of Public Works, the Ministry of Employment and Social Security, the National Statistics Institute, the State Employment Service, Markit, the European Commission, the Department of Customs and Special Taxes and the Bank of Spain.*

Strong growth with signs of moderating

GDP growth accelerated in Q2 2018. The national accounts published by the National Statistics Institute, with the breakdown of GDP by component, show a 0.6% quarter-on-quarter growth in Q2 (2.4% year-on-year), slightly higher than the initial estimate (0.5% quarter-on-quarter and 2.3% year-on-year) and that of Q1 (0.4% and 2.2%, respectively). By component, private consumption and exports contributed the most to these positive figures, backed by the improvement in the labour market and household incomes, on the one hand, and by the disappearance of temporary factors which had held back foreign sales in Q1 (such as the lower level of refining activity), on the other. However, these encouraging figures are somewhat lower than the average observed in 2016-2017 (which was above 0.6% quarter-on-quarter). What is more, together with the latest activity and confidence indicators, they indicate that as the economy consolidates its position in the expansionary phase of the cycle, the growth rate slows. On the one hand, this slowdown reflects the loss of momentum in the factors that temporarily favoured growth in recent years (such as low oil prices and interest rates at historical lows) and, on the other hand, it reflects a reduced level of dynamism among Portugal's main trading partners. With regards to risks, at the global level downside risks prevail, particularly due to the fear of a rise in protectionism. At the domestic level, the low household savings rate (4.4% of disposable income in Q2 2018) is cause for concern, as this could hinder consumption. That said, exports could provide a positive surprise thanks to stronger car production.

The labour market exhibits a positive trend. Employment continued to grow at a healthy rate in July (2.1% year-on-year, seasonally adjusted data), although the figures are clearly lower than those of the previous year (3% on average in 2017). Thus, there are also signs of a moderation of growth in the labour market. Similarly, the reduction in the number of vacancies in job centres (in year-on-year terms and with data up to May) suggests a decline in the availability of jobs, although part of this can be explained by the relatively high starting point. On the other hand, the unemployment rate stabilised in July at 6.8%, although in year-on-year terms, this figure is 2.1 pps lower than that of July 2017.

The external lending capacity contributes to the reduction of external borrowing. In Q2 2018, the economy maintained a positive external lending capacity, although it deteriorated from 1.2% of GDP in Q1 2018 to 0.7%. This decrease was almost entirely due to the deterioration in the external lending capacity of households, which went from 1.3% in Q1 to 0.7% in Q2, while the financial sector improved its lending capacity up to 2.1% (1.9% in Q1). On the other hand, the non-financial corporate sector and the general government

Portugal: GDP

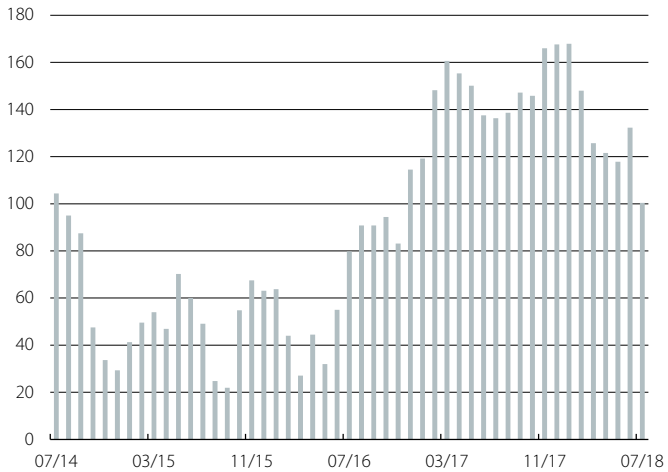
Year-on-year change (%)

	Q3 2017	Q4 2017	Q1 2018	Q2 2018
GDP	2.5	2.5	2.2	2.4
Private consumption	2.7	2.2	2.2	2.7
Public consumption	0.6	0.6	0.7	0.9
Investment	9.3	6.1	4.3	3.7
Investment in transport equipment	10.8	0.4	5.7	–5.7
Investment in capital goods	15.4	9.3	8.6	7.8
Investment in construction	8.1	6.5	2.1	3.3
Exports	6.2	7.2	4.9	7.0
Imports	8.7	7.2	5.6	7.2

Source: *CaixaBank Research, based on data from the National Statistics Institute of Portugal.*

Portugal: employment

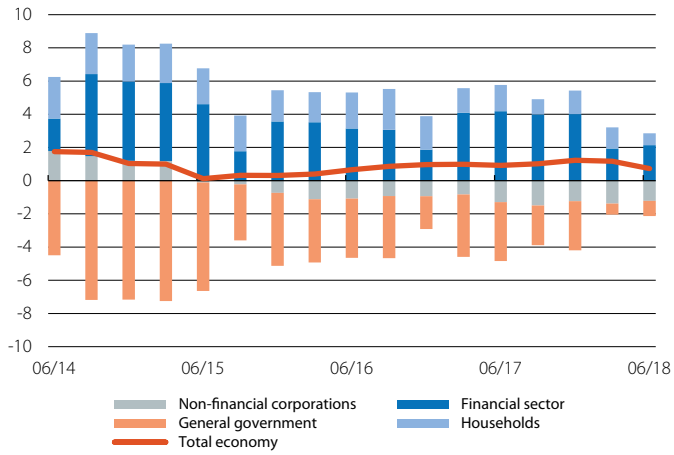
Year-on-year change (thousands)



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

Portugal: external lending capacity/ financing needs

(% of GDP)



Source: *CaixaBank Research, based on data from the National Statistics Institute of Portugal.*

maintained external financing needs of 1.2% and 0.9%, respectively.

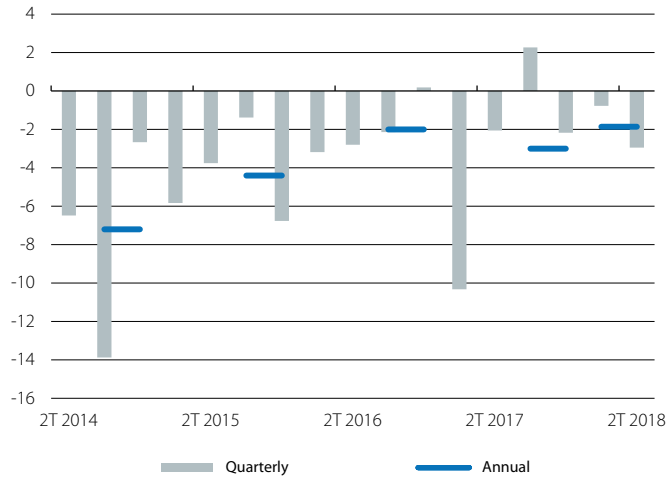
The public accounts evolve favourably and continue taking advantage of the performance of the economy. The deficit data relating to the first six months of the year confirm the improvement in the public accounts, with a deficit of 0.6% of GDP (excluding one-off factors related to bank restructuring costs, such as the recapitalisation of Novo Bank). This represents an improvement of 1.35 pps compared to the first six months of 2017. The cash flow data also show an improvement in the public accounts, with a government deficit of 577 million euros, equivalent to 0.4% of GDP (data up to August). By component, the cash flows reveal a positive performance in tax revenues (+5.3% year-on-year) and an increase of 2.1% in expenditure. This includes the reduction in staff costs (–1.2%, influenced by a base effect, since civil servants' 2017 Christmas payment was split into 12 monthly payments), which was more than offset by expenditure on the acquisition of goods and services (+7.7%) through the payment of outstanding debts to the public healthcare system. These dynamics reinforce the expectation that the public deficit will end 2018 below 1.0% of GDP.

Housing prices slow down but their growth rate remains high. The price of houses rose by 11.2% in Q2 2018, 1.0 pp below the figure for Q1 and putting an end to five consecutive quarters of acceleration in prices. However, this slowdown is expected and reinforces the expectation that supply will narrow the gap that separates it from demand, thanks to the increase in the granting of new construction licenses and new housing developments, which will contribute to a more moderate growth in prices.

