MR05

MONTHLY REPORT • ECONOMIC AND FINANCIAL MARKET OUTLOOK

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ECONOMIC & FINANCIAL ENVIRONMENT

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The Spanish economy maintains a steady pulse

Favourable growth in Portugal, but with doubts over the external sector

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THE CAUSES OF POLITICAL POLARISATION

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The deep roots of polarisation, or on the need to recover the lost narrative

CaixaBank Research

MONTHLY REPORT - ECONOMIC AND FINANCIAL MARKET OUTLOOK
May 2019

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Political polarisation

The European elections scheduled for 26 May will serve as an important test not only for the health of the European project but also to demonstrate the degree of political polarisation in the Old Continent. A source of concern is the possible rise of extremist parties – whether Eurosceptic, anti-establishment, or both – that question the very principles upon which the EU has been built.

The phenomenon of political polarisation, which we address in the Dossier of this *Monthly Report*, has spread across a large number of countries and represents a response to factors we could classify as relating to demand and supply. The demand factors would be those that have driven a portion of the electorate towards more extreme positions. Among others, these include the long economic crisis and its aftermath, the increase in inequality, the refugee crisis and the feeling of insecurity caused by technological and demographic changes (is my job at risk? What about my pension?). Dissatisfied with the status quo – «the system» – and the responses of the major political parties to these challenges, a portion of the electorate has identified with more extreme options that question the very political and economic system itself and seek to eclipse the more traditional parties.

By supply factors, we are referring to the emergence of new parties, or the re-emergence of old ones, which position themselves far from the political centre ground. In addition, the traditional parties, driven by changes in voters' preferences and the appearance of new competitors, are tempted to radicalise their discourse and move away from the centre. This is a path that entails risks since, in the end, the majority of voters remain in the centre ground.

Other changes in the environment have also facilitated the polarisation of demand (voters) and supply (parties). For instance, new communication technologies have cut the cost of entry for new parties on the supply side. Social networks, meanwhile, facilitate the dissemination of falsehoods that feed social polarisation. This is partly because the messages – by no coincidence – reach those who are not only more likely to consider them to be true (they validate their prejudices) but are also more likely to share them with others with a similar ideology. The echo effect and the comfort of feeling that one's convictions are shared by many others contribute to polarisation.

Polarisation entails significant costs. For example, it leads to a deterioration of social cohesion by decreasing the population with a minimally shared view on the major challenges facing the economy and society and the options available to respond to them. This fracturing of society makes it more difficult to achieve significant consensus in order to implement reforms that respond to the challenges we face – both because political fragmentation prevents it and because the centrist parties have less incentives to reach agreements amongst themselves for fear of losing ground to the extreme ends of the spectrum. The absence of consensus and reforms, in turn, ends up worsening the economic situation and leads to an increase in political instability, the very factors that stoke the more extreme options.

Therein lies the difficulty of halting and reversing political polarisation since, to do so, it is essential to carry out reforms that respond to the major challenges of our times. Building a broad consensus requires strong leadership, empathy with those who think differently, a connection with voters and, of course, a sense of responsibility. Perhaps this is a lot to ask, but it is what complex times like those we live in demand.

Enric Fernández
Chief Economist
30 April 2019

Chronology

APRIL 2019

10 The EU delays Brexit until 31 October 2019.
28 General elections are held in Spain.

MARCH 2019

7 The ECB announces a new round of targeted longer-term refinancing operations (TLTRO), due to begin in September.
15 The rating agency S&P improves Portugal's credit rating from BBB– to BBB.
21 The EU delays Brexit until 12 April 2019.

FEBRUARY 2019

28 The US suspends the tariff increase on imports of products from China, which was due to come into force on 1 March.

JANUARY 2019

15 The UK Parliament rejects the withdrawal agreement signed between the Government and the EU by 432 votes to 202.
25 The longest partial government shutdown in US history comes to an end after 35 days.

DECEMBER 2018

7 OPEC and its partners agree to cut crude oil production by 1.2 million barrels per day between January and June 2019.
13 The ECB confirms that it is bringing the net purchases of assets to an end in December 2018.
19 The Fed raises the official rate by 25 bps, placing it within the 2.25%-2.50% range.

NOVEMBER 2018

5 The US reinstates sanctions on Iran.
21 The European Commission recommends launching an excessive deficit procedure against Italy.
25 The EU and the United Kingdom sign a Brexit agreement.

Agenda

MAY 2019

1 Federal Open Market Committee meeting.
6 Spain: registration with Social Security and registered unemployment (April).
8 Portugal: employment and unemployment (Q1).
9 Spain: industrial production index (March).
10 Portugal: international trade (March).
13 Portugal: CPI (April).
15 Portugal: GDP flash estimate (Q1).
20 GDP of Japan (Q1).
21 Spain: foreign trade (March).
23 Spain: loans, deposits and NPL ratio (March).
27 Portugal: state budget execution (April).
28 Spain: state budget execution (April).
Euro area: economic sentiment index (May).
30 Spain: CPI flash estimate (May).
31 Spain: balance of payments (March).
Portugal: quarterly national accounts (Q1).

JUNE 2019

4 Spain: registration with Social Security and registered unemployment (May).
6 Governing Council of the European Central Bank meeting.
7 Portugal: international trade (April).
18 Spain: quarterly labour cost survey (Q4).
18-19 Federal Open Market Committee meeting.
21 Portugal: coincident indicators (May).
23 Spain: loans, deposits and NPL ratio (Q1 and April).
Portugal: quarterly national accounts (Q1).
24 Spain: balance of payments and NIIP (Q1).
Portugal: housing prices (Q1).
Portugal: balance of payments (April).
27 Spain: CPI flash estimate (June).
Spain: household savings rate (Q1).
Spain: state budget execution (May).
Euro area: economic sentiment index (June).
Euro area: European Council meeting.
28 Spain: quarterly national accounts (Q1).
Spain: balance of payments (April).
Portugal: CPI flash estimate (June).

The global economic outlook looks somewhat better than expected

Nothing can stop US growth (for the time being). In the early months of 2019, the US experienced some very severe weather conditions. There was also a federal government shutdown, which lasted longer than previous episodes. The economic activity indicators reported were irregular or, in some cases, even weak. The outlook for the trade tensions, while certainly moving in the right direction, remains far from being given the all-clear. The result of all this? An economic growth of 0.8% quarter-on-quarter (3.2% annualised) and of 3.2% year-on-year in Q1 2019. This represents better growth than expected and higher than that of Q4, which already exceeded expectations. It could be argued that the composition f growth, with a large component relating to the accumulation of inventories, suggests that the pattern of growth in Q1 may not be indicative of the next few quarters to come. Nevertheless, for the time being, the Americans are still dancing to the tune of their economic activity. And so are the Chinese. Q1 growth, which stood at 6.4% year-on-year, confirmed that the rate of economic expansion is stabilising. We know that the effective level of growth is lower than the official figures suggest. Nevertheless, even assuming this gap exists, the economic activity indicators reiterate that the Chinese authorities are once again overcoming the worst omens. As in the case of the US, the future should bring less growth. For China, and by extension for the world, it is important that this transition to lower growth involves a soft and controlled landing.

The cocktail of uncertainty in Europe goes down better than expected. While in other parts of the world the party goes on, albeit with the knowledge that the time for a slower dance is coming soon, in the Old Continent it came to an end almost before it started. This is evidenced by the rapid succession in recent months of analysts' and institutions' downward revisions of their 2019 growth expectations. Following these changes in the scenario, the outlook is dominated by the high degree of uncertainty surrounding the soap opera that is Brexit, the unpredictable Italian saga, the outcome of the European elections, the shock experienced in the automotive sector and the doubts over the protectionist shift in global trade. This is a combination of factors that is difficult to read into. And yet, just when everyone was expecting a mediocre growth figure for Q1 came the surprise that the euro area economy had grown by 0.4% quarter-on-quarter. That said, this good news does not change the underlying tone of the European scenario: until the downside factors dissipate, growth will be held back.

***Allegro ma non troppo* in the Iberian Peninsula.** The economies of Spain and Portugal are dancing at their own pace, which is somewhat better than that of their counterparts in the rest of the euro area. At least, that is what the growth figures indicate. The Spanish economy grew by 0.7% quarter-on-quarter in Q1 2019 (2.4% year-on-year), a slightly higher rate than that registered in the previous quarter and clearly above that of the euro area as a whole. The key to Spain's cyclical decoupling remains the strength of domestic demand, which combines a still reasonably strong tone in private consumption with a recovery in investment that is proving to be somewhat more spirited than expected. Portugal, meanwhile, could be en route to achieving growth of 0.5% quarter-on-quarter in Q1 2019, or even slightly more, based on the trends in the economic activity indicators. In both cases, looking beyond the composition of growth shown by the national accounts, there is an underlying structural improvement evident in various areas (deleveraging in the private sector, a restoration of health to the banking sector, a recovery of foreign competitiveness and an improvement in the public finances). There is also a particular sensitivity to the tailwinds. These are two fronts that have facilitated Spain and Portugal's greater growth rate relative to their European counterparts. However, without too much drama, growth is expected to reduce to somewhat less dynamic rates over the coming quarters. In this context, and once the electorally loaded months of April and May have passed, it will be important for Spain's future government to fine tune the orchestra. After all, future periods of prosperity will need to be harnessed with appropriate policies from as early as the first few bars, and the Portuguese cabinet that emerges from the legislative elections next October will need to follow suit.

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

Financial markets

	Average 2000-2007	Average 2008-2016	2017	2018	2019	2020	2021
INTEREST RATES							
Dollar							
Fed funds (upper limit)	3.43	0.48	1.50	2.50	2.50	2.50	2.25
3-month Libor	3.62	0.70	1.61	2.79	2.70	2.65	2.40
12-month Libor	3.86	1.20	2.05	3.08	2.85	2.80	2.55
2-year government bonds	3.70	0.73	1.84	2.68	2.55	2.60	2.50
10-year government bonds	4.70	2.61	2.41	2.83	2.75	2.80	2.70
Euro							
ECB depo	2.05	0.40	–0.40	–0.40	–0.40	–0.10	0.00
ECB refi	3.05	1.00	0.00	0.00	0.00	0.25	0.50
Eonia	3.12	0.65	–0.34	–0.36	–0.35	–0.10	0.15
1-month Euribor	3.18	0.79	–0.37	–0.37	–0.33	–0.08	0.18
3-month Euribor	3.24	0.98	–0.33	–0.31	–0.28	–0.05	0.20
6-month Euribor	3.29	1.14	–0.27	–0.24	–0.18	0.05	0.35
12-month Euribor	3.40	1.34	–0.19	–0.13	–0.08	0.15	0.50
Germany							
2-year government bonds	3.41	0.69	–0.69	–0.60	–0.40	–0.10	0.35
10-year government bonds	4.30	1.98	0.35	0.25	0.40	0.70	1.20
Spain							
3-year government bonds	3.62	2.30	–0.04	–0.02	0.02	0.19	0.64
5-year government bonds	3.91	2.85	0.31	0.36	0.42	0.56	1.00
10-year government bonds	4.42	3.82	1.46	1.42	1.40	1.50	1.90
Risk premium	11	184	110	117	100	80	70
Portugal							
3-year government bonds	3.68	4.42	–0.05	–0.18	–0.17	0.10	0.72
5-year government bonds	3.96	5.03	0.46	0.47	0.44	0.69	1.27
10-year government bonds	4.49	5.60	1.84	1.72	1.60	1.85	2.35
Risk premium	19	362	149	147	120	115	115
EXCHANGE RATES							
EUR/USD (dollars per euro)	1.13	1.30	1.18	1.14	1.15	1.19	1.23
EUR/JPY (yen per euro)	129.50	126.36	133.70	127.89	125.35	126.14	130.38
USD/JPY (yen per dollar)	115.34	97.50	113.02	112.38	109.00	106.00	106.00
EUR/GBP (pounds per euro)	0.66	0.83	0.88	0.90	0.85	0.84	0.83
USD/GBP (pounds per dollar)	0.59	0.63	0.75	0.79	0.74	0.71	0.68
OIL PRICE							
Brent ($/barrel)	42.3	85.6	64.1	57.7	66.0	63.0	63.0
Brent (euros/barrel)	36.4	64.8	54.2	50.7	57.4	52.9	51.2

Forecasts

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

International economy

	Average 2000-2007	Average 2008-2016	2017	2018	2019	2020	2021
GDP GROWTH							
Global	4.5	3.3	3.8	3.6	3.3	3.4	3.5
Developed countries	*2.7*	*1.2*	*2.4*	*2.2*	*1.8*	*1.7*	*1.6*
United States	2.7	1.4	2.2	2.9	2.4	1.7	1.7
Euro area	2.3	0.4	2.5	1.8	1.3	1.5	1.4
Germany	1.6	1.1	2.5	1.5	1.0	1.6	1.6
France	2.0	0.6	2.3	1.5	1.4	1.5	1.5
Italy	1.5	–0.7	1.8	0.7	0.4	0.8	0.7
Portugal	1.5	–0.4	2.8	2.1	1.8	1.7	1.7
Spain	3.8	0.0	3.0	2.6	2.3	1.9	1.7
Japan	1.5	0.4	1.9	0.8	0.8	0.7	0.8
United Kingdom	2.8	1.0	1.8	1.4	1.3	1.5	1.5
Emerging countries	*6.5*	*5.2*	*4.8*	*4.5*	*4.3*	*4.6*	*4.6*
China	11.7	8.4	6.9	6.6	6.2	6.0	5.8
India	9.7	6.9	6.9	7.4	6.9	6.2	6.0
Indonesia	5.5	5.7	5.1	5.2	4.9	4.8	5.9
Brazil	3.6	1.7	1.1	1.1	2.1	2.0	2.2
Mexico	2.4	2.1	2.1	2.0	1.6	2.1	2.5
Chile	5.0	3.2	1.3	4.0	3.2	3.0	2.8
Russia	7.2	1.0	1.6	2.2	1.8	2.0	2.3
Turkey	5.4	4.8	7.3	2.9	–2.5	2.3	3.0
Poland	4.0	3.2	4.8	5.1	3.5	2.9	2.4
South Africa	4.4	1.8	1.5	0.7	1.6	1.8	2.0
INFLATION							
Global	4.2	3.8	3.2	3.6	3.5	3.4	3.4
Developed countries	*2.1*	*1.5*	*1.7*	*2.0*	*1.6*	*1.7*	*1.8*
United States	2.8	1.6	2.1	2.4	2.0	1.9	1.9
Euro area	2.1	1.4	1.5	1.8	1.3	1.5	1.8
Germany	1.7	1.3	1.7	1.9	1.4	1.6	1.9
France	1.8	1.2	1.2	2.1	1.3	1.5	1.8
Italy	1.9	1.5	1.3	1.2	0.8	1.3	1.6
Portugal	3.0	1.2	1.4	1.0	0.8	1.4	1.7
Spain	3.2	1.3	2.0	1.7	1.4	1.6	1.9
Japan	–0.3	0.3	0.5	1.0	0.7	1.3	1.3
United Kingdom	1.9	2.3	2.7	2.5	2.0	2.0	2.1
Emerging countries	*6.8*	*5.8*	*4.3*	*4.8*	*4.9*	*4.6*	*4.5*
China	1.7	2.6	1.6	2.1	2.4	2.4	2.6
India	4.5	8.5	3.3	3.9	3.4	4.9	5.1
Indonesia	8.4	5.7	3.8	3.2	2.4	2.6	2.8
Brazil	7.3	6.4	3.5	3.7	4.1	4.1	4.1
Mexico	5.2	3.9	6.0	4.9	4.1	3.7	3.5
Chile	3.1	3.5	2.2	2.7	2.9	3.0	3.0
Russia	14.2	9.3	3.7	2.9	4.9	4.0	4.0
Turkey	27.2	8.1	11.1	16.2	19.5	12.0	9.0
Poland	3.5	2.1	1.6	1.2	2.0	2.5	2.5
South Africa	5.3	6.2	5.3	4.6	4.2	5.3	5.3