The reduction in lending to the non-financial private sector slows down. In its recent assessment of the country, the IMF highlighted the increased strength of financial institutions' balance sheets and of the banking system, emphasising the progress achieved in reducing non-performing loans (NPLs), as well as the increase in operational efficiency. However, it also pointed out the need to continue to reduce the high levels of NPLs, which pose an obstacle to improving the profitability of the Portuguese banking system. The data available up to July, meanwhile, continue to reflect strong growth in new lending, with a significant increase in lending for home purchases (27.2% year-on-year) and consumer credit (15.4%). In addition, there is an increase in new lending to non-financial corporations (+14.1%, particularly in the large firm segment). Nevertheless, the stock of loans granted to the non-financial private sector continues to decline (–1.5% year-on-year in July), albeit at a more moderate rate than last year (–4.3%).

Portugal: government balance

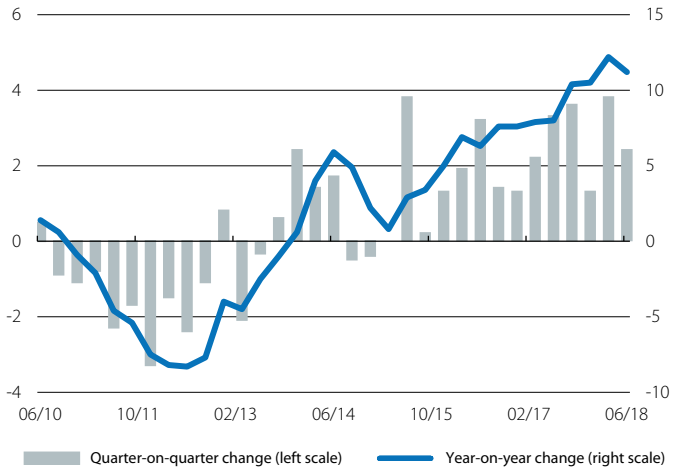
(% of GDP)



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

Portugal: housing prices

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



Source: *CaixaBank Research, based on data from the National Statistics Institute of Portugal.*

Portugal: lending to the private sector

July 2018

	Balance (EUR millions)	Year-on-year change (%)
Lending to individuals	**120,469**	**0.0**
Loans for housing	98,178	–1.3
Consumer loans & other purposes	22,291	5.6
Consumption	14,602	12.8
Lending to companies	**72,234**	**–3.8**
Non-property developers	65,955	–3.6
Property developers*	6,279	–6.0
Total lending to the private sector*	**192,703**	**–1.5**

Note: ** Loans granted to the non-financial private sector.*
Source: *CaixaBank Research, based on data from the Bank of Portugal.*

Recovery of employment and growth of the Portuguese economy

One of the main characteristics of the recent economic recovery in Portugal has been the surprising progress of the labour market. In fact, between 2014 and 2017, the number of jobs grew by more than 351,000, which represents an average annual growth of 1.9%, slightly higher than the average GDP growth of 1.8% in the same period. What are the main factors that are contributing to this change?

The relationship between GDP and employment: before and after the financial crisis

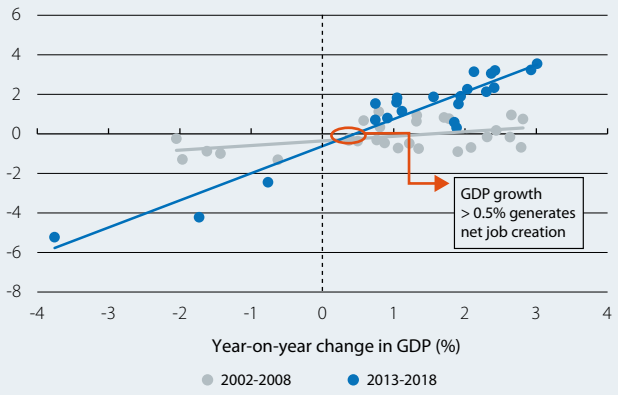
Between Q4 2013 (the period that marks the beginning of the recovery of economic activity and employment) and Q2 2018, employment increased by 9.2% and GDP by 8.3%. This reveals a considerable ratio of 1.1 jobs created for each new unit of GDP, substantially above that of the euro area in the same period (0.6). This value also contrasts with that observed in the past in the Portuguese economy, since between 1995 and 2008, the relationship between employment and GDP was 0.6 jobs per unit of GDP.

One of the explanations for this dynamism in the labour market is that the economy has managed to create jobs in net terms starting at lower GDP growth rates than prior to the international financial crisis. As can be seen in the first chart, the correlation between growth in employment and that of GDP (the so-called Okun curve) has become steeper since 2013, meaning that increases in the GDP growth rate are associated with a greater acceleration in the rate of job growth. The chart also highlights that the Portuguese economy is now able to create employment starting at a year-on-year GDP growth rate of 0.5%, a rate significantly lower than that of the period between 2002 and 2008, when it was 1.5%.

The stronger relationship between employment and GDP after the financial crisis coincides with the structural reforms introduced in the labour market, especially those implemented in the period 2011-2015. In this regard, the ECB has stressed that countries that implemented structural reforms, like Portugal, are now seeing how employment reacts more substantially to the recovery in GDP.[1] In Portugal, the reforms implemented during this period were aimed at simplifying the legislation and they managed to increase the flexibility of the labour market, as shown by the Employment Protection Legislation (EPL) indicator developed by the OECD.[2] More specifically, the

Portugal: growth in GDP and employment

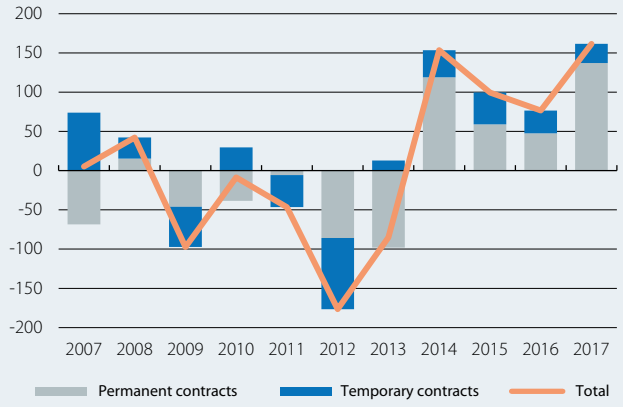
Year-on-year change in employment (%)



Note: *Each point on the chart corresponds to one quarter.*
Source: *CaixaBank Research, based on data from the National Statistics Institute of Portugal.*

Portugal: employees

Year-on-year change (thousands)



Source: *CaixaBank Research, based on data from the National Statistics Institute of Portugal.*

OECD considers that the changes made to severance pay in this period[3] may have provided a significant boost to the recent bout of job creation. The programmes introduced to support recruitment[4] are also likely to have had a positive impact.

Nevertheless, it should be added that the rapid increase in employment in recent years is also a result of temporary factors. Specifically, the pressure on companies to cut costs during the recession forced many of them to reduce their workforce in excess, just in order to survive, a phenomenon that is reversing now that the recovery has become established. During the period

1. European Central Bank, Economic Bulletin of June 2016.
2. See OECD (2017), «Labour Market Reforms in Portugal 2011-2015: A Preliminary Assessment». The EPL fell by 0.95 points, one of the biggest reductions in all OECD countries, although it remains high (3.18, compared to 2.04 in the OECD in 2013).
3. Severance pay for dismissal in permanent contracts was reduced from 30 days' wages per year worked down to 12 days, and the minimum level of compensation to which workers were entitled was eliminated. The new rules apply to new employment contracts.
4. Such as the Employment Contract, a form of financial support to help companies hire unemployed people who are registered in the job centres.