Forecasts

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

Spanish economy

	Average 2000-2007	Average 2008-2016	2017	2018	2019	2020	2021
Macroeconomic aggregates							
Household consumption	3.6	–0.7	2.5	2.3	1.8	1.7	1.6
Government consumption	5.0	0.8	1.9	2.1	1.7	1.5	1.4
Gross fixed capital formation	6.0	–3.4	4.8	5.3	3.5	2.9	2.5
Capital goods	5.3	0.3	6.0	5.4	4.4	3.0	2.6
Construction	6.2	–6.1	4.6	6.2	3.6	2.9	2.5
Domestic demand (vs. GDP Δ)	4.6	–1.2	2.9	2.9	2.1	1.9	1.7
Exports of goods and services	4.8	2.7	5.2	2.3	1.1	3.7	3.6
Imports of goods and services	7.1	–1.0	5.6	3.5	0.3	4.0	3.7
Gross domestic product	**3.8**	**0.0**	**3.0**	**2.6**	**2.3**	**1.9**	**1.7**
Other variables							
Employment	3.4	–1.3	2.8	2.5	2.2	1.6	1.5
Unemployment rate (% of labour force)	10.5	20.8	17.2	15.3	13.6	12.2	11.0
Consumer price index	3.2	1.3	2.0	1.7	1.4	1.6	1.9
Unit labour costs	3.3	0.2	0.2	0.8	2.1	2.3	2.4
Current account balance (cum. % GDP)	–6.0	–1.6	1.8	0.9	0.6	0.7	0.7
External funding capacity/needs (cum., % GDP)	–5.3	–1.2	2.1	1.5	0.8	0.9	0.9
Fiscal balance (cum., % GDP)[1]	0.4	–7.0	–3.0	–2.5	–2.4	–1.8	–1.5

Note: *1. Excludes losses for assistance provided to financial institutions.*

Forecasts

Portuguese economy

	Average 2000-2007	Average 2008-2016	2017	2018	2019	2020	2021
Macroeconomic aggregates							
Household consumption	1.7	–0.2	2.3	2.5	2.0	1.8	1.7
Government consumption	2.3	–0.6	0.2	0.8	0.8	0.3	0.2
Gross fixed capital formation	–0.3	–3.5	9.2	4.4	4.0	4.0	3.8
Capital goods	1.3	0.0	13.7	6.0	5.9	5.9	5.9
Construction	–1.6	–6.3	8.3	3.1	2.5	2.5	2.5
Domestic demand (vs. GDP Δ)	1.4	–1.0	3.1	2.8	2.4	1.9	1.8
Exports of goods and services	5.2	3.5	7.8	3.7	3.8	4.0	4.6
Imports of goods and services	3.6	1.6	8.1	4.9	4.9	4.1	4.5
Gross domestic product	**1.5**	**–0.4**	**2.8**	**2.1**	**1.8**	**1.7**	**1.7**
Other variables							
Employment	0.4	–1.1	3.3	2.3	0.8	0.5	0.3
Unemployment rate (% of labour force)	6.1	12.2	8.9	7.0	6.5	6.2	6.0
Consumer price index	3.0	1.2	1.4	1.0	0.8	1.4	1.7
Current account balance (% GDP)	–9.4	–4.2	0.5	–0.6	–0.7	–0.5	–0.3
External funding capacity/needs (% GDP)	–7.9	–2.9	1.4	0.4	0.3	0.5	0.5
Fiscal balance (% GDP)	–4.4	–6.3	–3.0	–0.5	–0.4	–0.3	0.1

Forecasts

The financial markets remain buoyant

Investor optimism returns. In April, the publication of economic activity data and encouraging business profits contributed to the recovery of investor sentiment, which had been somewhat wary in March. In addition to the progress in the trade negotiations between the US and China and central banks continuing to express their intention not to tighten their monetary policy in the coming quarters, in April this supported a reduction in volatility in the financial markets, a recovery in yield rates (which had fallen in March) and greater buoyancy in the stock markets. However, as was emphasised by the ECB (at its April meeting) and the various communications of other major central banks, the main risks surrounding the growth scenario remained tilted to the downside and, as already happened in previous quarters, could lead to new spikes of volatility.

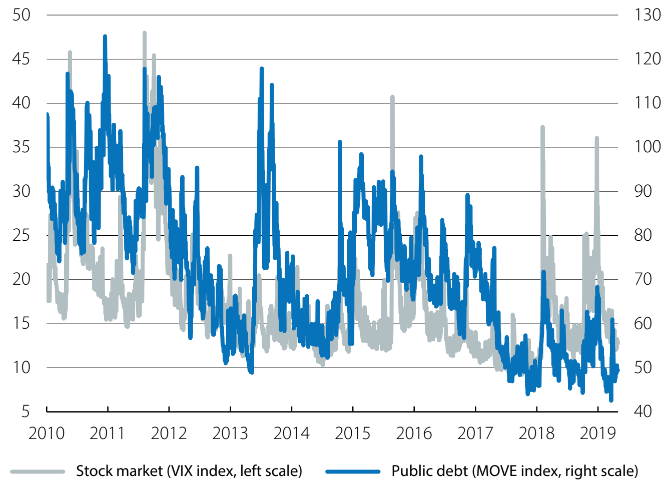
The stock markets show stronger growth. The recovery of investor sentiment was especially noted in the equity markets. They also benefited from a good start to the season of the publication of business profits relating to Q1 2019, given that, in the US in particular, most of the results reported up until the closing date of this *Monthly Report* exceeded market expectations (it should be recalled that, at the end of 2018, analysts lowered their general expectations due to the prospect of a slowdown in global economic activity). Thus, after brining a strong first quarter to a close (+13% in the case of the MSCI World Index), albeit with a less optimistic final month of March, in April the main international stock markets showed renewed buoyancy. In particular, the US' S&P 500 rose by around 4% and exceeded its all-time high registered in September 2018. In Europe, meanwhile, the Eurostoxx 50 rose by around 5%, as a result of good performance both in the economies of the core of the euro area and in those of the periphery.

Sovereign debt yields recover. While in March sovereign interest rates had dropped due to investors' doubts over global growth, in April they recovered thanks to the improvement in sentiment and, in particular, the publication of good economic growth data in China, the US and the euro area (see the International Economy section in this same *Monthly Report*). In particular, sovereign interest rates in Germany and the US rose steadily and Germany's 10-year yield returned to positive territory. In addition, the inversion of the US sovereign yield curve was reversed (after lasting just one week, a much shorter period than on previous occasions when the inversion of the yield curve had predicted a recession around a year in advance). In the periphery of the euro area, meanwhile, the risk premiums of Spain and Portugal fell by around 20 bps, while Italy's differential remained stable due to the persistence of doubts over the country's fiscal policy.

An ECB on hold puts the spotlight on the downside risks. As expected, at its meeting in April, the ECB left the parameters

Implicit volatility in the financial markets

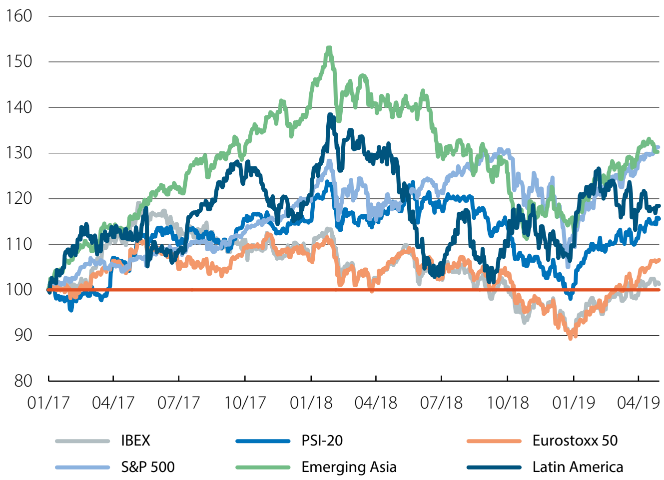
Index *Index*



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

Main international stock markets

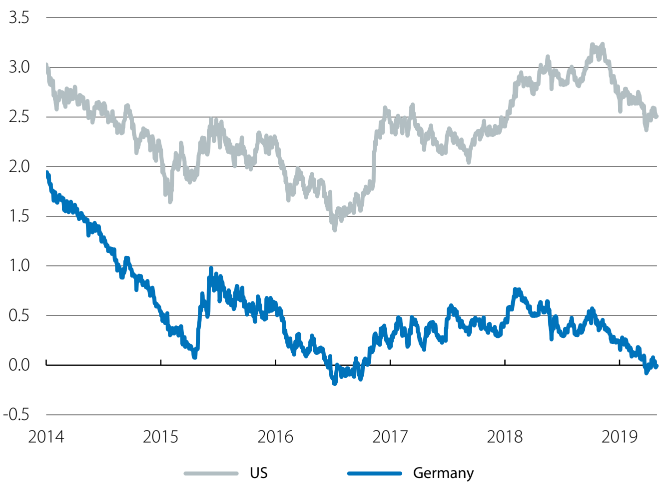
Index (100 = January 2017)



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

Yield on 10-year sovereign bonds

(%)



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

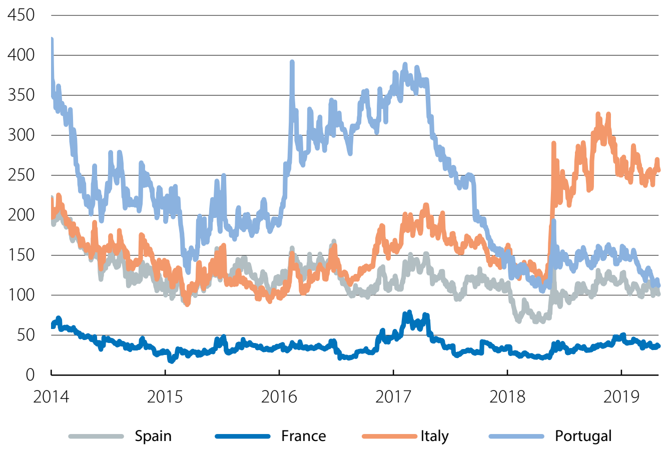
of its monetary policy unchanged and focused on analysing the state of the euro area's economy. The institution reiterated a relatively positive outlook for the medium term, emphasising that the likelihood of recession for the region is low and that the moderation of growth is a response to temporary factors and headwinds of a global nature (such as geopolitical tensions and the slowdown in China), while the dynamism of the labour market and domestic demand support the continuity of the expansion. In the short term, however, the ECB indicated that the economic activity data remained weak, particularly in the manufacturing sector (the meeting was prior to the publication of the euro area's GDP for Q1, which was higher than expected), and it recalled that the outlook remains dominated by major downside risks. As such, the entity undertook to closely monitor the evolution of the economy and the extent to which the current bump that the euro area is experiencing persists. This assessment will be key when it comes to making new decisions in upcoming meetings, such as on the cost at which the targeted longer-term refinancing operations (TLTROs) announced in March will be offered, or the assessment as to whether the ECB should take measures to mitigate the possible adverse effects of a prolonged period of low interest rates.

The Fed maintains its discourse of patience. Although the US economy is growing at a solid rate and the labour market is in full employment, the absence of firmer inflationary pressures and the prospect of the economy slowing down in the coming quarters have led the Fed to pause its cycle of interest rate hikes which it began in 2015. It even went as far as noting that it does not anticipate any rise in the reference rates in 2019. Following on from this, the most recent messages from the members of the Fed suggest that sustained increases in inflation above 2% would be needed prior to tightening monetary policy again. They also suggest that the institution will remain patient over the coming months, waiting to see how the economic indicators evolve before taking any decisions on interest rate changes.

Oil prices rise. In the context of improved investor sentiment in April, the price of a barrel of Brent oil continued to rise, temporarily exceeding 75 dollars after the US confirmed the end of the exemptions to sanctions on importers of Iranian crude oil. This was added to statements from some OPEC members that they would not take any major measures to compensate for lower exports from Iran, although OPEC and its main partners must still assess the extension of the agreement on production cuts that has supported the recovery in the price of crude oil in recent months (probably at its meeting in June).

Euro area: risk premiums of 10-year sovereign bonds

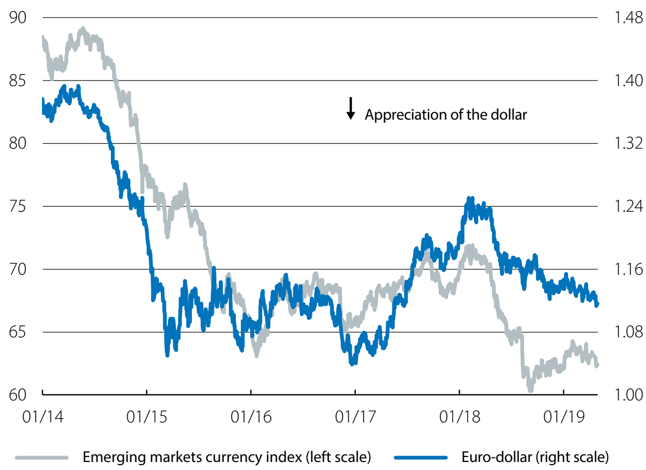
(bps)



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.*

Interest rates (%)

	30-Apr	31-Mar	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	–0.31	–0.31	0	–0.1	1.9
1-year Euribor	–0.11	–0.11	0	0.3	7.5
1-year government bonds (Germany)	–0.53	–0.55	2	3.8	8.9
2-year government bonds (Germany)	–0.58	–0.60	2	2.6	–1.0
10-year government bonds (Germany)	0.01	–0.07	8	–22.9	–56.8
10-year government bonds (Spain)	1.00	1.10	–10	–41.5	–31.0
10-year government bonds (Portugal)	1.12	1.25	–14	–60.7	–57.8
US					
Fed funds	2.50	2.50	0	0.0	75.0
3-month Libor	2.58	2.60	–2	–23.2	21.3
12-month Libor	2.72	2.71	1	–28.9	–6.0
1-year government bonds	2.37	2.39	–1	–22.2	14.0
2-year government bonds	2.27	2.26	1	–22.2	–22.2
10-year government bonds	2.50	2.41	10	–18.2	–46.5

Spreads corporate bonds (bps)

	30-Apr	31-Mar	Monthly change (bp)	Year-to-date (bp)	Year-on-year change (bp)
Itraxx Corporate	58	66	–8	–30.8	2.9
Itraxx Financials Senior	69	79	–11	–40.0	9.9
Itraxx Subordinated Financials	141	161	–20	–87.6	22.1

Exchange rates

	30-Apr	31-Mar	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
EUR/USD (dollars per euro)	1.122	1.122	0.0	–2.2	–6.2
EUR/JPY (yen per euro)	125.020	124.350	0.5	–0.6	–4.8
EUR/GBP (pounds per euro)	0.860	0.861	0.0	–4.3	–2.3
USD/JPY (yen per dollar)	111.420	110.860	0.5	1.6	1.4

Commodities

	30-Apr	31-Mar	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
CRB Commodity Index	422.1	426.5	–1.0	3.2	–5.3
Brent ($/barrel)	72.8	68.4	6.4	35.3	–0.8
Gold ($/ounce)	1,283.6	1,292.3	–0.7	0.1	–1.6

Equity

	30-Apr	31-Mar	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
S&P 500 (USA)	2,945.8	2,834.4	3.9	17.5	11.8
Eurostoxx 50 (euro area)	3,514.6	3,351.7	4.9	17.1	–1.1
Ibex 35 (Spain)	9,570.6	9,240.3	3.6	12.1	–5.1
PSI 20 (Portugal)	5,390.6	5,206.6	3.5	13.9	–2.0
Nikkei 225 (Japan)	22,258.7	21,205.8	5.0	11.2	–1.0
MSCI Emerging	1,079.2	1,058.1	2.0	11.7	–6.3

2019: a better than expected start to the year, but downside risks persist

The expansion of the global economy continues, but the growth outlook moderates. As a result of the maturity of the cycle, geopolitical uncertainty, trade tensions and temporary burdens on key economies, global economic activity has been progressing at a more contained rate in recent quarters. This is reflected in indicators such as the composite Purchasing Managers' Index (PMI) which, despite increasing slightly in March (52.8 points) thanks to the improvement in services, remains hampered by the weakness of the industrial sector (the manufacturing PMI remained at 50.6 points, barely above the 50-point threshold). This environment of more moderate growth is also reflected in the new macroeconomic forecasts that the IMF presented in April. The institution revised downwards its global growth forecasts (down to 3.3% for 2019 from the 3.5% forecasted in January), especially for the advanced economies, and maintained the balance of risks skewed to the downside. Despite this review, and as noted by the IMF itself, the rate of economic activity could show a better tone as the year progresses. This is because of the pause in the tightening of monetary policy by the major central banks, the maintenance of an expansive fiscal policy in countries such as China, the thaw in the trade dispute between the US and China, and the fading of the temporary burdens.

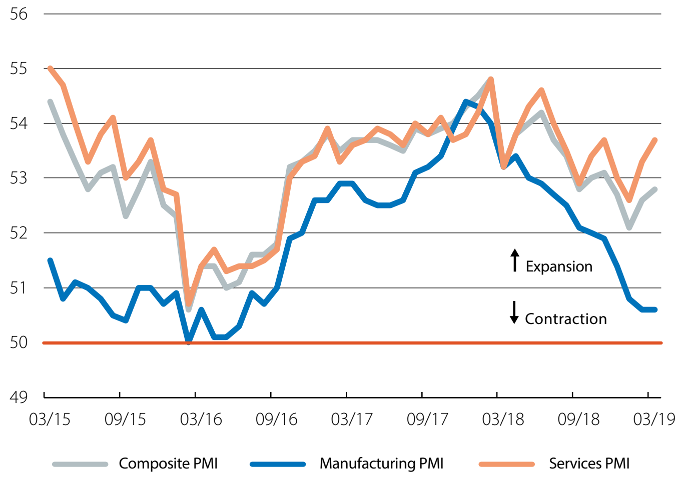
From the thaw in trade tensions to uncertainty over Brexit. In the sphere of trade, the US and China appear increasingly close to reaching an agreement which would favour a reduction in uncertainty at the global level. On this note, the US trade representative Robert Lighthizer and the Treasury secretary Steven Mnuchin travelled to China in late April with the goal of bringing the trade negotiations between the two countries to an end. The US has already announced that part of the negotiations cover aspects such as intellectual property, the forced transfer of technology and non-tariff barriers. But while the US and China are steering their trade tensions, the uncertainty surrounding Brexit persists. In particular, the EU granted the United Kingdom a new extension of article 50, this time until 31 October, in order to allow more time to reconsider the exit strategy. The United Kingdom will have until then to ratify the withdrawal agreement, although a wide range of possibilities remain open (ranging from repealing article 50 entirely and cancelling Brexit, to a no-deal departure). However, the extension reduces fears of a disorderly Brexit (an option that has also been rejected by a large majority of the British Parliament).

EURO AREA

Economic activity in the euro area proved higher than expected in Q1 2019. In particular, GDP grew by 0.4%

Global economic activity indicators

Level



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

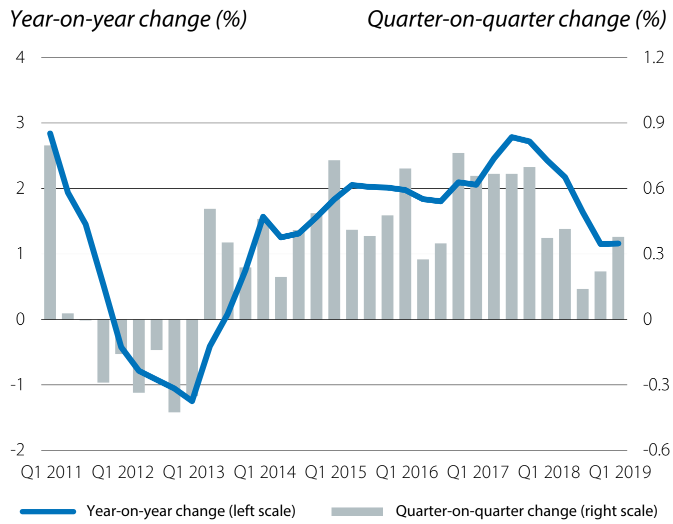
GDP: leading economies

Annual change (%)

	2018	2019 (f)	2020 (f)
Global economy	3.6	3.3	3.4
Advanced economies	2.2	1.8	1.7
US	2.9	2.4	1.7
Euro area	1.8	1.3	1.5
Spain	2.6	2.3	1.9
Portugal	2.1	1.8	1.7
Emerging economies	4.5	4.3	4.6
China	6.6	6.2	6.0

Note: *(f) CaixaBank Research forecast.*
Source: *CaixaBank Research.*

Euro area: GDP



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

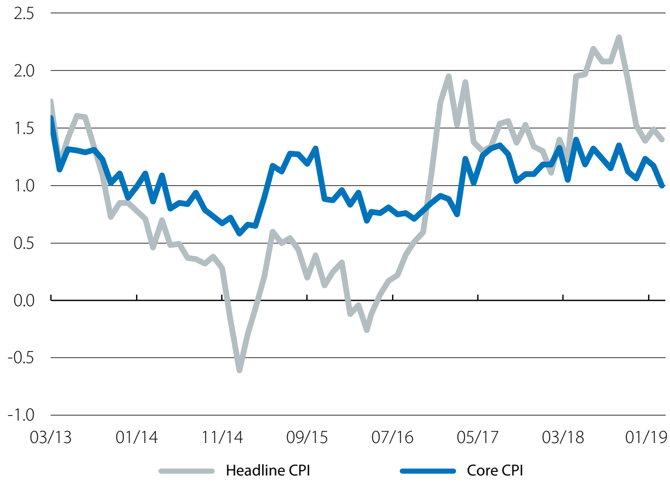
quarter-on-quarter, 2 decimal points above the figure for Q4 2018 and higher than our forecast and analysts' consensus. The figure proved to be a positive surprise, since the modest figures recorded by some sentiment indicators and the problems experienced in the industrial sector in the first part of the year indicated that the moderation seen in the second half of 2018 would continue into Q1. In fact, the euro area economy had gone from growth rates of 0.4% quarter-on-quarter in early 2018 to levels of around 0.2% by the end of 2018. Part of this slowdown reflects the impact of a temporary factor: the disruptions in the automotive sector following the new European emissions regulations. However, two factors of a longer-lasting nature have also held back economic activity: the slowdown in global trade and political sources of uncertainty (the resolution of Brexit, the conflict surrounding Italy's fiscal policy and the trade tensions between the US and China). As such, as some of these factors fade over the coming months, the euro area will show better performance in the second half of the year. By country for those we have data for, Spain showed particular promise, with growth of 0.7% quarter-on-quarter (see the section on Spanish Economy in this same *Monthly Report*), as did France (0.3%). Italy's GDP rose by 0.2% in quarter-on-quarter terms, a modest figure but nevertheless an improvement after two consecutive quarters with negative quarter-on-quarter growth. In this context, the containment of inflationary pressures in the euro area (1.4% year-on-year in March, 1 decimal point below the figure for the previous month, largely due to the slowdown in core inflation down to 1.0%) still suggests a very gradual recovery in inflation towards the ECB's target rate (~2%) and reinforces the view that the institution will maintain an accommodative policy over the coming quarters.

The more moderate dynamics in the growth of the euro area continue at the start of Q2. The PMIs for the euro area showed no sign of rising in April, indicating that growth in the region remains contained. In particular, the compound PMI for the euro area remained at modest levels (51.3 points in April, after the 51.6 points registered in March) and fell below analysts' expectations. In the breakdown by sector, the manufacturing PMI remained within contractionary territory (at 47.8 points), while that of services (at 52.5 points) fell by 0.8 points. Similarly, the consumer confidence index deteriorated slightly in April, reaching –7.7 points. This figure is worse than expected and breaks the trend of improvement seen between December and March. Thus, on the whole, the latest data suggest that the euro area economy has not yet overcome its temporary burdens at the beginning of Q2.

US

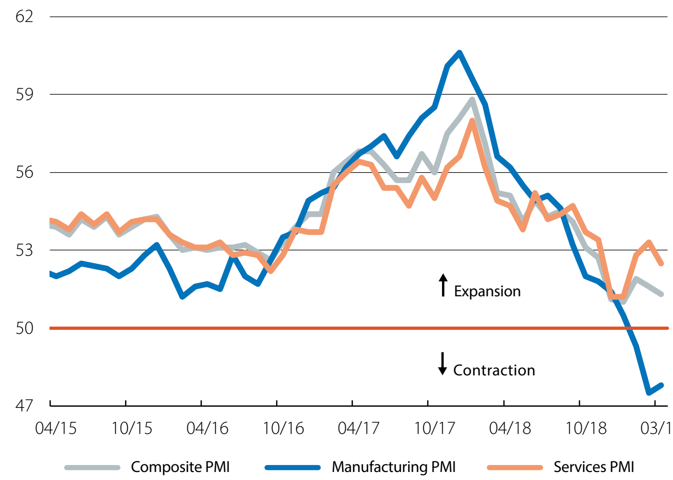
GDP data provide a positive surprise in the US. Economic activity grew by a solid 0.8% quarter-on-quarter (3.2% annualised) in Q1 2019, and by 3.2% year-on-year. This represents an improvement with respect to the previous quarter (when it stood at 0.5% quarter-on-quarter) and provided a positive surprise, since economic activity was expected to be held back by three factors: (i) the partial

Euro area: Harmonised CPI
Year-on-year change (%)



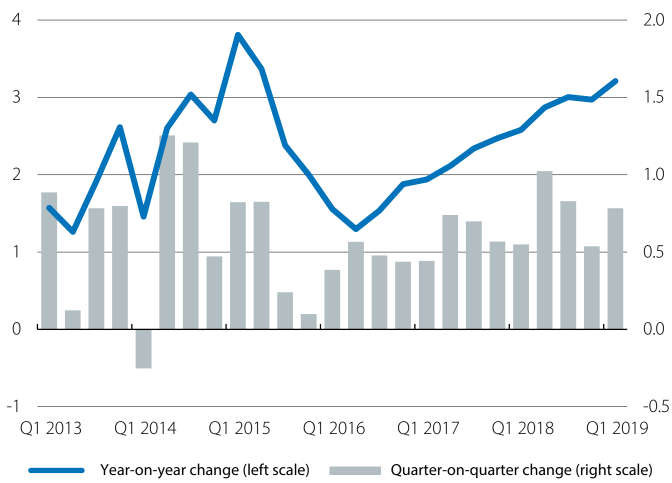
Source: *CaixaBank Research, based on data from Eurostat.*

Euro area: PMI economic activity indicators
Level



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

US: GDP
Year-on-year change (%) *Quarter-on-quarter change (%)*



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

federal government shutdown in January, (ii) the extreme cold that struck the north of the country, and (iii) the fact that the US statistics office tends to underestimate GDP growth in the first quarter. By components of demand, the acceleration in Q1 2019 was supported by external demand (with the improvement in exports and the drop in imports), inventory investment and public consumption. These are all elements that should subside over the coming quarters. In contrast, private consumption and business investment, which are mainstays of domestic demand, saw a slowdown in their growth rates, which is indicative of the future slowdown in US economic activity. Thus, despite the encouraging figure, we still expect a slowdown in the US economy, albeit somewhat more gradually than anticipated before the publication of the data: from 2.9% in 2018 down to 2.4% in 2019.

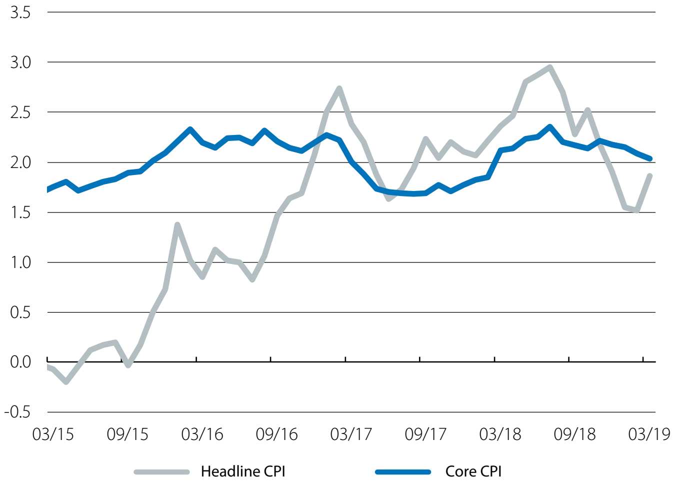
Contained inflationary pressures support the patience of the Fed. Although headline inflation picked up in March, core inflation, which has a closer correlation with economic activity, remained stable. In particular, headline inflation stood at 1.9% (4 decimal points above the figure for the previous month), largely due to the rise in fuel prices. On the other hand, core inflation, which excludes energy and food, stood at 2.0% (2.1% in February). This context of restrained inflationary pressures supports the Fed's current strategy of remaining patient in relation to its monetary policy.

EMERGING MARKETS

China experiences a pause in its slowdown and registers GDP growth of 6.4% year-on-year in Q1 2019. The figure, which coincided with that registered in Q4 2018 and was slightly higher than expected, reflected the improvement in industrial activity: by components of supply, manufacturing saw a significant acceleration in its year-on-year growth rate (from 5.8% in Q4 2018 to 6.1% in Q1 2019), in contrast with services (which saw a drop from 7.6% to 7.0%). The encouraging figure was also supported by the decline in trade tensions, following the progress made in the negotiations between China and the US, as well as by the positive impact of the monetary and fiscal stimulus measures undertaken by the Chinese government (described in the Economic Outlook section of the MR04/2019). These policies have allayed fears of a hard landing in the short term and the Chinese economy is expected to decelerate very gradually over the coming quarters. That said, its economic transition is complex and notable underlying imbalances persist (such as high corporate debt).

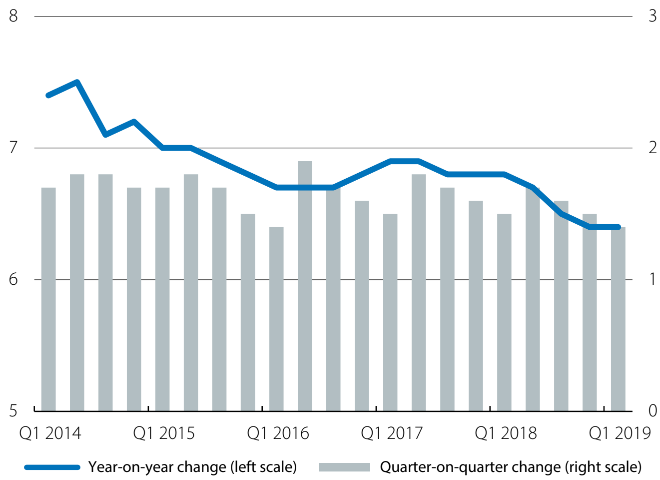
The Russian economy wrapped up a better than expected 2018 but faces a slowdown in 2019. In particular, Russia's GDP grew by 2.2% in 2018, following higher than expected growth at the end of the year (2.7% year-on-year in Q4, compared to 2.2% in Q3). As for 2019, however, we anticipate a moderate slowdown in growth to levels below 2%. Political uncertainty (with the situation in Ukraine and the threat of new international sanctions), a scenario with only a moderate rise expected in the oil price, and the return to rates more in line with the country's potential will support this trend.