2008-2013, 630,000 jobs were destroyed (i.e. 12% of the positions that existed in 2008). This was partly a result of a rigid and dual labour market, and partly because the Portuguese corporate sector is made up of small businesses, which are less likely to survive a recession. The rigidity of the labour market, as well as the lack of mechanisms available to reduce the number of hours worked per employee[5] during the financial crisis, exacerbated the loss of jobs. In addition, the reduced protection for temporary workers (compared to those with a permanent contract) and the high market duality[6] fostered a reduction in the number of employed people through their contracts not being renewed.

The sectoral composition is also important

The greater sensitivity of employment to GDP growth is also explained by the changes in the sectoral structure of GDP. During the period of recession (2008-2013), the loss of employment was greater in the construction sector (employment fell by 11.8% per annum) and in industry (–4.2%) than in the services sector (–0.8%). In this period, the weight of services in the total gross value added (GVA) increased to 76.7% in 2013, 2.5 pps higher than in 2008, while that of the construction sector fell by a similar proportion and that of industry remained stable. Thus, given that employment in the services sector tends to be highly sensitive to variations in GDP growth, the increase in the weight of the services sector helps to reduce the difference between the growth in GDP and that of total employment. Between Q1 2014 and Q2 2018, employment in the services sector experienced a cumulative growth of 12.5%, while the growth in GVA was more moderate, at 7.2%.

However, the construction and industrial sectors have also made a major contribution to job growth, since they experienced significant job creation following the destruction of jobs observed during the recession. As an example, in the construction sector one in every two jobs were destroyed, while in industry the figure was one in every five. In cumulative terms, between Q1 2014 and Q2 2018, employment increased by 13.3% in the construction sector and by 14.9% in industry. This was following cumulative reductions of 45.8% and 18.5% during the recession (2008-2013), respectively.

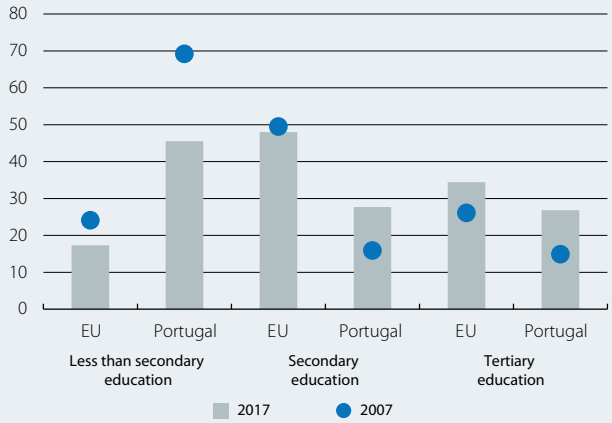
What will be the relationship between employment and GDP in the future?

The shift of the economy towards the tertiary sector (greater role of services in the productive structure), together with a less rigid labour market, will continue to foster a stronger relationship between employment and GDP in the future. As we have seen, according to the Okun curve, the economy is now able to create jobs at lower GDP growth rates than before, which allows individuals to benefit from the recovery in economic activity more quickly.

The other side of the coin of the strong rate of job creation is the slower growth in labour productivity. Even if part of the strong employment creation is the result of temporary factors –suggesting that labour productivity growth might recover in the coming years–, there are reasons to believe that this recovery will be limited. In particular, the low educational attainment of a significant fraction of the Portuguese workforce remains an important factor. In fact, in 2017, Portugal was the EU country with the highest percentage of workers with an education level below secondary education.[7] Increasing human capital remains one of the major challenges in order to boost productivity.

Portugal: employees according to educational level

Fraction of the total of all workers aged 15-64 (%)



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

5. The reduction in the number of hours worked during the period 2008-2013 was in line with the loss of jobs. That is, the reduction in the labour market essentially occurred in the extensive margin (number of jobs), rather than in the intensive margin (hours per worker).
6. In the first half of 2018, temporary contracts accounted for 19% of total employment, a percentage similar to that of 2008.

7. Bank of Portugal, Economic Bulletin of May 2018.

Activity and employment indicators

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

	2016	2017	Q4 2017	Q1 2018	Q2 2018	05/18	06/18	07/18	08/18	09/18
Coincident economic activity index	1.5	2.7	2.8	2.5	2.1	2.1	1.9	1.7	1.6	...
Industry										
Industrial production index	2.4	4.0	2.5	2.3	0.5	–2.7	–0.1	–1.3	–2.9	...
Confidence indicator in industry *(value)*	–0.7	2.3	3.5	2.1	0.0	–0.5	0.5	0.9	1.6	–1.2
Construction										
Building permits *(cumulative over 12 months)*	7.9	19.8	15.6	8.8	10.3	...	10.3	...	...	...
House sales	18.8	20.5	23.6	15.7	23.7	...	23.7	...	...	...
House prices *(euro/m² - valuation)*	3.8	5.0	4.5	5.4	6.1	...	6.1	...	...	...
Services										
Foreign tourists *(cumulative over 12 months)*	10.9	12.3	12.1	11.2	7.6	7.9	6.3			
Confidence indicator in services *(value)*	7.3	13.8	14.8	13.2	14.4	13.7	18.9	18.3	14.5	16.7
Consumption										
Retail sales	2.7	4.1	4.1	5.9	2.6	5.6	3.2	2.4	3.4	...
Coincident indicator for private consumption	1.7	2.4	2.5	2.3	2.1	2.1	2.0	1.8	1.6	...
Consumer confidence index *(value)*	–11.1	0.5	2.3	2.0	2.8	4.1	1.3	–1.4	–1.3	–1.5
Labour market										
Employment [1]	1.2	3.3	3.5	3.2	2.4	2.5	2.8	2.2	1.9	...
Unemployment rate (% labour force)	11.1	8.9	8.1	7.9	6.7	7.1	6.8	6.8	6.8	...
GDP	**1.9**	**2.8**	**2.5**	**2.2**	**2.4**	**...**	**2.4**	**...**	**...**	**...**

Prices

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

	2016	2017	Q4 2017	Q1 2018	Q2 2018	05/18	06/18	07/18	08/18	09/18
General	0.6	1.6	1.8	0.9	1.2	1.4	2.0	2.2	1.3	2.3
Core	0.8	1.3	1.6	0.9	0.9	1.1	1.5	1.8	0.7	...

Foreign sector

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

	2016	2017	Q4 2017	Q1 2018	Q2 2018	05/18	06/18	07/18	08/18	09/18
Trade of goods										
Exports *(year-on-year change, cumulative over 12 months)*	0.8	10.0	10.0	6.5	7.4	7.2	7.4	8.1	...	...
Imports *(year-on-year change, cumulative over 12 months)*	1.5	13.5	13.5	11.0	9.8	9.0	9.8	9.5	...	...
Current balance	**1.1**	**0.9**	**0.9**	**0.9**	**0.0**	**0.6**	**0.0**	**0.0**	**...**	**...**
Goods and services	3.8	3.5	3.5	3.2	3.1	3.6	3.1	3.2	...	...
Primary and secondary income	–2.7	–2.6	–2.6	–2.3	–3.1	–3.0	–3.1	–3.3	...	...
Net lending (+) / borrowing (–) capacity	**3.0**	**2.7**	**2.7**	**2.7**	**1.9**	**2.3**	**1.9**	**1.9**	**...**	**...**

Credit and deposits in non-financial sectors [2]

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

	2016	2017	Q4 2017	Q1 2018	Q2 2018	05/18	06/18	07/18	08/18	09/18
Deposits										
Household and company deposits	3.7	1.7	2.1	2.6	4.3	4.3	4.9	3.6	...	...
Sight and savings	19.5	15.7	2.1	2.6	4.3	15.4	16.2	11.4	...	...
Term and notice	–3.2	–5.8	–4.4	–4.1	–2.9	–2.9	–2.5	–1.8	...	...
General government deposits	–17.9	1.3	12.1	1.9	–0.8	–9.7	12.8	–1.2	...	...
TOTAL	**2.3**	**1.6**	**2.6**	**2.6**	**4.0**	**3.5**	**5.4**	**3.4**	**...**	**...**
Outstanding balance of credit										
Private sector	–3.9	–4.0	–3.4	–1.8	–1.8	–1.7	–1.6	–1.5	...	...
Non-financial firms	–5.6	–6.5	–6.0	–3.1	–3.7	–3.6	–3.6	–3.8	...	...
Households - housing	–3.3	–3.1	–2.1	–1.9	–1.6	–1.6	–1.4	–1.3	...	...
Households - other purposes	–0.5	0.9	0.2	3.0	4.1	4.3	4.5	5.6	...	...
General government	–9.4	9.3	22.9	19.0	14.8	17.4	10.6	–13.9	...	...
TOTAL	**–4.2**	**–3.5**	**–2.4**	**–1.0**	**–1.1**	**–1.0**	**–1.2**	**–2.1**	**...**	**...**
NPL ratio *(%)* [3]	**17.2**	**13.3**	**13.3**	**13.0**	**...**	**...**	**...**	**...**	**...**	**...**

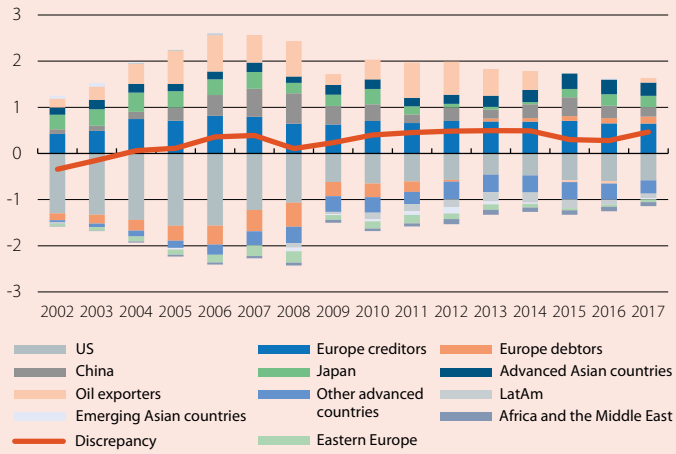
Notes: *1. Estimate by the National Statistics Institute. 2. Aggregate figures for the Portuguese banking sector and residents in Portugal. 3. Period-end figure.*
Sources: *CaixaBank Research, based on data from the National Statistics Institute, Bank of Portugal, European Commission and European Automobile Manufacturers' Association.*

The role of global imbalances 10 years on

Ten years after the outbreak of the great global economic and financial crisis, the global economy is growing at levels close to 4% per year, a reasonably high rate. Most projections indicate a continuation of this trend in the medium term. Nevertheless, in this scenario of considerable growth, some well-known risk factors are once again rearing their heads. These include global imbalances.

But what exactly do we mean when we talk about global imbalances? Generally speaking, we understand global imbalances as a situation of high and persistent current account deficits and surpluses, such that their existence can have global repercussions. The presence of current account deficits (and surpluses) is not cause for concern in itself, since they may be the result of optimal movements of capital from countries with a low growth outlook (surplus) towards countries with a better outlook (deficit). However, if these deficits (and surpluses) arise, for example, as a result of heavily expansionary fiscal policies, excess savings (brought about by a scenario with high risk aversion) that are flowing to foreign countries with a well-developed range of safe assets, or mercantilism policies, they may well be cause for concern.

Global imbalances: current account balances
(% of global GDP)



Source: *CaixaBank Research, based on data from the IMF (WEO, April 2018).*

A combination of these factors is precisely what gave rise to some worrying global imbalances at the beginning of the millennium. Whereas in the early 2000s the sum of the current account deficits throughout the world represented no more than 1% of global GDP, in 2007 it was more than 2.5% (see first chart). This increase, of course, also occurred in the surpluses. In addition, this increase at both ends of the current account scale was concentrated in just a few countries. On the surplus side, there were sharp increases in Central Europe (led by Germany); in the oil-exporting countries, which benefited from the sharp rise in the price of oil (going from just 30 dollars per barrel of Brent oil in 2000 to over 100 dollars in 2007); and in China, where the country's significant savings in search of safe assets and its neo-mercantilism policies in support of the exporting sectors were key drivers of the global imbalances.[1] On the other side of the scale, rising fiscal deficits in the US and in several countries of Europe's periphery were an important factor in the increase in global imbalances[2] (the twin deficits hypothesis, which suggests that excessively expansionary fiscal policies decrease their net national savings and increase external dependency, took on greater importance in that decade).[3]

This accumulation of imbalances during the early years of the 2000s exacerbated the impact of the 2008 financial crisis. The sudden breakdown of the international flows of capital that occurred following the collapse of Lehman Brothers forced those economies that were highly dependent on external savings (and, therefore, had a large current account deficit) to sharply cut their spending, thus depressing their economic activity. In addition, the strong global interconnection between the major economies through trade and financial flows led to the problem spreading on a global scale.

It should be noted that, following the outbreak of the financial crisis, many of the excessive deficits and surpluses were substantially corrected. Thus, the overall global current account deficit in 2012 stood at around 1.5% of global GDP. The reduction in the dispersion between countries' current account balances was also significant. Specifically, the largest economies with deficits reduced their combined external imbalance by half. By way of illustration, the US, which was the main country responsible for the large current account deficit, managed to reduce its deficit by 1 point of global GDP, while on the other side of the scale, China reduced its current account surplus by almost half a point of global GDP.[4]

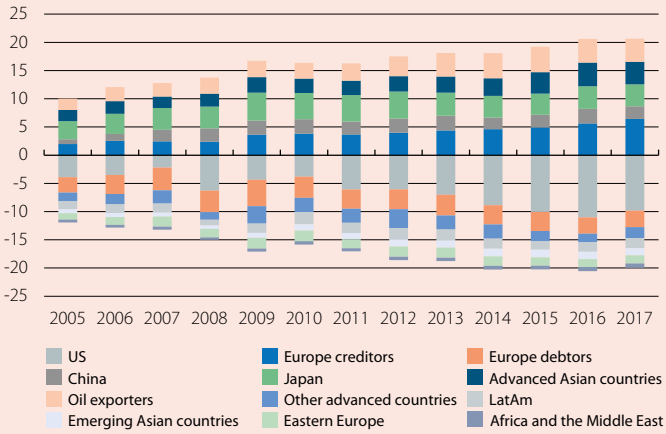
1. The high level of savings in the emerging Asian countries is known globally by the economic term «savings glut».
2. See the article «From the Great Recession to today: the errors of monetary and fiscal policy» in this same *Monthly Report*.
3. See M. Chinn (2017), «The Once and Future Global Imbalances? Interpreting the Post-Crisis Record», Federal Reserve Bank of Kansas City's Jackson Hole Conference.
4. As a percentage of their respective GDP figures, the US went from a maximum deficit of 5.8% in 2006 to a minimum of 2.1% in 2013. China, meanwhile, went from a surplus of almost 10% in 2007 to 1.5% in 2013 (according to data from the IMF, WEO, April 2018).

In recent years, the current account imbalances have remained stable at around 1.5%, the same figure as in 2012. Although still above the levels seen in the early 2000s, this clearly lies below those seen in 2007. All in all, there are two elements that qualify this relatively reassuring view. The first is the major fiscal boost being carried out by the US Administration, with the tax cuts approved by Congress in December 2017 and the increase in projected expenditure for 2018 and 2019, which will widen the current account deficit. This increase will no doubt have a negative impact on global imbalances. Not in vain, the US remains the country with the highest current account deficit in the world: with a deficit of 449,141 million in 2017, it represented 51% of the total of all the countries in deficit put together.