US: CPI
Year-on-year change (%)



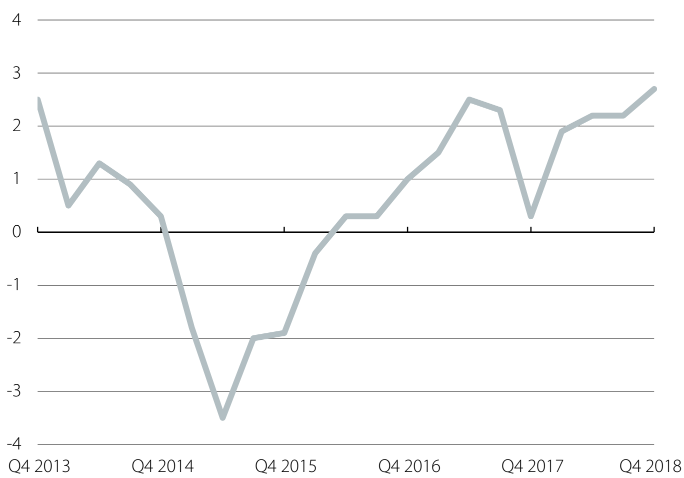
Source: *CaixaBank Research, based on data from the Bureau of Labor Statistics.*

China: GDP
Year-on-year change (%) *Quarter-on-quarter change (%)*



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

Russia: GDP
Year-on-year change (%)



Source: *CaixaBank Research, based on data from the Federal Statistics Service of Russia.*

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

UNITED STATES

	2016	2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	01/19	02/19	03/19
Activity									
Real GDP	1.6	2.2	2.6	2.9	3.0	3.0	–	3.2	–
Retail sales (excluding cars and petrol)	3.4	4.2	4.4	5.2	5.4	3.5	4.4	2.8	3.6
Consumer confidence *(value)*	99.8	120.5	127.1	127.2	132.6	133.6	121.7	131.4	124.1
Industrial production	–2.0	2.3	3.4	3.4	5.0	4.0	3.7	3.5	2.8
Manufacturing activity index (ISM) *(value)*	51.3	57.4	59.7	58.7	59.7	56.9	56.6	54.2	55.3
Housing starts *(thousands)*	1.177	1.208	1.317	1.261	1.234	1.185	1.298	1.142	1.139
Case-Shiller home price index *(value)*	189	200	209	211	212	214	215	215	...
Unemployment rate *(% lab. force)*	4.9	4.4	4.1	3.9	3.8	3.8	4.0	3.8	3.8
Employment-population ratio *(% pop. > 16 years)*	59.7	60.1	60.3	60.4	60.4	60.6	60.7	60.7	60.6
Trade balance [1] *(% GDP)*	–2.7	–2.8	–2.9	–2.9	–2.9	–3.0	–3.0	–3.0	...
Prices									
Headline inflation	1.3	2.1	2.2	2.7	2.6	2.2	1.6	1.5	1.9
Core inflation	2.2	1.8	1.9	2.2	2.2	2.2	2.2	2.1	2.0

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

JAPAN

	2016	2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	01/19	02/19	03/19
Activity									
Real GDP	0.6	1.9	1.2	1.4	0.1	0.3	–	...	–
Consumer confidence *(value)*	41.7	43.8	44.4	43.7	43.4	42.8	41.8	41.5	40.5
Industrial production	0.2	2.9	2.0	1.3	–0.1	0.5	0.7	–1.2	–3.0
Business activity index (Tankan) *(value)*	7.0	19.0	24.0	21.0	19.0	19.0	–	12.0	–
Unemployment rate *(% lab. force)*	3.1	2.8	2.5	2.4	2.4	2.4	2.5	2.3	2.5
Trade balance [1] *(% GDP)*	0.7	0.5	0.4	0.4	0.1	–0.2	–0.4	–0.3	–0.4
Prices									
Headline inflation	–0.1	0.5	1.3	0.6	1.1	0.9	0.2	0.2	0.5
Core inflation	0.6	0.1	0.4	0.3	0.3	0.3	0.4	0.4	0.5

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	Q1 2018	Q2 2018	Q3 2018	Q4 2018	01/19	02/19	03/19
Activity									
Real GDP	6.7	6.8	6.8	6.7	6.5	6.4	–	6.4	–
Retail sales	10.4	10.3	9.9	9.0	9.0	8.3	8.2	8.2	8.7
Industrial production	6.1	6.6	6.6	6.6	6.0	5.7	5.3	5.3	8.5
PMI manufacturing *(value)*	50.3	51.6	51.0	51.6	51.1	49.9	49.5	49.2	50.5
Foreign sector									
Trade balance [1] *(value)*	512	420	404	377	349	352	373	345	383
Exports	–8.4	7.9	13.7	11.5	11.7	4.0	9.2	–20.8	14.2
Imports	–5.7	16.3	19.4	20.6	20.4	4.4	–1.5	–5.2	–7.6
Prices									
Headline inflation	2.0	1.6	2.2	1.8	2.3	2.2	1.7	1.5	2.3
Official interest rate [2] *(value)*	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4
Renminbi per dollar *(value)*	6.6	6.8	6.4	6.4	6.8	6.9	6.8	6.7	6.7

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.*

EURO AREA

Activity and employment indicators

Values, unless otherwise specified

	2016	2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	01/19	02/19	03/19
Retail sales *(year-on-year change)*	1.6	2.5	1.7	1.8	1.2	1.7	2.2	2.8	...
Industrial production *(year-on-year change)*	1.6	3.0	3.1	2.3	0.5	–2.0	–0.7	–0.3	...
Consumer confidence	–8.6	–6.0	–4.2	–5.3	–5.7	–6.9	–7.9	–7.4	–7.2
Economic sentiment	104.1	110.1	113.2	111.8	110.9	108.9	106.3	106.2	105.6
Manufacturing PMI	52.5	57.4	58.3	55.5	54.3	51.7	50.5	49.3	47.5
Services PMI	53.1	55.6	56.4	54.6	54.4	52.8	51.2	52.8	53.3
Labour market									
Employment (people) *(year-on-year change)*	1.4	1.6	1.6	1.6	1.4	1.3	–	...	–
Unemployment rate *(% labour force)*	10.0	9.1	8.5	8.3	8.0	7.9	7.8	7.8	7.7
Germany *(% labour force)*	4.2	3.8	3.5	3.4	3.4	3.3	3.2	3.2	3.2
France *(% labour force)*	10.1	9.4	9.2	9.1	9.0	8.9	8.9	8.8	8.8
Italy *(% labour force)*	11.7	11.3	10.9	10.7	10.3	10.6	10.4	10.5	10.2
Spain *(% labour force)*	19.7	17.2	16.1	15.4	15.0	14.5	14.3	14.2	14.0

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

Prices

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

	2016	2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	01/19	02/19	03/19
General	0.2	1.5	1.3	1.7	2.1	1.9	1.4	1.5	1.4
Core	0.8	1.1	1.2	1.2	1.2	1.2	1.2	1.2	1.0

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	Q1 2018	Q2 2018	Q3 2018	Q4 2018	01/19	02/19	03/19
Current balance	**3.3**	**3.5**	**3.6**	**3.7**	**3.4**	**3.2**	**3.2**	**3.1**	**...**
Germany	8.4	8.0	7.9	8.1	7.5	7.3	7.2	7.1	...
France	–0.8	–0.6	–0.4	–0.3	–0.5	–0.3	–0.1	–0.2	...
Italy	2.5	2.6	2.6	2.7	2.6	2.5	2.6	2.6	...
Spain	2.3	1.8	1.8	1.6	1.3	0.9	0.9	0.8	...
Nominal effective exchange rate [1] *(value)*	**94.3**	**96.5**	**99.6**	**98.5**	**99.2**	**98.5**	**97.8**	**97.4**	**96.8**

Note: *1. Weighted by flow of foreign trade. Higher figures indicate the currency has appreciated.*
Source: *CaixaBank Research, based on data from the Eurostat, European Commission and national statistics institutes.*

Credit and deposits of non-financial sectors

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

	2016	2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	01/19	02/19	03/19
Private sector financing									
Credit to non-financial firms	1.8	2.5	3.3	3.7	4.2	3.9	3.4	3.8	3.5
Credit to households [1,2]	1.7	2.6	2.9	2.9	3.1	3.2	3.2	3.3	3.2
Interest rate on loans to non-financial firms [3] *(%)*	1.4	1.3	1.2	1.2	1.2	1.2	1.2	1.2	...
Interest rate on loans to households for house purchases [4] *(%)*	1.8	1.7	1.6	1.6	1.6	1.6	1.6	1.6	...
Deposits									
On demand deposits	10.0	10.1	9.2	8.0	7.3	7.1	6.4	6.9	7.7
Other short-term deposits	–1.8	–2.7	–2.2	–1.5	–1.4	–0.9	–0.8	–0.2	–0.2
Marketable instruments	2.4	1.4	–5.8	–3.2	–5.6	–3.3	–0.1	–0.2	–4.9
Interest rate on deposits up to 1 year from households *(%)*	0.5	0.4	0.4	0.4	0.3	0.3	0.3	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.*

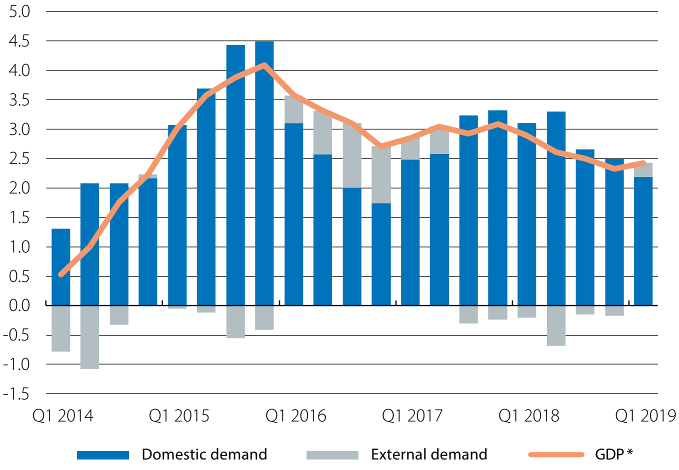
The Spanish economy maintains a steady pulse

Growth gains traction in Q1 2019. According to data from the National Statistics Institute of Spain, GDP grew in the first quarter of the year by 0.7% quarter-on-quarter (2.4% year-on-year), above the average growth of the euro area (0.4% quarter-on-quarter). In the breakdown by component, the data show that domestic demand remained the main driver of growth, boosted mostly by investment. As such, following the temporary fall that occurred in Q4 2018 (–0.2% quarter-on-quarter), investment rebounded in earnest to grow by 1.5% quarter-on-quarter. Growth in private consumption also remained strong, albeit more moderate than in the previous quarter (–0.1 pps down to 0.3% quarter-on-quarter). Although this stands in contrast to the strong growth in employment shown by the data from the labour force survey (LFS), it is still considered normal given the inherent volatility of the series. In addition, the figure is consistent with CaixaBank Research's scenario, which predicts that consumers will moderate their rate of spending in 2019 after having followed through, over the past few years, on the consumer choices that were postponed during the financial crisis. External demand, meanwhile, continued the improvement it had shown in the previous quarter and contributed 0.2 pps to GDP growth in quarter-on-quarter terms. However, this contribution was due to the fact that imports fell by more than exports (–1.1% and –0.5% quarter-on-quarter, respectively). As such, we see that the trade flows continue to moderate, as we would expect in the current global context of trade tensions and moderation in the growth of the euro area. Overall, incorporating this figure has led us to revise the GDP growth forecast for 2019 slightly upwards by 0.2 pps, bringing it to 2.3%.

The economic activity indicators remain encouraging. Although the economic activity data for the second quarter of the year are not yet known, the latest available indicators show that economic activity has gained strength in the year to date. The PMI for the services sector rebounded in March by 2.3 points up to 56.8 points, the highest value since February 2018. The index for the manufacturing sector, meanwhile, remained somewhat contained but nevertheless rose by 1 point up to 50.9. On the other hand, retail sales grew by 1.7% year-on-year in March, 0.3 pps more than in February and above the average for 2018 (0.7%). Finally, the most modest figure came from industrial production, which remained stagnant (–0.2% year-on-year). This figure reflects, at least in part, the current troubles in the automotive sector, which continues to feel the impact of the Europe-wide changes in the regulation of the sector and the lower momentum of external demand.

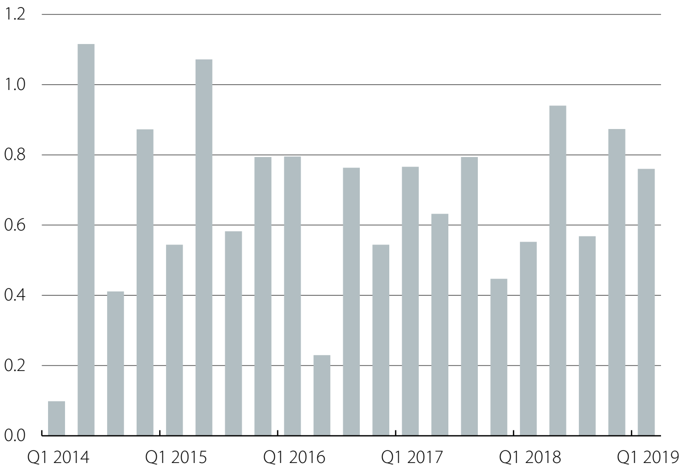
The labour market provides a pillar of growth. The labour market performed very well in the first quarter of the year, as shown by the fact that job creation rose by 0.2 pps up to 3.2% year-on-year (597,000 jobs were created in the past 12 months), the fastest rate in the past three years. The latest

Spain: GDP
Contribution to year-on-year growth (pps)



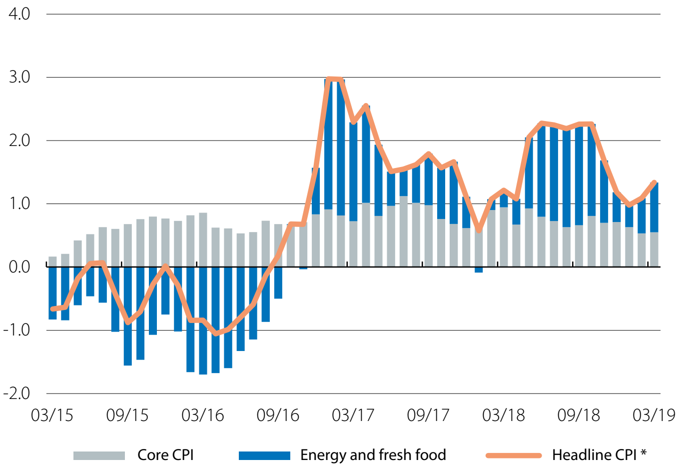
Note: ** Year-on-year change (%).*
Source: *CaixaBank Research, based on data from the National Statistics Institute.*

*Spain: employment **
Quarter-on-quarter change (%)



Note: ** Seasonally-adjusted series.*
Source: *CaixaBank Research, based on data from the National Statistics Institute (LFS).*

Spain: CPI
Contribution to year-on-year growth (pps)



Note: ** Year-on-year change.*
Source: *CaixaBank Research, based on data from the National Statistics Institute.*

data from the quarterly labour cost survey, meanwhile, have confirmed the slight rising trend in wages. More specifically, the cost of labour per effective hour increased by 1.4% in 2018 (0.0% in 2017). In addition, the wage increases agreed in collective labour agreements stood at 2.2% in March, 0.7 pps higher than the value registered in March 2018. Thus, the buoyancy of the labour market is contributing to maintaining a positive climate of confidence and to increasing households' gross disposable income.

Slight rebound in inflation in March. Headline inflation stood at 1.3% year-on-year in March (1.1% in February) and increased for the second consecutive month following three months of moderation. However, this was not reflected in core inflation, which remained at 0.7%. In other words, the rebound in inflation was entirely due to the non-core components, and more specifically to fuel and electricity prices.

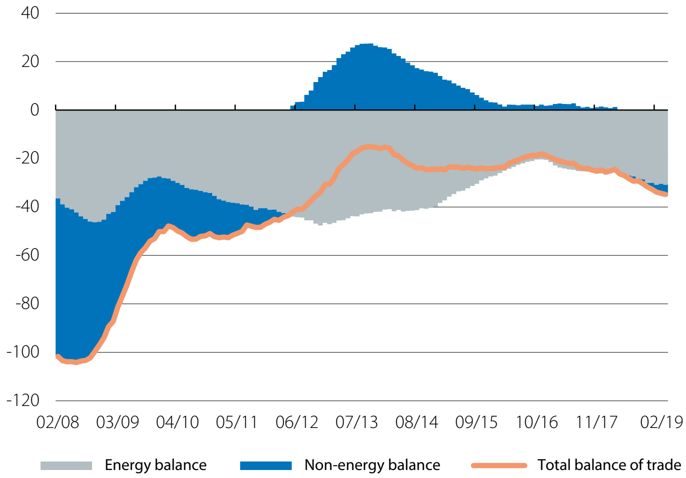
Non-energy goods continue to reduce the current account surplus. The current account balance stood at 9,380 million euros in February 2019 (0.77% of GDP), 1.0 pp below the figure for February 2018 (1.79% of GDP). By component, 7 tenths of this decrease can be explained by the deterioration in the balance of goods, of which 4 tenths correspond to non-energy goods and 3 to the increase in the price of oil. The lower surplus in services, meanwhile, deducted 3 tenths from the current account surplus, distributed equally between tourism and non-tourism services. Finally, the balance of revenues (–1.1%) remains virtually unchanged thanks to accommodative financial conditions that are keeping the cost of external debt under control.

The general government deficit deteriorates slightly. The budget implementation data available up to February reflect a deterioration in the public accounts for the general government as a whole, with the exception of local government corporations. Thus, in the first two months of the year, the cumulative public deficit increased by 1 decimal point relative to the figure for February 2019, standing at 0.95% of GDP. It should be noted, however, that this result is affected by several extraordinary factors, on both the revenue and the expenditure sides (accounting effects, the temporary suspension of the tax on the value of electricity production and refunds related to maternity benefits, among others). As for the central government deficit, based on the data available up to March it stood at 0.54% of GDP, 2 decimal points above the figure for March 2018.

Deleveraging continues in the private sector. In 2018, the debt of households and non-financial corporations stood at 58.9% and 93.2% of GDP, respectively, 2.2 and 3.2 pps below the figures for 2017. As such, household debt now lies close to the euro area average (57.6%), while that of non-financial corporations remains clearly below it (euro area average of 105.9%). This sustained reduction in debt, for the sixth consecutive year, shows that the Spanish economy is now in a healthier position. Looking ahead to the next few quarters, we expect private sector debt to continue to fall, albeit at more moderate rates.