Secondly, financial globalisation has added a layer of complexity to the international flows of capital, which current account balances do not capture. The global correction of current accounts following the financial crisis could well be masking international financial risks that remain significant or that may even be on the rise.[5] On the one hand, the current account balance and, therefore, its counterpart in the financial account may have declined in net terms, but at the same time, the gross flows – i.e. capital inflows and outflows – are significant and their fluctuations could be a major source of instability. In 2008, for instance, while in the US the current account deficit dropped by 30 billion dollars, gross capital inflows into the country fell by 1.7 trillion. This decline mainly reflected the breakdown of inflows of European capital into the US and, to a lesser extent, the decline in flows from emerging Asian countries. This is a trend we would not have predicted simply by observing the current account balances, since the European region as a whole had a balanced current account, and it was Asia that had a significant current account surplus. The reason behind the different behaviour of Europe and Asia was that European banks were highly exposed to the American financial products backed by mortgages, while their Asian counterparts were not.

Net international investment position

(% of GDP)



Source: *CaixaBank Research, based on data from the IMF (WEO, April 2018).*

On the other hand, the significant expansion in countries' international asset and liability positions diminishes the importance of current account balances as a measure of macrofinancial vulnerability. A large stock of financial assets and liabilities leads to the change in economies' net international investment position (NIIP)[6] being increasingly affected by net capital gains, while being less affected by current account balances. In the end, it is the NIIP that demonstrates these economies' capacity to meet their payment obligations in the medium and long term. In this regard, in recent years, the debtor and creditor positions (indicated by the NIIP) have not stopped growing, and according to the most recent estimates by the IMF, the gap will continue to widen. Without a doubt, this trend adds some pressure to the reassuring scenario implied by more contained current account balances (see second chart).

In short, the course of financial globalisation has led to highly complex international macrofinancial relationships. This requires an analysis of various indicators in order to more accurately gauge the levels of global macrofinancial stress. Therefore, although the reduction in global imbalances since the highs of 2007 is symptomatic of more controlled stress levels, the high external debtor positions of some economies, together with the significant gross flows of international capital, prevent us from taking an overly complacent view, since they suggest that some pockets of macrofinancial vulnerability have not yet dissipated.

Clàudia Canals
CaixaBank Research

5. See M. Obstfeld (2012), «Does the Current Account Still Matter?», American Economic Review, 102(3), 1-23. See also C.E. Borio and P. Disyatat (2015). «Capital flows and the current account: Taking financing (more) seriously», BIS Working Paper.
6. The NIIP is defined as the difference between the stock of external financial assets and liabilities.

From the Great Recession to today: the mistakes of monetary and fiscal policy

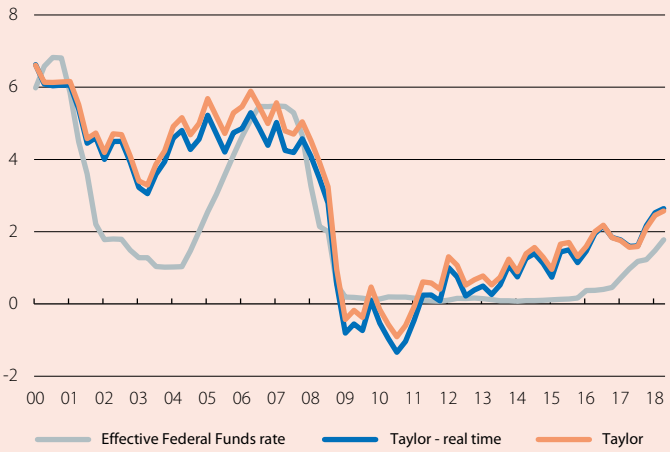
In a meeting with various economists in November 2008, Queen Elizabeth II asked: «Why did nobody notice it?», referring to the financial crisis, which that year substantially reduced the returns of the English crown's financial assets. Even today, exactly 10 years after the financial crisis, it is difficult to answer that question. Nevertheless, with the benefit of hindsight, we can say that monetary and fiscal policy decisions played a significant role, helping us to understand what caused the outbreak of the financial crisis and the subsequent Great Recession. In this article, we will shed light on the erroneous nature of the various monetary and fiscal policy decisions that facilitated the creation of macroeconomic and financial imbalances prior to the crisis, as well as the extent to which we have learned from that bitter experience.

To begin with, it is important to remember that a country's or a region's fiscal and monetary policies should act as stabilisers for the economy and be counter-cyclical in nature. In other words, they should stimulate the economy in times of recession, and they should try to ensure sustainable and balanced growth in economic activity during the boom periods in order to be better prepared for hard times. Economists agree that in the years leading up to the Great Recession, both policies were excessively accommodative in the US and in the euro area, which favoured the creation of financial and macroeconomic imbalances. This fact could be due to two factors: perhaps the fiscal and monetary authorities decided to stimulate the economy more than they should have given that, as we know, it was already growing above its potential; or perhaps they did not correctly read what phase of the business cycle the economy was in, believing that there was still room for further growth. The latter could have led the authorities to believe that expansive fiscal or monetary measures were necessary to stimulate demand, when in reality we now know that the economy was already growing above its potential. On the monetary side, the accommodative policy stance can also be explained by the fact that the authorities focused on the trends in prices, without taking into account the macrofinancial risks that these policies entailed.

In order to clarify the extent to which monetary policy was excessively accommodative in the years leading up to the financial crisis, we can use Taylor's rule. This rule indicates what interest rate should have been set by the central bank based on inflation, a measure of how far economic activity is from reaching its potential (the so-called output gap) and other additional variables.[1] In addition, in order to identify what impact an incorrect interpretation of the cyclical phase could have had, we can estimate the interest rate according to Taylor's rule based on the actual output gap that existed at the time, and compare it with the rate according to Taylor's rule which the authorities were using at the time. Thus, we can see in the first chart how the interest rate set by the Federal Reserve between 2002 and mid-2005 was indeed well below that suggested by Taylor's rule. Furthermore, if we compare the two versions of the rate according to Taylor's rule, we can see that they are similar, meaning that any errors arising from an inaccurate estimate of this figure in real time would have played only a modest role.

US: monetary policy

(%)



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

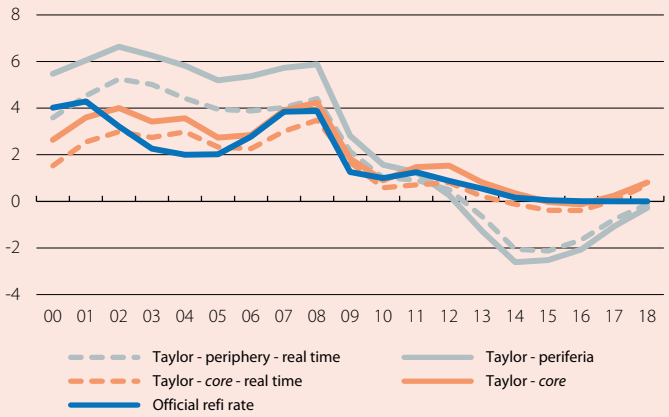
We have performed the same exercise for the euro area, but separating the main countries that make up this region into the core countries and the peripheral countries. If we look at the second chart, we can draw two thought-provoking conclusions. Firstly, the difference between the interest rate suggested by Taylor's rule and the official rate of the European Central Bank shows us that the ECB's monetary policy was more sensitive to the economic situation of the core countries than to that of the peripheral countries between 2002 and 2005. As an example, in 2004 the interest rate suggested by Taylor's rule was 5.8% for the peripheral countries. However, in that same year, the official rate averaged 2%, much closer to the 3.6% that Taylor's rule prescribed for the core countries. Secondly, short-sightedness when identifying what phase of the business cycle each country was in could have played a highly significant role in Europe. This is because the difference between the rate suggested by the current version of Taylor's rule and that which we obtain using real-time data is 0.7 and 1.3 pps for the core and peripheral countries, respectively.

1. Specifically, $i_t^{Taylor} = \rho\,(i_{t-1}^{Taylor}) + (1-\rho)\,[(r_t^n + \pi^*) + 1{,}5\,(\pi_t - \pi^*) + 0{,}5\,(y_t - y_t^n)$ where $\rho = 0{,}5$ is the smoothing parameter, r_t^n eis the natural interest rate estimated according to the Laubach-Williams model, π_t is current inflation and $\pi^* = 2\%$ is the target inflation, y_t is the GDP and y_t^n, the potential GDP.

Thus, the monetary authorities possibly thought that the need to raise rates was less urgent than it really was. In reality, in 2004 both central banks were already showing some concern regarding the excessively accommodative approach of monetary policy, but the decisions they took to address these concerns were insufficient and often came too late. For instance, the minutes of the Fed's meeting of March 2004 show how «some members were concerned that keeping monetary policy stimulative for so long might be encouraging increased leverage and excessive risk-taking.»[2] In this same regard, the then president of the ECB, Jean-Claude Trichet, said before the European Parliament in November of that same year that the excessively expansionary monetary policy being pursued by the ECB could become a source of unsustainable asset price increases. Nevertheless, the refi rate remained unchanged at 2% throughout the year that followed Trichet's warnings.

Euro area: monetary policy

(%)



Note: *Core includes France and Germany, while periphery includes Greece, Italy and Portugal. In both cases, each country has been weighted according to its GDP.*
Source: *CaixaBank Research, based on data from the European Commission.*

With regards to fiscal policy, the stabilising role normally attributed to it also did not work effectively in the years leading up to the financial crisis, neither in the US nor in the euro area. In the latter region, the consequences of an inadequate fiscal policy were particularly ill-fated. In fact, the fiscal policies that were pursued in some euro area countries, when the economy was still in a period of boom prior to the crisis, provide a textbook example of how the adverse effects of a recession can be magnified by decisions taken on tax matters. As such, those countries with a level of debt that had not been sufficiently reduced in the years prior to the crisis (Greece is a clear example) had to face the recession from a delicate starting point. As a result, they were unable to implement expansionary fiscal policies to moderate the decline in economic activity, since this would have jeopardised the sustainability of public debt. The fiscal policy of these countries ended up being procyclical, since they had to adjust their public accounts during the recessive phase of the cycle, instead of making these adjustments during the years prior to the crisis, when the economy was growing above its potential. On the contrary, those countries whose fiscal policies allowed them to have relatively low levels of debt prior to the recession (Germany is a good example) were able to mitigate the impact of the crisis without jeopardising their capacity to repay their sovereign debt.

Ten years after the outbreak of the crisis, it is natural to wonder about the current situation. From a monetary policy point of view, it seems that interest rates are close to, albeit slightly below, the levels suggested by Taylor's rule. Nevertheless, we must bear in mind that the various unconventional measures implemented by the central banks, specifically the large-scale asset purchase programmes, have accentuated the accommodative stance of the monetary authorities' policies.[3] If we consider the size of the central banks' balance sheets, the monetary policies continue to be more accommodative than they should be and this may be contributing to the overvaluation of some financial assets. At the fiscal policy level, the budget adjustments carried out by the peripheral countries, together with the European Commission's greater degree of control over Member States' levels of debt and their deficits, point towards a less procyclical fiscal policy that is better prepared to deal with future recessions. Nevertheless, many countries now have higher levels of debt than they did in 2008, which reduces the fiscal authorities' room for manoeuvre in the event of another recession. For example, in 2008 Spain faced the Great Recession with a comfortable level of debt over GDP of 39%, whereas this indicator now stands at 98%.

In short, we do not know exactly when the next recession will come, nor how deep it will be. We also do not know whether we will then be able to answer a question similar to that posed by Queen Elizabeth II in 2008. What we do know is that, in the past, several decisions were taken which we can now say were incorrect, partly due to opting for the wrong recipes and partly due to a misreading of what phase in the cycle we were in at the time. Although the measures that have been taken since the financial crisis have been aimed at correcting these errors, the response of fiscal and monetary policy to the crisis has also left us with less capacity to respond to future crises (high public debt, very low interest rates, central banks with unprecedented balance sheet volumes, etc.). Let us hope that progress will be made in the right direction to correct these situations in time and prevent the next recession from catching us unprepared.

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2. See the article «On music, risks and leverage 10 years after Lehman» of this same Dossier for more details about the consequences of excessive risk-taking and the increase in leverage.
3. For a more detailed analysis of this topic, see the article «Discovering monetary policy in the shadow» in the MR02/2016.

Regulation more appropriate to the nature of the banking sector

As is well known, the financial system is inevitably subject to asymmetric information problems that can cause conflicts of interest between the different players: borrowers, creditors, shareholders, bank managers, etc. This tends to exacerbate the system's procyclical nature, that is, the trend for credit booms to emerge in expansionary phases, and it can lead to an excessive accumulation of risks, excessively low levels of capital or misconduct in the commercialization of products.[1] In this context, the regulations seek to prevent cycles of excessive credit growth and risk-taking, although this goal is not always easy to achieve, as we saw during the last financial crisis which began exactly 10 years ago.

In this article, we analyse the extent to which the regulatory initiatives adopted in recent years have served to realign past imbalances and to provide the banking sector with the capacity to remain solvent when faced with adverse scenarios in the future. Ultimately, we must ask ourselves whether we have learned the lesson in order to avoid the same mistakes from being repeated. Let's see if we have managed it.

Capital and liquidity ratios in the euro area and US

	Capital ratio * (%)		Loans/deposits ratio (%)	
	2007	2017	2007	2017
Euro area	7.9	15.6	124	98
US	8.5	13.7	97	76

Note: ** Tier 1 ratio over risk-weighted assets.*
Source: *CaixaBank Research, based on data from the Federal Reserve Bank of St. Louis, the Federal Reserve Bank of New York, the EBA and the ECB.*

The last financial crisis highlighted, among other problems, two major sources of financial instability: systemic risk and the excessively procyclical nature of credit.

Systemic risk refers to shocks affecting the financial system as a whole, which can be caused, for instance, by a financial institution experiencing difficulties, as was the case with Lehman Brothers 10 years ago. One of the main causes of this risk is the so-called moral hazard, whereby a financial institution takes excessive risks on the assumption that, before going bankrupt, it would be bailed out with public funds.This problem became particularly evident in those «systemic» institutions, considered too big, complex and interconnected to fail.[2] In addition, these institutions benefited from a lower financing cost, as investors took for granted that they were unlikely to be allowed to fail.

Measures have been taken to try to address this problem by strengthening the so-called macroprudential regulation, which seeks to prevent systemic crises and contribute to greater financial stability. To this end, specific capital surcharges have been incorporated into the regulations for financial institutions that are considered systemic and for systemic risks implemented at the global level. These changes were introduced following the financial crisis and are known as Basel 3. In addition, in order to offer a credible solution to this problem, a new resolution framework has been introduced in Europe, making it easier to restructure a financial institution in difficulty and seeking to avoid the use of public funds in this process. This framework requires an institution's shareholders and creditors to assume the losses (bail in), rather than the taxpayers. For this to be feasible in practice, new requirements for absorbing losses have been established.[3]

On the other hand, in order to mitigate or smooth out the credit cycles in order to prevent an excessive accumulation of risks (the procyclical nature of the system), Basel 3 has introduced a considerable increase in the capital requirements, both in quantity and in quality. This framework has also adopted a wide range of tools. These include the countercyclical capital buffer, which serves to ensure that capital is accumulated during periods of expansion in order to absorb losses in recessions,[4] and other measures related to capital and liquidity (higher risk-weighting of assets, more stringent requirements, reporting requirements, etc.). Besides Basel 3, additional measures can be developed at the national level to control the granting of credit, if the competent authority (usually the central bank of each country) decides to do so. Such measures can include placing limits on loans in relation to their guarantee amount (loan-to-value, or LTV) or in relation to the debtor's payment capacity (debt-to-income, or DTI).[5] All of these measures are useful for mitigating the cyclical trend in credit and private sector indebtedness and unsustainable asset price increases. That said, they will always tend to be more effective if they are properly combined with monetary and fiscal policy tools (see the article «From the Great Recession to today: the mistakes of monetary and fiscal policy» in this same Dossier).