Spain: balance of trade

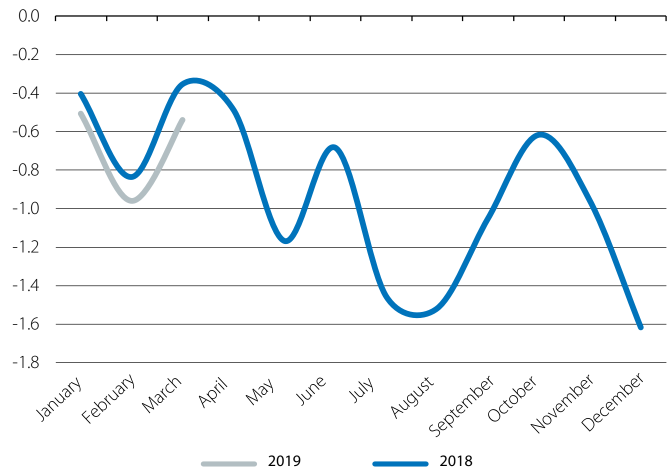
12-month cumulative balance (EUR billions)



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

Central government balance

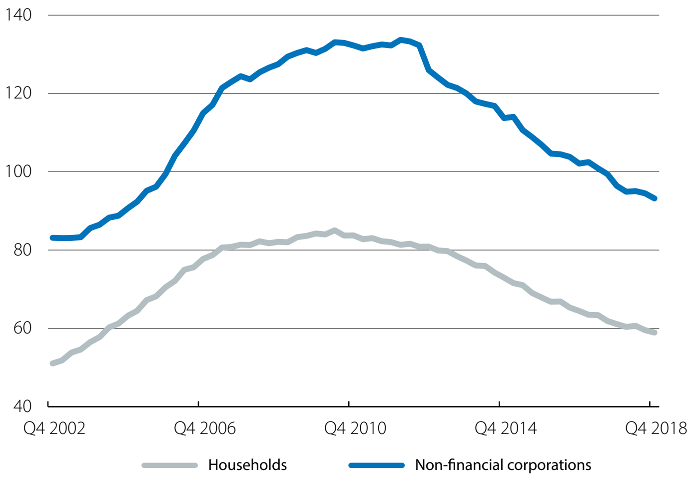
(% of GDP)



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

Private sector debt

(% of GDP)



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

Activity and employment indicators

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

	2017	2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	02/19	03/19	04/19
Industry									
Industrial production index	3.2	0.3	1.1	0.5	–2.7	...	–0.3	...	...
Indicator of confidence in industry *(value)*	1.0	–0.1	1.2	–2.6	–1.9	–3.8	–5.2	–2.2	–4.9
Manufacturing PMI *(value)*	54.8	53.3	53.7	52.4	51.8	...	49.9	50.9	...
Construction									
Building permits *(cumulative over 12 months)*	22.9	25.7	28.1	25.8	23.9	...	25.5	...	...
House sales *(cumulative over 12 months)*	14.1	13.9	15.7	13.2	11.0	...	7.2	...	...
House prices	6.2	6.7	6.8	7.2	6.6	...	–	–	–
Services									
Foreign tourists *(cumulative over 12 months)*	10.0	4.0	5.3	1.5	0.9	–1.4	1.1	...	...
Services PMI *(value)*	56.4	54.8	55.8	52.6	54.0	55.3	54.5	56.8	...
Consumption									
Retail sales	1.0	0.7	0.0	–0.4	1.4	1.4	1.4	1.7	...
Car registrations	7.9	7.6	9.2	17.0	–7.6	–7.0	–8.8	–4.3	...
Consumer confidence index *(value)*	–3.4	–4.2	–3.0	–3.7	–6.2	–4.8	–5.4	–2.0	–6.1
Labour market									
Employment [1]	2.6	2.7	2.8	2.5	3.0	3.2	–	–	–
Unemployment rate (% labour force)	17.2	15.3	15.3	14.6	14.4	14.7	–	–	–
Registered as employed with Social Security [2]	3.6	3.1	3.1	2.9	3.0	2.9	2.9	2.9	...
GDP	**3.0**	**2.6**	**2.6**	**2.5**	**2.3**	**2.4**	**–**	**–**	**–**

Prices

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

	2017	2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	02/19	03/19	04/19
General	2.0	1.7	1.8	2.2	1.7	1.1	1.1	1.3	1.5
Core	1.1	0.9	1.0	0.8	0.9	0.7	0.7	0.7	...

Foreign sector

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

	2017	2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	01/19	02/19	03/19
Trade of goods									
Exports *(year-on-year change, cumulative over 12 months)*	8.9	2.9	5.2	4.5	2.9	...	2.2	...	...
Imports *(year-on-year change, cumulative over 12 months)*	10.5	5.6	6.9	6.2	5.6	...	5.2	...	...
Current balance	**21.5**	**11.3**	**18.7**	**15.0**	**11.3**	**...**	**9.4**	**...**	**...**
Goods and services	33.6	23.5	30.3	26.7	23.5	...	22.3	...	...
Primary and secondary income	–12.1	–12.3	–11.6	–11.7	–12.3	...	–13.0	...	...
Net lending (+) / borrowing (–) capacity	**24.2**	**17.6**	**21.9**	**18.8**	**17.6**	**...**	**15.9**	**...**	**...**

Credit and deposits in non-financial sectors [3]

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

	2017	2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	02/19	03/19	04/19
Deposits									
Household and company deposits	2.8	3.2	3.0	3.4	3.7	5.1	5.5	5.4	...
Sight and savings	17.6	10.9	11.0	10.3	10.0	11.1	11.6	11.2	...
Term and notice	–24.2	–19.9	–20.7	–18.7	–16.8	–13.7	–13.7	–12.9	...
General government deposits	–8.7	15.4	17.6	10.4	16.9	17.8	16.4	19.6	...
TOTAL	**1.9**	**3.8**	**3.8**	**3.8**	**4.5**	**5.8**	**6.2**	**6.2**	**...**
Outstanding balance of credit									
Private sector	–2.2	–2.4	–2.8	–2.3	–2.2	–2.1	–2.3	–1.4	...
Non-financial firms	–3.6	–5.5	–6.4	–5.6	–5.7	–5.5	–6.0	–3.4	...
Households - housing	–2.8	–1.9	–2.0	–1.7	–1.4	–1.2	–1.1	–1.1	...
Households - other purposes	3.7	5.1	5.0	5.5	4.7	4.0	4.4	3.2	...
General government	–9.7	–10.6	–9.4	–8.9	–11.8	–10.3	–11.4	–8.4	...
TOTAL	**–2.8**	**–2.9**	**–3.2**	**–2.7**	**–2.8**	**–2.6**	**–2.8**	**–1.8**	**...**
NPL ratio *(%)* [4]	**7.8**	**5.8**	**6.4**	**6.2**	**5.8**	**5.7**	**5.8**	**5.7**	**...**

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.*

Portugal: favourable growth, but with doubts over the external sector

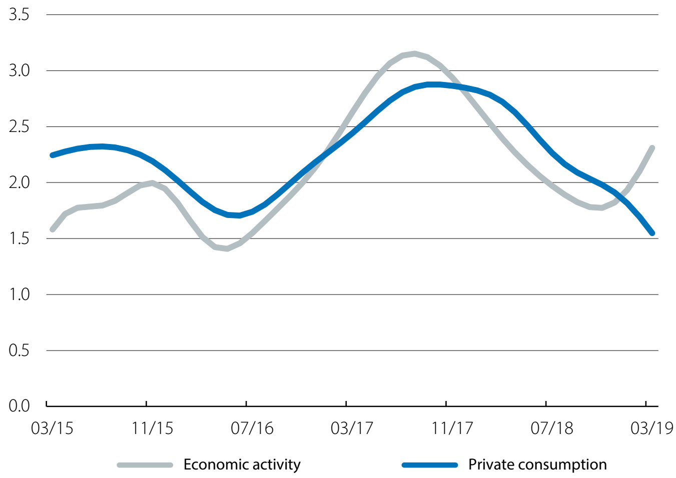
The economic activity indicators suggest a positive start to the year, despite some mixed signals. Pending the publication of GDP for Q1 2019, overall the indicators suggest that economic activity continued to grow at a steady pace in the first quarter of the year. Specifically, the coincident economic activity indicator developed by the Bank of Portugal, which historically corresponds closely to GDP growth, accelerated to 2.3% in March and stood at 2.1% on average for the quarter. In addition, the available data reflect a positive performance of investment in all its components and an acceleration in turnover in both the manufacturing and the services sector, thanks to an improvement in their economic sentiment indicators. Offsetting these encouraging dynamics, however, are some more mixed signals. The coincident indicator for private consumption continued to decline in Q1 2019, closing at 1.5% in March and with a quarterly average of 1.7% (3 decimal points less than in Q4 2018). This suggests that household consumption could have been less buoyant in the early stages of the year. On the other hand, as set out below, a more dissonant note continues to ring in the external sector, where the most recent figures continue to point towards an increase in the current account deficit which is partially restricting the country's capacity to reduce its external indebtedness.

The deterioration of the current account balance continued in February. The current account deficit stood at 1.9 billion euros (12-month cumulative balance), equivalent to 1.0% of GDP, reflecting a clear deterioration compared to last year's figure (–0.3% of GDP). This difference was due to the reduction in the deficit of goods (–7.7% of GDP), since both the balance of services (+8.2%) and that of income (–1.5%) remained practically unchanged. The balance of capital, meanwhile, remained in positive territory and more than offset the current account deficit (the overall balance stood at +0.1% of GDP in February). In this context, it is worth highlighting the importance of preserving an external surplus that allows the country to continue to reduce its net external debt (in 2018, this stood at 89% of GDP, 2.7 pps below the figure for 2017).

Tourism activity performs encouragingly at the start of the year. In total for January and February 2019, the number of foreign tourists increased by 6.0% compared to the same period last year. By origin, the recovery in the arrival of tourists from the United Kingdom was of particular note, growing by an impressive 7.2%, as was the marked increase in tourists from the US (25.3% year-on-year) and China (22.1%). On the other hand, the revenues of tourist accommodation establishments increased by 6.5% year-on-year thanks to the

Portugal: coincident economic activity indicators

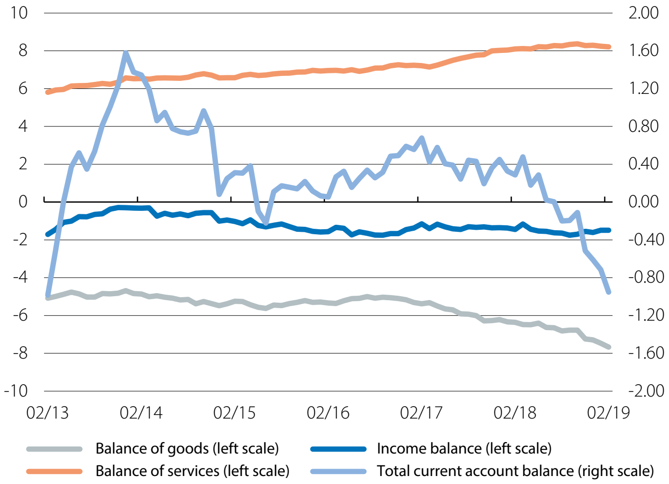
Year-on-year change (%)



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

Portugal: current account balance

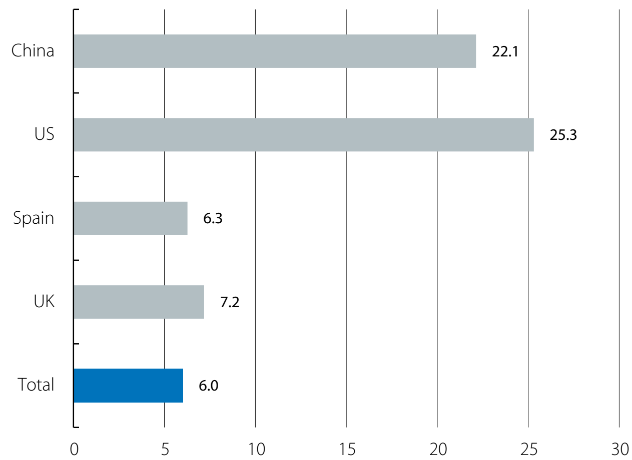
(% of GDP) *(% of GDP)*



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

Portugal: entry of tourists by origin

Year-on-year change (cumulative figure for January-February 2019, %)



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

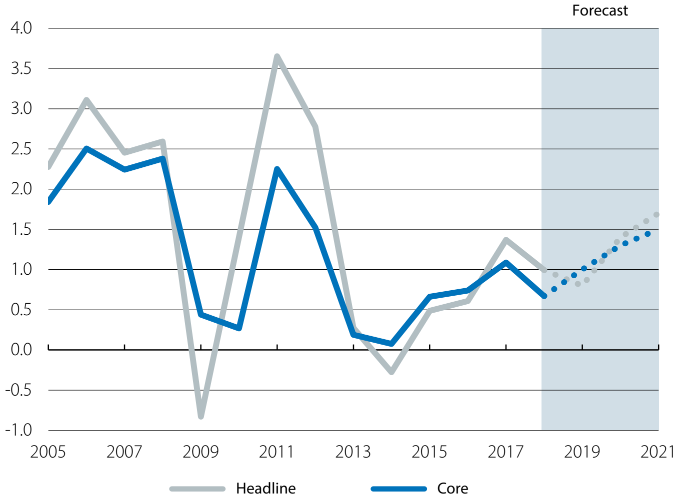
increase in the number of tourists, given that the average revenue per available room barely grew (from 25.3 euros to 25.8 euros).

Inflation remains at moderate levels. In April, headline inflation (measured according to the consumer price index) stood at 0.8% year-on-year, while core inflation (which excludes unprocessed food and energy prices, which are especially volatile) reached the same modest figure. This puts both measures only slightly above the 0.7% registered in March. Thus, for the past 12 months as a whole, headline inflation averaged 1.0% (the same as in March).

Corporations and households make progress in reducing their levels of indebtedness. In particular, in Q4 2018, the indebtedness of non-financial corporations and of households continued to decrease, reaching 100.6% and 66.9% of GDP, respectively (representing a reduction of 6.7 and 2.2 pps compared to Q4 2017). In addition, relative to the all-time highs recorded between 2009 and 2013, the debt of non-financial corporations has declined by 40.8 pps, while that of households has reduced by 25.2 pps.

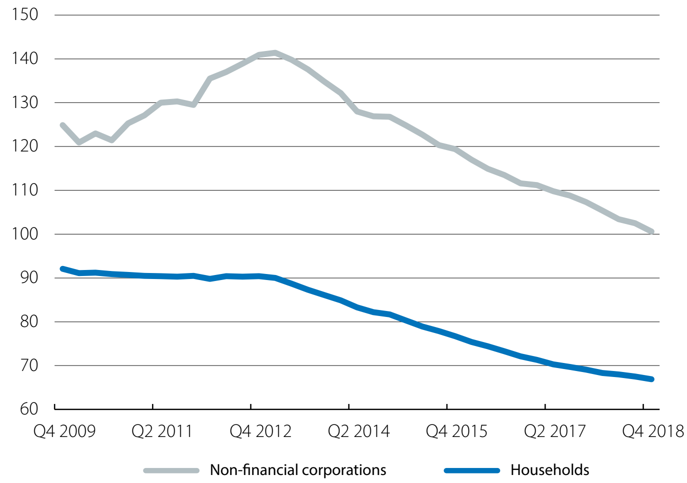
Private sector credit continues to contract. In particular, it registered a decline of 2.5% year-on-year in February, largely as a result of the contraction in lending to non-financial corporations (–5.6% year-on-year; excluding sales of doubtful loans, it would have increased by 0.5%). At the same time, lending to households fell by 0.6% year-on-year due to the contraction of lending for housing (–1.4% year-on-year, due to the fact that new lending is growing at a steady rate, albeit still not enough to offset repayments). Consumer credit, on the other hand, continued to show strong growth (9.4% year-on-year). The non-performing loan ratio for the private sector, meanwhile, fell from 14.6% in 2017 to 10.5% in 2018, thanks to a 29.0% annual reduction in doubtful loans. The segment that contributed the most to the improvement was that of companies, whose doubtful loans contracted by 7 billion euros during the year, bringing the NPL ratio among businesses down to 18.5% (–6.7 pps). The notable improvement in non-performing loans during 2018 can largely be attributed to the greater buoyancy of sales of doubtful loan portfolios, a trend that will continue during 2019.