1. For further details, see J. Gual (2009), «El carácter procíclico del sistema financiero», Documentos de Economía "la Caixa" n° 14.
2. This problem also occurred in groups of smaller financial institutions, which together could generate the same level of instability if they were to go bankrupt (too many to fail).
3. These requirements are known as MREL (minimum requirements for own funds and eligible liabilities).
4. Countries such as Sweden and Norway already apply this measure, while others such as France, the United Kingdom and Ireland will apply it soon.
5. Portugal, for instance, has recently used these measures to regulate the supply of credit in the mortgage market.

As we are seeing, the regulation introduced as a result of the financial crisis has been designed to significantly increase the prudential requirements of the banking sector.[6] The result of all this is that the solvency and liquidity of the sector in the EU and US as a whole have improved substantially compared to 2007 (see table below) and currently stand well above the minimum level required. This increases their ability to absorb future shocks, while shareholders have more at stake in the event of potential future losses, which should encourage greater prudence.

Even so, the last financial crisis demonstrated that in order to have a truly solid banking sector, it is also essential to strengthen other areas (besides prudential measures). This has led to the implementation of measures in the fields of accounting, corporate governance and conduct. In the field of accounting, the introduction of new accounting standards (IFRS 9) is an attempt to provide a more faithful representation of credit risk in financial reporting. In this regard, the requirements for recognising provisions due to credit risk have been increased, and provisions for non-performing loans must now be calculated according to the expected loss throughout the whole life of the loan (previously, non-performing loans were provisioned based on the loss expected over the next 12 months). This generally results in a higher level of provisions and contributes to financial stability.

In addition, attempts have been made to correct certain corporate governance problems that are inherent to the financial sector and can be exacerbated when the incentives among different players are not entirely aligned.[7] One way to align these incentives has been to encourage compensation schemes that are more closely linked to future returns and risks, in order to avoid excessive and short-term risk-taking. At the same time, both regulators and supervisors have placed greater emphasis on aspects such as the size of Boards of Directors, the professionalisation of their members, their independence and the dynamics of how they operate. In addition, financial institutions have strived to define internal control policies that establish risk appetite thresholds for each risk (financial, business, operational, etc.). In the field of conduct, meanwhile, significant steps have been taken in relation to transparency and the marketing of products (information on costs, associated risks, etc.).[8]

The EU has also embarked in recent years on the construction of a banking union. This is intended to reduce the link between sovereign risk and banking risk and to mitigate financial fragmentation. However, there is still much work to be done. In particular, it is essential to implement a common deposit guarantee scheme that protects all deposits equally, regardless of the financial institution and the country of origin. At the same time, there is a need for a lender of last resort at the European level that can offer support to the single resolution fund and to the deposit guarantee scheme itself in the event of systemic events. There is also a need to design a scheme to provide liquidity for financial institutions undergoing resolution.

Furthermore, despite efforts to reduce the sector's cyclical nature, some of the measures implemented have procyclical effects (such as IFRS 9 and risk-weighted assets), which tends to undermine some of their beneficial effects for financial stability. Finally, it should be noted that more intense regulation of the banking sector tends to lead to the intermediation activity deviating towards less regulated sectors, such as so-called shadow banking.[9]

In short, thanks to the implementation of the measures introduced following the financial crisis, today the financial sector is more robust than before. This will help to minimise the impact to the economy and financial stability in periods of upheaval, since countries with better-capitalised banking systems tend to experience shorter recessions and less contraction in the supply of credit.[10] However, the outstanding tasks we have mentioned should be properly addressed sooner rather than later.

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CaixaBank Research

6. In addition to the measures referred to above, we must add the introduction of a leverage ratio (simple ratio of capital over assets, without taking into account the assets' risk), a liquidity coverage ratio and a stable funding ratio. More recently, the Basel 3 framework has been revised to also limit disparity in the calculation of risk-weighted assets between different financial institutions.
7. This occurs, for example, when a bank's managers are incentivised to maximise the business' profitability over a shorter term than the shareholders, without considering that the risks of investments carried out may materialise over the longer term.
8. Regulations such as MIFID 2 (in force since 2018) regulate these areas.
9. Financial institutions (insurance companies, investment funds, etc.) that conduct financial activities with features of a banking nature, but are less regulated and do not have a protection network, such as a lender of last resort.
10. See, for example, Jiménez *et al.* (2012), «Credit supply and monetary policy: identifying the bank balance-sheet channel with loan applications», American Economic Review August Vol. 102, No. 5, and Jorda *et al.* (2017), «Bank Capital Redux: Solvency, Liquidity, and Crisis», Working Paper Series 2017-6, Federal Reserve Bank of San Francisco.

On music, risks and leverage 10 years after Lehman

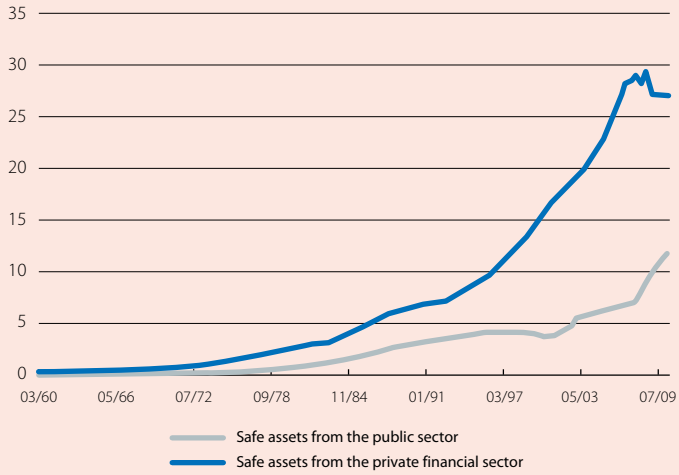
10 years ago, on 15 September 2008, the bankruptcy of Lehman Brothers plunged the world into the worst financial crisis since the Great Depression of the 1930s. If its origin was in a relatively small market (US subprime mortgages), how can it have had such far-reaching consequences? We know[1] that the financial crisis was preceded by a long period of global imbalances, accommodative financial conditions and inadequate financial regulation. These factors were added to an excessive risk-taking and a rise in indebtedness, thus materialising into a financial crisis. Let's see what role these two factors played and what ramifications we are still experiencing today.

How risk aversion led to greater risk-taking

To begin with, we must go back to the Asian crises of the late twentieth century and the stock market crash of 2001, which triggered an increase in risk aversion and a greater desire, at the global level, to own safe assets. This demand, initially unsatisfied by the existing supply, incentivised the financial system of the advanced economies (led by the US) to create safe assets through the so-called process of securitisation. As an example, in the mortgage market this process consisted of bundling up mortgages into a new security, known as a mortgage-backed security (MBS), which gave the owner the right to receive regular payments from the mortgages that made up the MBS. MBSs grouped together a very large number of mortgages, so it was considered highly unlikely that the payments on all of these mortgages would default at the same time. Thus, this cash flow was considered «safe» and could be securitised into an asset that would also be safe. Indeed, the US financial sector produced a large supply of seemingly safe assets with which to satisfy the demand (see first chart). In fact, the attraction was so great that the practice spread rapidly, to the point that financial institutions bought and sold these assets between one another and held them on their balance sheets. However, this generated strong interconnections in the financial system, which was the seed that would later transmit the problems of the subprime mortgage market to the entire international financial system.

US: supply of safe assets *

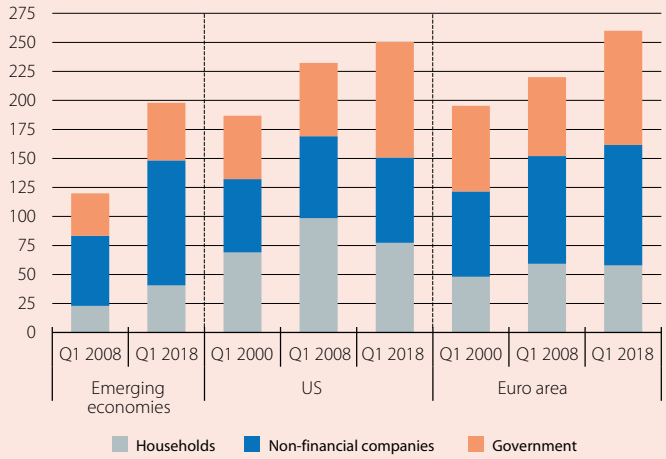
(USD trillions)



Note: ** Safe assets mostly consist of debt securities of issuers considered creditworthy and with institutional stability.*
Source: *CaixaBank Research, based on data from Gorton* et al. *(2012), «The Safe-Asset Share», NBER Working Paper.*

Total credit to the non-financial sector

(% of GDP)



Note: *The Bank for International Settlements does not provide sectorial data fo the emerging economies as a whole prior to 2008.*
Source: *CaixaBank Research, based on data from the Bank for International Settlements.*

Implosion

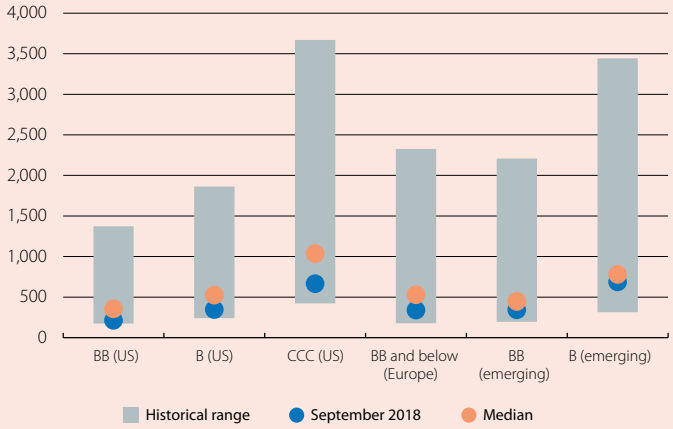
Besides these interconnections, the perception of these assets as «safe» had an inherent weakness: it underestimated the likelihood of a widespread increase in defaults on mortgages. Given the environment at the beginning of the 21st century, with low interest rates and dynamic economic activity, it was only human to think that things would remain not so different in the future, that the cost of credit would remain low and that default rates would be minimal. Nevertheless, by casting some dark clouds over this optimistic sentiment, the rise in mortgage defaults caused investors to wonder about how safe those assets really were. Furthermore, when investors became aware that many of the financial institutions held those assets on their balance sheets, and those assets had now become perceived as less valuable, they questioned the institutions' solvency. Finally, the very opacity and complexity of the product (an MBS could contain thousands and thousands of mortgages) exacerbated this distrust. In this situation, the granting of loans between institutions evaporated, as did, ultimately, liquidity.

1. See the other three articles of this same Dossier for an in-depth analysis of each of these factors.

Not only that, but the doubts surrounding the institutions' solvency were accentuated by the other protagonist of this article: leverage. The financial institutions had financed the expansion of their balance sheets (which contained an accumulation of securitised assets) with an increase in leverage, in other words, through debt (as opposed to using equity capital). On the one hand, this was favoured by bad regulation, given that securitisation allowed institutions to reduce their capital requirements. On the other hand, the over-optimism provided a feedback mechanism for this leverage and created a seemingly virtuous circle: the expectations of an increase in the value of the assets raised the value of the collateral, which allowed more risk to be taken and the level of debt to be increased, which in turn increased the value of the assets even more. In fact, even knowing that the optimism was excessive, the market players wanted to keep betting: the optimism of the rest of the economy continued to raise the value of the assets, thus feeding back into the circle. In the words of Charles Prince, then one of the top executives at Citigroup, «As long as the music is playing, you've got to get up and dance.» However, when the music did stop playing, the virtuous circle became a vicious one: having high leverage meant having relatively little capital to absorb losses, which raised doubts over institutions' solvency and restricted their access to financing. This forced them to sell assets and depressed prices, resulting in a loss of value which once again cast doubts over their solvency, again feeding back into the vicious circle.

Corporate credit spreads per rating bucket (1999-2018)

Spreads against US sovereign yields (bps)



Source: *CaixaBank Research, based on data from the Bank of America Merrill Lynch.*

In this way, the strong interconnections generated by the process of securitisation and the high leverage acted as a conveyor belt, causing the increase in defaults on subprime mortgages in 2007 to filter into much of the international financial system, bringing it to the brink of collapse.

Risks and debt 10 years on

Today we are still experiencing after-effects from that crisis, both in terms of leverage and risk-taking. On the one hand, in the advanced economies the financial sector has significantly deleveraged, but this has been offset by an increase in public sector indebtedness. Furthermore, household debt and that of non-financial companies remains high, and in the emerging economies there has been significant growth in debt, especially among non-financial companies and in China (where the financial system displays strong and opaque interconnections).[2]

On the other hand, the accommodative monetary policy and low interest rates that have dominated since 2008 (as a result of the severity of the financial crisis and the great recession that followed it) have encouraged risk-taking in search of higher returns. Therefore, although, broadly speaking, the international financial and economic system is now in better health, pockets of localised risk have appeared. With regards to risk-taking, since risk premiums have fallen to historical lows (see the third chart), the accommodative financial conditions have facilitated the issuance of corporate bonds of a lower quality. Moreover, with regards to leverage, the search for returns has led to a large-scale expansion of the global market for so-called leveraged loans (commercial loans granted to institutions with a high risk of default or which already have high levels of debt): in 2017, these loans amounted to 788 billion dollars and exceeded the levels of 2007. What is more, in this market, signs of a mature phase of the global business cycle are beginning to appear: companies with poor credit ratings continue to have abundant access to credit, corporate debt ratings have shown some deterioration and new debt issues incorporate less protection for investors.[3] Finally, the strong increase in corporate indebtedness among the emerging economies also reflects their ability to access cheap financing in dollars or euros. However, we are already seeing how sentiment can change course with the withdrawal of the monetary stimulus by the Fed and the ECB.

With all these elements, the world is travelling along a winding road. The major central banks face the challenge of removing that monetary stimulus that was necessary to revive the global economy, precisely in order to prevent the accumulation of vulnerabilities from once again leading to financial upheaval. To paraphrase Warren Buffet, only at the end of the process, when the tide of monetary stimulus has gone out, will we see whether or not the global economy is swimming naked.

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2. See the Focus «Shadow banking in China: a looming shadow», in the MR02/2017.
3. For more details, see the Global Financial Stability Report for April 2018, produced by the International Monetary Fund.

KEY FIGURES

CAIXABANK GROUP
As of 30 June 2018

	MILLION €
Customer funds	366,163
Loans and advances to customers, gross	225,744
Profit attributable to Group, YTD	1,298
Market capitalisation	22,157
Customers (millions)	15.7
Employees	37,286
Branches	5,239
Retail branches in Spain	4,543
Number of ATMs in Spain	9,411

BPI
As of 30 June 2018

	MILLION €
Customer funds	33,311
Loans and advances to customers, gross	23,080
Profit attributable, YTD	366
Profit attributable to operations in Portugal, YTD	223
Customers (millions)	1.9
Employees	4,843
Branches	497
Number of ATMs	1,351

"LA CAIXA" BANKING FOUNDATION COMMUNITY
Projects: Budget 2018

	MILLION €
Social	307.5
Excellence in research and training	91.1
Raising awareness of culture and knowledge	121.4
Total Budget	**520** *

* Of which €10 million are allocated to Portugal.

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