Portugal: inflation (CPI)
Annual average (%)



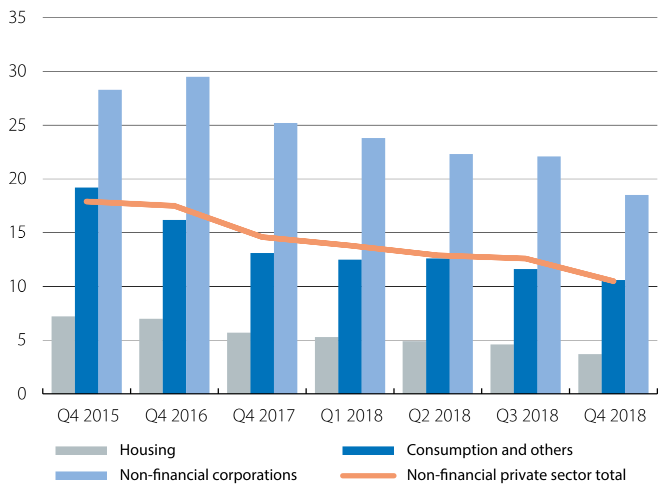
Source: *CaixaBank Research, based on data from the National Statistics Institute of Portugal.*

Portugal: private sector debt
(% of GDP)



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

Portugal: NPL ratio by segment
(%)



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

Portugal: macroprudential measures and the state of the housing credit cycle

- In Portugal, credit for the purchase of housing represents a significant portion of household debt, so in terms of financial stability, it is important to monitor its levels over time.
- Despite the significant recovery in new lending for the purchase of housing, the stock of this credit segment continues to contract due to early repayments.
- Looking ahead, the recovery in housing credit is likely to be gradual, with healthier lending criteria than in the past.

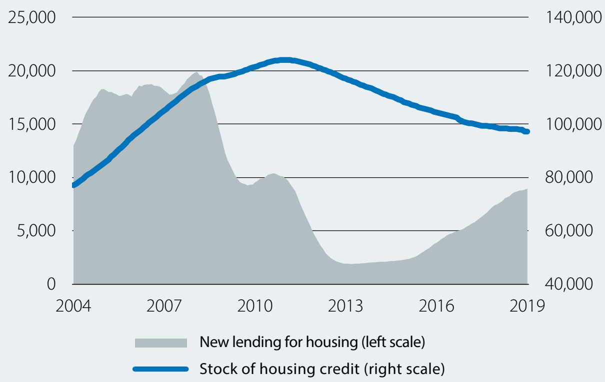
The financial system tends to be cyclical and the growth of credit tends to accompany and support the expansionary phases of the economy. For example, between 1995 and 2000 the Portuguese economy expanded at a rate of 4.0%, while total credit[1] increased by 22.1% (annual averages). This relationship also occurs in reverse order, that is, the contraction of the economy is usually both accompanied and accentuated by the decline in credit. This is what occurred during the sovereign debt crisis, when the Portuguese economy shrank at a rate of 2.3%, while credit fell by 4.8% (annual averages). In view of the links between financial and economic cycles, tools have been developed to smooth out fluctuations in credit and to foster financial stability.

In July 2018, the Bank of Portugal decided to apply a set of macroprudential measures to new contracts for housing loans, mortgage lending or equivalent and consumer credit.[2] In particular, these measures include: (i) limits on the loan-to-value (LTV)[3] ratio, which in the case of purchases of an own and permanent home is 90%; (ii) limits on the debt service-to-income (DSTI)[4] ratio, which must be equal to or less than 50%, with some exceptions;[5] (iii) limiting the duration of loans to 40 years, to be gradually reduced to 30 years by the end of 2022, and (iv) requiring capital and interest payments to be regular (i.e. without interest-only or grace periods). Other European countries, such as France and Finland, have also taken measures of this kind, with similar criteria or through other instruments. The Bank of Portugal justifies the implementation of these measures in Portugal based on the (still) high levels of household indebtedness, the low savings rate, the rise in new lending and some signs of excessive relaxation in lending criteria.

1. Includes lending to both the resident sector (households, general government, non-financial corporations and non-monetary financial institutions, except insurance companies and pension funds) and the non-resident sector.
2. These measures were implemented as a «recommendation»: banks are not bound by them, but if they choose not to implement them, they must justify themselves to the regulator.
3. Ratio between the amount of the loan and the property valuation.
4. Ratio between the sum of the monthly payments of all loans and the holder's net monthly income.
5. Up to 20% of the total amount of new credit granted by each financial institution in each year can involve a DSTI of up to 60%, and up to 5% of the total amount of new lending can exceed the DSTI limits.

Portugal: stock and flows of housing credit

12-month cumulative balance (EUR millions) (EUR millions)



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

So, with these measures, it aims to ensure that the financial system does not assume excessive risk and that households do not take on a high financial burden.

Where is Portugal in the housing credit cycle?

Portuguese families continue to have high levels of debt – despite having reduced them over the past few years. In 2018, household debt stood at 66.9% of GDP, a 25.2-pp reduction compared to the all-time high recorded in 2009 (92.1% of GDP), but still high compared to the euro area average (57.6%). This deleveraging process masks differing dynamics in the various credit segments. On the one hand, the stock of consumer credit has grown at considerable rates (9.4% year-on-year in February 2019), due to the recovery of the economy and the stock's low starting point. On the other hand, the stock of housing credit continues to contract, albeit in a less accentuated manner (–1.4% year-on-year in February 2019). In fact, in this segment, the buoyancy of new lending (+11.7% year-on-year in the first two months of 2019)[6] is still insufficient to offset repayments.[7]

6. New lending tailored for remortgages.
7. See Bank of Portugal (2018). «Relatório de Acompanhamento dos Mercados Bancários de Retalho». In 2017, the sum of repayments increased by 29.9% compared to 2016.

The main source of household debt is housing credit, which accounted for 73% of the total debt in Q3 2018. For this reason, it is worth taking a closer look at the dynamics of this segment. The rate of new lending for the purchase of housing has grown at a considerable rate, but still well below the levels seen prior to the 2008 financial crisis. More specifically, the granting of new loans increased by 17.9% in the past 12 months up to February 2019 as a whole, reaching 9 billion euros. However, new lending (4.3% of GDP) is substantially below the peak registered over 10 years ago (11.2% of GDP in 2007).

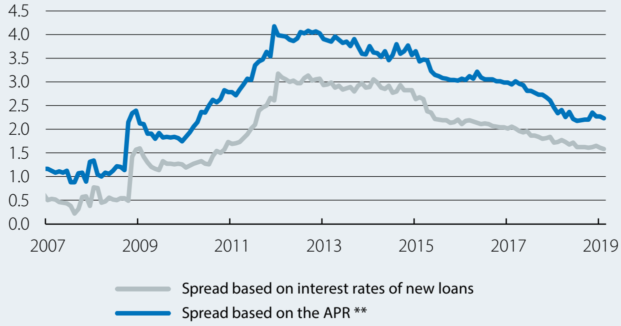
In turn, the average maturity of new loans for housing remains at levels below those registered in 2006, when it exceeded 35 years. Nevertheless, since 2015 the average maturity has increased slightly to 33.3 years in 2017,[8] slightly above the 30-year target set by the Bank of Portugal for new contracts by 2022. In addition, compared to other countries in the euro area, Portugal has a much higher than average maturity (for instance, in Spain the average maturity of new contracts drawn up in 2018 was 23.7 years). These high maturities are particularly relevant, since they hinder the possibility to extend the duration of loans in the event of renegotiation. Furthermore, they can lead to payments being prolonged beyond the retirement age (at which point people typically start to receive a lower income).

There is also a compression in the average interest rate spreads in new loans granted for housing (relative to the 6-month Euribor, for instance). This is to be expected in the current context of low interest rates, greater competition among banks and better prospects for the economy and the real estate market. However, as shown in the second chart, although the spreads have fallen since 2015, they remain well above the lows registered prior to 2008. This suggests that there is a greater awareness of the importance of interest rates correctly reflecting the risk profile of households, which is preventing the spreads from dropping to the low levels seen in the past.

The compression of the spreads also has an impact on the DSTI ratio, since it reduces the monthly payments on loans used for home purchases. This ratio has decreased in recent years, declining from around 35% in 2008 to below 20% in 2016. This reduction has been facilitated by the environment of low interest rates supported by the monetary policy of the ECB, as well as by the fact that a large proportion of mortgages have a variable interest rate (84.8% of loans for the purchase of housing were signed at a variable rate in the first two months of 2019). However, the high prevalence of variable-rate loans could pose a risk to the financial stability of households in a scenario of rising interest rates. Finally, the LTV ratio has also increased since 2013, but it remains at levels below those of 2006 (73.2% in 2017, compared to 79.6% in 2006). While this increase suggests less restrictive lending criteria, the average ratio of the economy remains substantially below the 90% limit set by the Bank of Portugal, which reduces the potential losses for the financial system in the event of defaults.

Portugal: new lending for housing: average spread *

(%)



Notes: ** Differential relative to the 6-month Euribor, the most widely used index for housing loans in Portugal (representing 48.6% of all contracts in force at the end of 2017). See Bank of Portugal (2018). «Relatório de Acompanhamento dos Mercados Bancários de Retalho».*
*** Annual percentage rate, which includes other costs in addition to interest charges.*
Source: *CaixaBank Research, based on data from the Bank of Portugal.*

In conclusion, the stock of housing credit in Portugal continues to decline because the strong growth in new lending is insufficient to counteract repayments on housing loans. However, this reduction in the total volume is expected to gradually moderate. Furthermore, the indicators that characterise the current state of the credit cycle, together with the measures implemented by the Bank of Portugal, suggest that there should not be any excessive growth in household borrowing in the short and medium term. In addition, they support the maintenance of healthier lending criteria than in the past, while also favouring the stability of the financial system and that of households themselves.

Vânia Duarte

8. See the Bank of Portugal's June 2018 financial stability report.

Activity and employment indicators

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

	2017	2018	Q3 2018	Q4 2018	Q1 2019	12/18	01/19	02/19	03/19	04/19
Coincident economic activity index	2.9	2.1	1.9	1.8	2.1	1.8	1.9	2.1	2.3	...
Industry										
Industrial production index	4.0	0.1	–1.6	–1.3	–4.1	–1.3	–2.6	–2.1	–7.6	...
Confidence indicator in industry *(value)*	2.1	0.8	0.6	–0.6	–1.5	–0.6	–1.0	–1.3	–2.3	–3.2
Construction										
Building permits *(cumulative over 12 months)*	15.6	20.3	13.7	20.3	...	20.3	...	...	...	...
House sales	20.5	16.8	18.4	9.4	...	9.4	...	...	...	...
House prices *(euro / m² - valuation)*	5.1	5.8	6.2	6.1	6.9	6.1	6.3	6.8	6.9	...
Services										
Foreign tourists *(cumulative over 12 months)*	16.0	3.0	6.9	3.5	...	3.0	3.0	2.8	...	...
Confidence indicator in services *(value)*	13.3	14.1	16.9	12.6	15.4	12.2	15.7	16.0	14.4	12.6
Consumption										
Retail sales	4.1	4.2	2.6	5.2	4.3	4.2	5.9	5.3	1.8	...
Coincident indicator for private consumption	2.7	2.4	2.2	2.0	1.7	1.9	1.8	1.7	1.5	...
Consumer confidence index *(value)*	–0.1	0.6	–0.2	–1.7	–8.3	–2.2	–7.2	–8.3	–9.5	–9.3
Labour market										
Employment	3.3	2.3	2.1	1.6	...	1.5	1.5	1.4	1.1	...
Unemployment rate (% labour force)	8.9	7.0	6.7	6.7	...	6.6	6.6	6.5	6.4	...
GDP	**2.8**	**2.1**	**2.1**	**1.7**	**...**	**1.7**	**...**	**...**	**...**	**...**

Prices

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

	2017	2018	Q3 2018	Q4 2018	Q1 2019	12/18	01/19	02/19	03/19	04/19
General	1.4	1.0	1.4	0.8	0.8	0.7	0.5	0.9	0.8	0.8
Core	1.1	0.7	0.8	0.5	0.8	0.6	0.8	1.0	0.7	0.8

Foreign sector

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

	2017	2018	Q3 2018	Q4 2018	Q1 2019	12/18	01/19	02/19	03/19	04/19
Trade of goods										
Exports *(year-on-year change, cumulative over 12 months)*	10.0	5.3	7.0	5.3	...	5.3	4.8	4.7	...	...
Imports *(year-on-year change, cumulative over 12 months)*	13.5	8.0	8.6	8.0	...	8.0	8.4	8.7	...	...
Current balance	**0.9**	**–1.2**	**–0.4**	**–1.2**	**...**	**–1.2**	**–1.4**	**–1.9**	**...**	**...**
Goods and services	3.5	2.0	3.1	2.0	...	2.0	1.6	1.1	...	...
Primary and secondary income	–2.6	–3.2	–3.5	–3.2	...	–3.2	–3.0	–3.0	...	...
Net lending (+) / borrowing (–) capacity	**2.7**	**0.9**	**1.6**	**0.9**	**...**	**0.9**	**0.7**	**0.2**	**...**	**...**

Credit and deposits in non-financial sectors

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

	2017	2018	Q3 2018	Q4 2018	Q1 2019	12/18	01/19	02/19	03/19	04/19
Deposits [1]										
Household and company deposits	1.7	3.8	4.4	4.2	...	4.7	5.0	4.7	...	...
Sight and savings	15.7	14.3	13.6	14.6	...	16.2	14.9	13.4	...	...
Term and notice	–5.8	–3.0	–2.1	–3.1	...	–3.3	–2.0	–1.6	...	...
General government deposits	1.3	–1.9	1.0	–9.9	...	–32.3	–15.7	–12.4	...	...
TOTAL	**1.6**	**3.5**	**4.2**	**3.4**	**...**	**2.7**	**4.0**	**3.9**	**...**	**...**
Outstanding balance of credit [1]										
Private sector	–4.0	–1.7	–1.4	–1.8	...	–2.1	–2.7	–2.5	...	...
Non-financial firms	–6.5	–3.8	–3.7	–4.5	...	–4.5	–6.0	–5.6	...	...
Households - housing	–3.1	–1.5	–1.2	–1.3	...	–1.7	–1.5	–1.4	...	...
Households - other purposes	0.9	4.5	5.8	5.2	...	4.2	3.5	3.4	...	...
General government	9.3	2.4	–12.4	–11.6	...	–12.9	–13.5	–13.4	...	...
TOTAL	**–3.5**	**–1.6**	**–1.9**	**–2.3**	**...**	**–2.6**	**–3.2**	**–3.0**	**...**	**...**
NPL ratio *(%)* [2]	**13.3**	**...**	**11.3**	**...**	**...**	**9.4**	**...**	**...**	**...**	**...**

Notes: *1. Aggregate figures for the Portuguese banking sector and residents in Portugal. 2. Period-end figure.*
Source: *CaixaBank Research, based on data from the National Statistics Institute, Bank of Portugal and Datastream.*

Medium-term outlook for the European economy: lower growth, but with room for improvement

- **Euro area growth will be lower over the coming years than in the previous expansive cycle.**
- **There are structural factors (low productivity, population ageing and imbalances in the labour market) that will limit the medium-term economic outlook.**
- **The buffers of the euro area have improved since the financial crisis, but the persistence of certain imbalances will hamper their full reconstruction.**

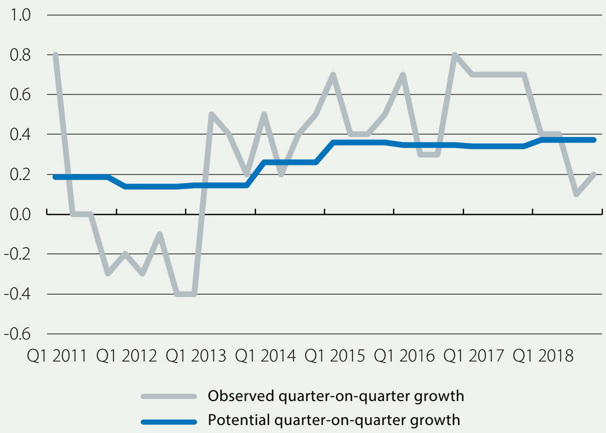
Medium-term economic outlook: lower growth

Beyond the cyclical fluctuations in the short term, what can we expect from the European economy in the medium term? This question is particularly important given the slowdown in economic activity in recent quarters and the expectation that the euro area will continue to grow at a more moderate pace over the coming months (we expect it to grow below 1.5% in 2019, after the 2.5% of 2017 and the 1.8% of 2018).

In fact, as we can see in the first chart, the growth of the European economy has followed a downward trend since 2017, and in the last two quarters of 2018 it has stood considerably below its potential, something not seen since the sovereign debt crisis of 2012. This downward trend has been largely driven by a spate of adverse shocks (trade tensions, Brexit, strikes, meteorology, problems in the automotive sector, etc.). Nevertheless, faced with the high sensitivity that the European economy has shown to such shocks, we must analyse how solid the foundations on which the economic activity stands really are. Looking to the future, we expect euro area growth over the next few years to be positive – thanks to the strength of domestic demand – but moderate, standing below that of the previous expansive cycle (growth of 2.2% between 2000 and 2007).

Euro area: GDP

Quarter-on-quarter change (%)



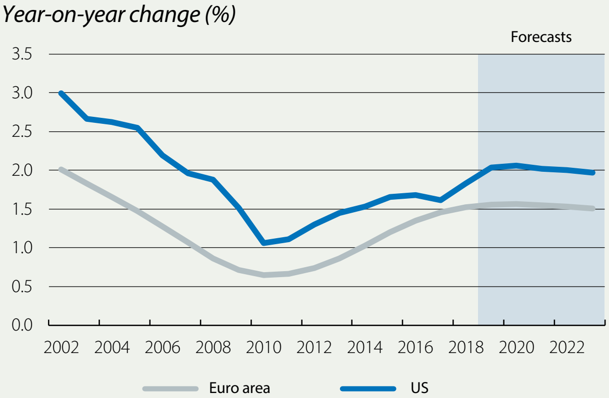
Source: *CaixaBank Research, based on data from Eurostat.*

In addition, the risks are skewed to the downside. On the one hand, the reduced support of the external environment, due to the slowdown in global demand, will make it difficult for exports to grow at high rates in the next few years. On the other hand, political uncertainty has come to stay and will remain ever present, whether due to Brexit or political polarisation. This trend can be observed in the evolution of the uncertainty index built by the academics Baker, Bloom and Davis for the euro area: between 2017 and 2018 it stood at 215 points, somewhat above the average for 2013-2016 (192) and well above the average of the previous expansive cycle (100 points on average in 2000-2007).

In order to assess the medium-term economic outlook for the euro area in more detail, a good guide is its potential GDP: what the European economy can produce in a sustainable manner, without generating pressures that drive inflation away from its target rate or cause other imbalances. In the second chart we can see that, according to our estimates, the potential growth of the euro area in the next five years will stand at around 1.5%. This is significantly lower than in the pre-crisis period (slightly above 2.0%), as well as being below our prediction for the US (1.9%).

Potential GDP *

Year-on-year change (%)



Note: ** Euro area estimates based on a Hodrick-Prescott filter, with economic growth data for the euro area and forecasts by CaixaBank Research. US estimates by the Congressional Budget Office (CBO).*
Source: *CaixaBank Research, based on data from the CBO.*

What factors lie behind this pattern of more moderate growth? The answer can be found in a series of structural factors that limit growth in the medium term. Essentially, these include the trends in productivity, demography, investment and structural imbalances in the labour market.

Starting with productivity, according to estimates by the European Commission, average growth in total factor productivity between 2018 and 2020 will stand at 0.7%, but with a decreasing trend (albeit in line with the 0.73% average rate for the past 20 years, excluding periods of crisis) and below that expected in the US (1.1% on average between 2018 and 2028). Following on from this, one of the factors holding back buoyancy in productivity is insufficient diffusion: studies show that productivity grows in companies that are already more productive, but this does not filter down to the rest of the economy.[1]

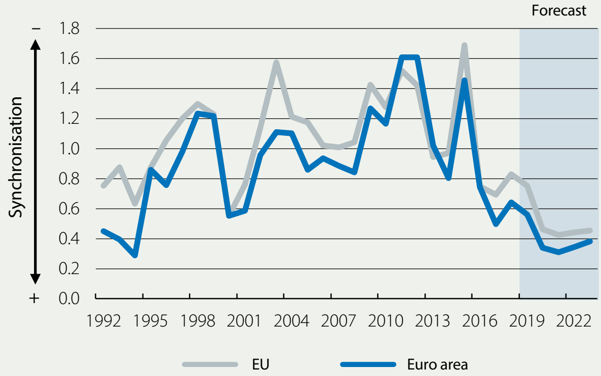
With regard to demography, the impact of population ageing will begin to become apparent. Not in vain, it is estimated that the dependency ratio[2] will increase between 2017 and 2026 by 5.4 pps due to the retirement of the baby boomers, reaching almost double that of the period 2009-2017. Population ageing will have an unquestionable impact on economic growth due to the reduction it entails for the labour force. In addition, this phenomenon could reduce the growth of Europe's productivity, measured in terms of total factor productivity.[3]

As for investment, it has proven to be one of the most dynamic components during the economic recovery. Nevertheless, its growth is expected to slow down in the next few years (following growth of 3.3% in 2018, the ECB expects it to grow by 2.2% in 2019-2021, 0.6 pps lower than the growth of 2000-2007). This is due to a moderate impact of geopolitical uncertainty on business sentiment and a gradual tightening of financial conditions.

Finally, structural unemployment in the euro area is expected to remain at relatively high levels (the European Commission projects a rate of 7.8% in 2020). This is in contract to the increasing difficulties that firms are experiencing to fill their vacancies with suitably qualified workers – a symptom of mismatches between the demand and supply of skills in the labour market. Such mismatches can limit production in the future: in 2030 just 36.5% of EU workers will be high-skilled, yet it is expected that 4 out of every 5 new jobs created will require a high level of qualification, largely due to technological change,[4] hence the importance of improving the human capital of the workforce.

Synchronisation of the business cycle in Europe

*Index **



Note: ** Weighted sum of the standard deviations of each country less the average growth of the EU or the euro area. As a method of weighting, we use each country's weight in terms of nominal GDP.*
Source: *CaixaBank Research, based on data from the IMF.*

Analysis of the euro area's mechanisms to cushion the risks it faces

Besides growth potential, it is important to analyse the euro area's ability to address the next few years and be well equipped to tackle the next recession with guarantees. As we shall see, significant progress was achieved after the financial crisis. However, looking ahead to the next few years, we face the prospect of veryslow strides due to the fact that the different buffers (fiscal, external position and monetary policy) are being rebuilt slowly and hampered by an incomplete institutional design (for a comprehensive analysis of this factor, see the following article «European integration: the next five years... and the following decades» in this same Dossier).

In relation to the public finances, public debt has declined moderately (from 94% of GDP in 2014 to 83% in 2020 according to the European Commission's forecast), thanks to economic growth and accommodative financial conditions (not due to greater fiscal consolidation). Nevertheless, it remains high and above the 60% safety threshold laid down by one of the criteria of the Maastricht Treaty. Moreover, the disparity between countries is high and most peripheral nations have levels of public debt in excess of 90%. This reduces the margin for implementing countercyclical policies if necessary, especially in view of the lack of progress achieved in terms of greater fiscal integration.

As for the external position, the European Commission expects the euro area as a whole to maintain a current account surplus above 3% over the next two years, although this figure once again masks significant disparity: some countries (such as Germany and the Netherlands) have considerable surpluses, while the countries of the periphery, following a major correction, are closer to an equilibrium. In this regard, it will be important for the peripheral countries to maintain levels of competitiveness that enable them to consolidate their external surpluses and thus reduce their external debt.

Finally, in monetary policy, it would be desirable to raise interest rates when the circumstances permit it in order to have an additional buffer that allows rates to be reduced when the economic situation worsens. Therefore, it is inappropriate to keep rates as low as they currently are for longer than is absolutely necessary. However, all the indicators suggest that the process of monetary normalisation will be very slow and that we will not be able to count on a big buffer in the sphere of monetary policy.

The high asymmetries in the growth rates between countries in the last economic crisis (see in the last chart the fall in the level of synchronisation during the financial crisis) already highlighted the limitations for providing a common economic policy response that could work on a widespread basis. Unfortunately, the incomplete reconstruction of the buffers and the lack of substantive progress at the institutional level suggest that the capacity to deal with adverse shocks is not yet sufficiently robust and that the current pattern of growth will be vulnerable to the emergence of new shocks if no measures are taken.

Javier Garcia-Arenas

1. See D. Andrews, C. Criscuolo and P. Gal (2016). «The global productivity slowdown, technology divergence and public policy: a firm level perspective», Hutchins Center Working Paper.
2. Proportion of the population over 65 years of age compared to the working-age population between 16 and 64 years of age.
3. See S. Aiyar, C. Ebeke, and X. Shao (2016). «The impact of workforce aging on European productivity», IMF Working Papers.
4. See S. Chatzichristou (2018), «The future of skills: what does data tell us?», presentation by the European Center for the Development of Vocational Training.

European integration: the next five years... and the following decades

- **The underlying conditions are in place for a new leap forward in the European integration process, but this is unlikely to happen over the next five years.**
- **The euro area will make progress in completing its institutional framework, especially with regards to the banking union.**
- **Defence, the relationship with China and migration are becoming focal points in the political sphere for joint decision-making (although this is still some way off).**

A challenging time

There seems to be a consensus that the coming years will be decisive for the EU; today more than ever the future looks both difficult and unpredictable. To approach this ambitious exercise, we need to provide a general description, which might be as follows. At a time of change in the global order, almost unprecedented in previous decades, the main hegemonic power, the US, is reviewing its function in the world system and reducing its ties, so far in largely undefined ways, with the multilateral institutions that have defined the liberal institutional order. Furthermore, the US and its main rival appear to be more on a collision course than one of cooperation and, given this situation, Europe is questioning its role in the world. The economic situation is at the forefront of the debate, as Europe encapsulates many of the difficulties in facing the structural transformations affecting industrialised economies. Finally, rising political polarisation is frequently expressed as criticism of the European integration project. Does this ring a bell? Of course, you say, as it summarises, at least in part, some of the characteristics of the present.

Yet, this description in fact refers to the situation of the European Economic Community at the start of the 1970s. At that time, US withdrawal from multilateralism took the form of withdrawal from the Bretton Woods system and the gold standard in 1971. They were difficult times: the US was losing the Vietnam War and the country was debating how to deal with its problems, in which isolationism was a powerful temptation. The unnamed rival was of course the Soviet Union. We now know that it was a political giant with feet of clay, but it was not perceived as such at that time and in Europe the debate revolved around how to increase collaboration with the USSR and its partners without threatening the defence provided by the US. In economic terms, the underlying pressures were basically how to manage major changes in supply or, in other words, switch from industrialisation to a service economy. This became the highest priority when the oil crises hit in the following years. Finally, the confluence of significant polarisation and criticism of the European project was summarised at the time as «Eurosclerosis». What would we have thought then about the immediate prospects for European integration? It is unlikely that we would have felt particularly optimistic.

Yet the following two decades saw some of the most important leaps in the history of European integration. Thus, the European Economic Community became the European Community, eventually called the European Union. A union of 9 members became the EU15 and it began to prepare for expansion to the east, leading to the current EU with 28 members. Economic integration, timidly achieved through the common market, became the much more complete internal market. And finally, the current Economic and Monetary Union (EMU) was forged. In short, the 1980s and 1990s were a veritable golden age for European integration.

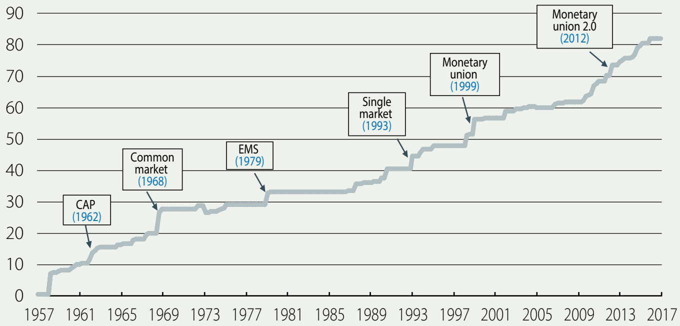
The lessons of the past

Leading the reader into comparing the current situation with that of five decades ago is more powerful than the apparent conclusion that excessive pessimism in the past was a poor predictor for subsequent events. If we accept this statement, the point argued here is that the factors acting at that time could be similar to some of the elements we see today. To make full use of this short exercise in comparison, we will start by describing what we understand by European integration. Although integration is a multidimensional process and, thus, difficult to reduce to a single measure, the essence of the European experience may be summed up using an indicator of EU country integration. As shown in the graph, the trend in the European project has been towards greater integration (there have been no retreats), sometimes speeding up when major leaps forward were made. What factors explain this dynamic?

First of all, there is a mechanism at work that we might term endogenous or «functionalist». Through this mechanism, integration that begins in relatively technical areas, such as steel, coal or trade, expands into other complementary fields, such as regulatory harmonisation or freedom of movement for productive factors. The second key factor is changes in the configuration of the world order. Thus, the bipolarity that arose after the Second World War (1945) gave way to unipolarity following the fall of the Berlin Wall (1989) and the current incipient multipolarity. These changes in the system of world governance, although infrequent, have in the past led the EU to develop new competencies as a global actor. The third factor that in the past led to progress in European integration is the existence of economic changes that demand a capacity for structural reform. Such changes can be deep and long lasting, such as the switch to the service economy that transformed the productive structure of European economies in the 1970-80s, or more specific, such as the double recession of 2008-2009 and 2012-2013. Faced with these economic transformations, European integration has played a role on two different levels. Firstly, experience shows that often the political toll of implementing required reforms is easier to swallow internally when explained as the demands of a supranational institution. Secondly, and undoubtedly more importantly, many structural changes require public policy responses that can only be optimised at the supranational level.

European integration index

Level (100 = maximum value)



***Note:** The index is a measure of the integration of EU countries that considers nine areas of European coordination: the common market, the single market, supranational institutions, economic union, financial union, fiscal union, monetary policy coordination, monetary union and democratic legitimacy.*

***Source:** CaixaBank Research, based on data from E. Dorrucci et al. (2015). «The Four Unions "PIE" on the Monetary Union "CHERRY": A New Index of European Institutional Integration». ECB Occasional Paper, 160.*

We are now ready to analyse the two «golden decades» of European integration. As the graph shows, the need to ensure the survival of the new-born common market of 1968 after the supply-side shocks in the 1970s and abandonment of fixed exchange rates led to a first attempt at monetary integration, the European Monetary System, whose stability in some periods was punctuated with volatility in others. Such dysfunction created the need for a more complete monetary integration, the current EMU. Furthermore, during the complicated decade of the 1980s, European economies simultaneously faced a dramatic change in the productive model (the so-called «industrial restructuring» was not damaging to Spain at that time) in the previously mentioned context of the oil crisis and the onset of the complex situation of stagflation. This highlighted the need for a leap forward in economic integration and the transformation of the common market into the current internal market. The internal market required an unprecedented drive to liberalisation while definitively lessening the threat of competitive devaluations, in turn making the EMU an unavoidable complementary step.

The situation today is (probably) no different

So much for historical comparison. If this is a reasonable explanation for the past, what may we say about the future? As suggested at the start of this article, the basic premise is that once again we are facing factors that in the past have led to leaps in the European integration process.

What are these factors? First of all, possibly the most striking element is the change in political polarity, a transition toward a clearly asymmetric multi-polar world: the US will undoubtedly remain the hegemonic power for some time, but the rise of China and the activism of many mid-level powers, such as Russia and India, is a long way from the so-called «unipolar moment» of the 1990s. We said earlier that in a similar context in the past, Europe gradually accepted its role as a global actor, falteringly at times, with little conviction at others, but unavoidable in the end. It may well now follow an equally uncertain path. A second element that appears to be repeating itself consists of the long-term dynamics affecting the economy. If previously this was the switch to the service economy, this time it is technological disruption produced by digitalisation, demographic transition and climate change. The natural response to all three should involve a transnational dimension, which the EU already provides and will continue to do so (obviously, with differences in each area). Finally, a third recurring element is the endogenous development of integration itself: in certain areas, the effect of overflow, or complementarity, is not yet complete and will continue to produce further advances.

Do these three factors mean we are at the gates of a new stage of intense European integration? It all depends on how we define «gates». If it means we are already crossing the threshold, then definitely not, but it may be the case if we take a broader time scale. Obviously, the key lies in new elements that distinguish the current situation from the past. By far the most important such element is the heterogeneity of preferences: alongside the public perception, there is growing empirical evidence that political preferences in many fields are more polarised than in the past.[1] As is to be expected, this polarisation is also expressed in the demand for European integration, and is particularly intense in areas where more progress in European integration needs to be made. Why might such polarisation significantly affect the dynamics of European integration? It is often argued that the political expression of this polarisation could alter the normal operation of community institutions. Without ignoring the obvious, this points to something more profound. Remember that one of the key factors for steady progress in European integration is the functionalist mechanism, i.e. factors that spread from one, generally technical, area of integration to another complementary one. Thus, the common market became the internal market and then the EMU. The key to this process is the confluence of two realities in these areas: economies of scale in the area in question and (relatively) similar preferences among the actors. By contrast, in many areas where this new stage in European integration needs to materialise, often of a far more political nature, the latter element becomes diluted, as preferences on such issues are more heterogeneous, due to the diversity in societies, cultures and identities. This has always been the case, but if one also adds the increased polarisation in recent years, the panorama becomes more complicated. Nevertheless, this does not mean that progress towards integration cannot be made.

Arrival in the EU agenda

Which of these effects will prevail in the medium term? To provide a diagnosis as detailed as possible, we focus on certain areas we consider central to the EU and where we believe there will be new developments in the medium term. In each, we have attempted to offer a balance of what can be expected in the next five years.

Economic and Monetary Union 2.1: margin for functionalist manoeuvre

Monetary integration is an area where the so-called «functionalist overflow» still has room to advance. The clearest example of this is the commitment to the full European banking union, a project that would decisively complement the institutional design of the EMU. Specifically, after establishing single supervision and resolution mechanisms and after agreeing on the Eurozone Rescue Fund (ESM) acting as a lender of last resort (backstop) for the Single Resolution Fund, we may expect progress in the political debate over the next five years and the third and final pillar of banking union to be given the green light: the single European Deposit Insurance Scheme (EDIS). The aim of EDIS is to guarantee a banking system under equal conditions and help separate sovereign risk from banking risk, an essential step towards reducing the vulnerability of national deposit insurance systems to large local shocks. In this context, the most delicate issue will be the extent to which the political will of individual countries permits a truly ambitious agreement on EDIS that ensures full risk sharing. Furthermore, following the functionalist logic, the Eurogroup continues to work on the embryonic countercyclical stabilisation mechanism for the eurozone. Although its funding might be limited and come with demanding conditions (thereby distancing it from the operation of automatic stabilisers in member countries), it could be the seed for a future fiscal policy for the eurozone as a whole.

Taxation: preferences for harmonisation among citizens, rather than political decision-makers

In accordance with citizens» demands, changes in business models (due to changing technology) and tax collection requirements in individual states, more harmonised taxation, especially with regard to company tax, is an area in which qualitative change may be about to occur. However, here there is a confluence of two different problems. First of all, there is a striking heterogeneity of preferences among different countries. Secondly, in terms of institutional operation, such heterogeneity significantly hinders progress in this area, given that decision-making requires unanimity. The failure of the relatively modest proposal for a digital tax is a clear example of the power of veto. To overcome these barriers, the European Commission aims to introduce a qualified majority system, firstly on issues where there is most consensus, such as tax fraud and evasion, to extend it later to other areas, such as defining new taxable actions. This is an area in which there is likely to be progress and public debate will help drive further, longer-term ambitions.

Schengen, immigration and internal security: the polarising issue par excellence

The migration crisis of 2015 and the persistent terrorist threat has led to de facto questioning of both Schengen (in 2015-2016 border controls were reintroduced in 9 of the 26 countries in the area and are still in place in 6 of them) and the Europeanisation of external border controls. Furthermore, piecemeal measures have been taken that seek to reduce the entry of unauthorised immigrants. Finally, with regard to internal security, the EU has adopted a variety of measures in the last few years, such as registering passenger names, tougher regulations for the arms trade and strengthening the fight against terrorist funding.

1. See, for instance, Gentzkow, M. (2016). «Polarization in 2016». Toulouse Network for Information Technology Whitepaper. And Rodrik, D. (2018). «Populism and the Economics of Globalization». Journal of International Business Policy, 1-22.

However, the effects of these measures have failed to convey the sensation that the EU is safer than 10 years ago, while feeding, not always directly, political polarisation. A further complication is the fact that migratory pressure in the south has not lessened in recent years, as the demographics of sub-Saharan Africa and factors affecting these flows will tend to generate greater movements of people. Thus there is a striking contradiction between a largely short-term, defensive approach and long-term dynamics. Probably more time is needed for citizens to adopt a broader view of the movement of people within the EU and from outside the Union, possibly longer than the next five years.

European defence: differences in the means and possibly in the ends

Defence is a central area in which tensions for the EU as a global actor, arising from changes in the international order, are particularly notable. Factors such as the US's reassessment of its role in defending the Old Continent, the rise of China and Russian revisionism are likely to run for some time, highlighting the need for the EU to adjust to the previously mentioned asymmetric multipolarity. In this issue, we are at the start of a profound debate, which essentially hangs on two major decisions: progressing towards an instrument that could give rise to a future European army, and redefining the role of European countries in NATO. Regarding the former decision, there is an abundance of political declarations, but few specific measures. Thus, both Germany and France have stressed the need for a European army, but without explaining what type of army they have in mind: one that is answerable to European institutions and defends the territory of the members states (an army of Europe) or a military force under the control of participant states (an army of the Europeans). The most likely option in this area of integration is stronger cooperation in security and defence (including cyber defence), which is voluntary and organised on a case-by-case basis. The EU could supplement national efforts, but its participation in the most demanding operations would be limited and EU/NATO cooperation would be conducted under the current structure and format. Anything more ambitious in the next five years is probably premature. However, once again, it could establish the foundations for more wide-reaching changes in the longer term.

Dealing with China: between taking a hard line and pragmatism

China has now made it clear that it represents the greatest change in the global institutional order. This is a dynamic game, in which the EU, China and the US are redefining their underlying strategies and Europe's response is probably a taste of what we will see in the coming years. To continue our main thread, a single response from the EU would require the benefits of such a response to outweigh the cost of divergent national positions which, in turn, reflect the heterogeneity of internal economic situations. What we have seen so far suggests that the benefits are not obvious to member states, as a bilateral response between different countries, or blocs of countries, and China has prevailed in at least two crucial areas: reciprocity in opening up markets (which is even more important if the US «closes» its market and Chinese trade is diverted to Europe) and the balance between attracting direct foreign investment from China and protecting sensitive sectors and technologies. As with defence, it is only now that an initial European approach to the issue is being outlined, suggesting a period of political discussion rather than decision-making.

The prelude to a major change?

Let us return to the key questions in this article: Over the next five years, will we see a leap forward in the European integration process? The short answer is that this period is not long enough for changes in the international order and the effects of the triple transition in technology, climate and demographics to produce radical changes in EU's current inertias. It is also too short a time scale to assess whether, in the immediate future, the benefits of integration will be overwhelmed by the costs of heterogeneity. Nevertheless, over the next five years we may begin to discern the necessary conditions for an as yet poorly defined acceleration in European integration. This is as least one conclusion that can be drawn from the review of prospects in different areas where change might be expected over the medium term. Historically, Europe has tended to show its least proactive face immediately before meeting challenges in an unexpectedly ambitious way. This might be the case now, although, obviously, we will not know until we are well into the next decade.

Roser Ferrer and Àlex Ruiz

Political polarisation: the phenomenon that should be on everyone's lips

- **Society has become notably more polarised in recent years. In the US, this manifests itself through a wider gap between the views of Republican and Democrat voters. In Europe, we have identified an increase in disagreements over fundamental issues such as immigration and European integration.**
- **Political parties have also become more polarised in advanced economies, most notably in the last decade.**

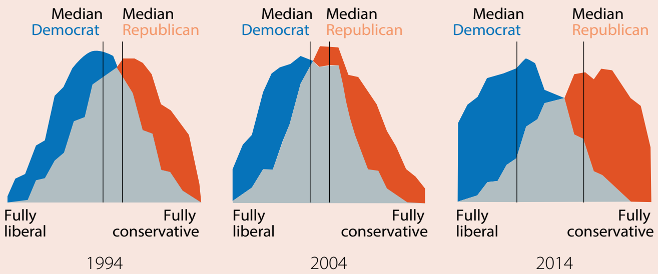
The degree of political polarisation in a society is a key variable that quantifies the extent to which public opinion is split into two opposing extremes. This is a very important variable to take into account: the greater the polarisation, the more difficult it is to generate a broad consensus among groups with different views in order to undertake reforms that allow society to achieve progress. As such, a high degree of polarisation can lead to irreconcilable positions, making it difficult to reach agreements.

When we read the press, it is easy to get the feeling that polarisation has increased considerably in recent years. Is this really the case? To find answers, it is worth delving deeper and differentiating between polarisation among voters and among political parties, as they do not necessarily go hand in hand.

Let us start by analysing polarisation in society. In the US, a highly contentious debate has arisen in academic circles over whether there has really been an increase in polarisation among the electorate. At first glance, one might think not: according to several studies,[1] the distribution of society's preferences on various topics (economic, social and moral) has remained very stable over the past 20 years and no significant radicalisation is noted in the positions.

Greater ideological division between Democrat and Republican voters in the US

Distribution of political values on a scale from –10 to +10



Note: *An ideological consistency index is estimated for voters on the basis of 10 questions on economic, social and moral issues. The index ranges from –10 (fully liberal) to +10 (fully conservative) and the distribution for the whole of the sample is taken. The blue area represents the ideological distribution of Democrat voters, while the orange area represents that of Republican voters. The grey area is the degree of overlap between the two distributions. Sample of 10,013 individuals.*
Source: *CaixaBank Research, based on data from American Pew Research.*

However, if we dig a little deeper, as the Stanford economist Matthew Gentzkow[2] has done, we can see that polarisation has in fact increased. The reason for this is that the correlation between voters' preferences and those of the political party they identify with has increased significantly over the past 20 years. Two examples are particularly illustrative. Firstly, 20 years ago it used to be relatively common to find Republican voters in favour of immigration or Democrat voters against it. Secondly, it was much more common for people to have conservative views on some issues (such as economic issues) and liberal views on others (say, social issues). In contrast, nowadays American voters have embraced the ideology of the party with which they sympathise in all aspects. The consequence of this trend has been a widening of the gap between the preferences of voters of the two main parties (see first chart) and greater antipathy towards the other side: in 1960, the percentage of voters of each party that would be displeased if their child married a person of the other party was insignificant, yet it has risen to 20% today. In other words, the polarisation of the electorate has increased quite clearly.

To analyse the polarisation of society in Europe, we use the European Social Survey (ESS), one of the most comprehensive surveys for analysing the political inclinations of European citizens. If we analyse how the distribution of Europeans' political preferences have changed between 2006 and 2016 along a spectrum ranging from 0 (far left) to 10 (far right), we observe significant stability: preferences for more extreme options have increased ever so slightly, but the changes are minor (see second chart). However, it would be a mistake to draw hasty conclusions if we consider that polarisation can manifest itself in specific topics, even if it does not do so in the traditional ideological spectrum of a world that may no longer respond to the classical left-right cleavage.

In order to determine the degree of political polarisation, we construct a disagreement index that measures the degree of disagreement in society on specific economic and social issues. The results, presented in the second chart, leave no room for doubt: society currently presents a significantly higher degree of disagreement than in 2004 on topics as varied as immigration, multiculturalism, European integration, trust in parliament and satisfaction with the government. The only variable where we obtain greater consensus is on the need for public policies to reduce inequality, a finding that should not come as a surprise considering the scars left by the 2008 financial crisis.

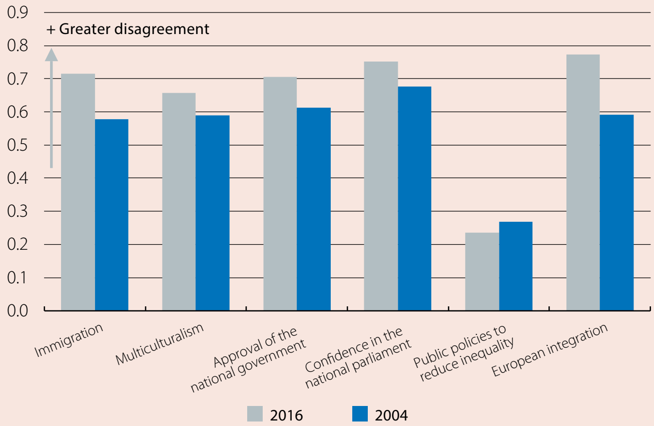
1. For further details, see P. Fiorina Morris and J.S. Abrams (2008). «Political Polarization in the American Public». Annual Review of Political Science 11:563-588.
2. See M. Gentzkow (2016). «Polarization in 2016», Working Paper, Stanford University.

This greater degree of disagreement over fundamental issues can be partly explained by the fact that positions on some issues have become aligned with the ideology – an explanation similar to what has happened in the United States. As an example, on the issue of migration, we note that there is currently a significant positive correlation between conservative ideological positions and rejecting immigration, something not seen in 2004.

Having established that there is greater polarisation among voters, it is not surprising to see that polarisation among political parties has also increased (see third chart). In fact, some academics, such as Stanford University political scientist Morris Fiorina, defend the hypothesis that it is precisely the greater polarisation among political parties that has set the pace and has led to a wider gap emerging between the various sensitivities in society. An important element is that, in most countries, there has been a significant increase in polarisation among political parties in the past 10 years. In advanced countries, for example, the polarisation of political parties has gone from 3.5 points in 2007 to 4.1 points in 2017. To give the reader an idea, in 2002, a parliament with a low level of polarisation – such as Germany's – had an index of 2.7 points, while in 2017, a France that was highly polarised between Macron and Le Pen had an index of 5.1 points.

Polarisation on various topics: degree of disagreement *

Disagreement index (min. = 0, max. = 1)

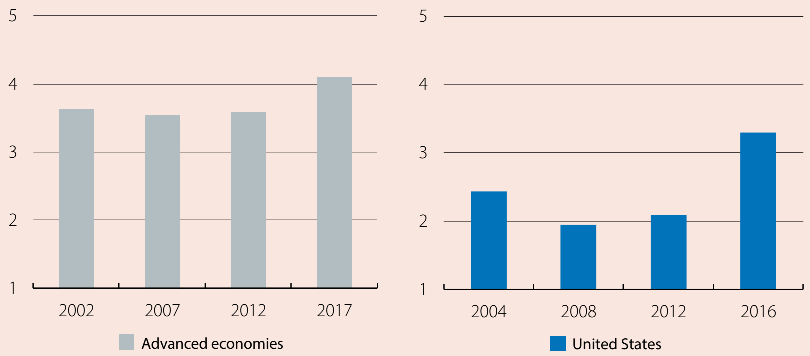


Note: ** The disagreement index ranges from 0 (100% of the population has the same opinion) to 1 (50% of the population is in favour and 50% against). Formally, we calculate the difference between the percentage of respondents of the European Social Survey in favour of and against each topic, and we subtract both this difference as an absolute value and the percentage of people with a neutral or undetermined opinion from 1.*
Source: *CaixaBank Research, based on data from the European Social Survey of 2016 (44,387 observations) and 2004 (47,537 observations).*

Before ending this article, it is worth starting to characterise the increase in political polarisation that we have identified in society. We can already identify two geographic patterns that are highly symptomatic and which, due to their structural nature, make us to believe that political polarisation is here to stay.[3] On the one hand, it has been documented that, in the US, voters currently live surrounded by people with the same political affinity, resulting in more homogeneous groups: In 1976, less than 25% of American citizens lived in districts in which there were overwheliming victories for one of the candidates («landslides»), while in 2004 the percentage already stood at almost 50%.[4] On the other hand, there is growing evidence of the existence of a gap in electoral behaviour and preferences and values between people living in rural areas and those in urban areas, both in the US and in Europe. In the US, for instance, people living in rural areas believe that 73% of the people living in these areas share the same values as them, but that only 41% of urban residents share them.[5]

Polarisation among political parties

Index



Note: *The political polarisation index provides a measure of how different a country's political parties are, weighted by their political representation. As a guide, a parliament with a low level of polarisation - such as the German one in the year 2002 (in which structural reforms were carried out) - had an index of 2.7 points. Sample of all elections in the EU, US, Australia and Canada between 1996 and 2015. The polarisation index ranges from 0 (all parties lie in the same position) to 10 (all parties lie at extreme positions).*
Source: *CaixaBank Research's own estimate, based on data from the Comparative Study of Electoral Systems.*

In short, politics is in vogue, and if there is one phenomenon that stands out today it is the high degree of political polarisation we are witnessing. This is a phenomenon that has been slowly incubating, and which is now an established reality that shows no signs of fading in the short term. Greater polarisation can increase citizens' interest in and commitment to politics, but it can also make it difficult to achieve the consensus needed to carry out structural reforms. It is for this reason that this phenomenon represents one of the cornerstones of the current political ecosystem.

Javier Garcia-Arenas

An extended version of this article can be found on the CaixaBank Research website: www.caixabankresearch.com

3. For an in-depth analysis of structural factors, see the article «The deep roots of polarisation, or on the need to recover the lost story» in this same Dossier.
4. See B. Bishop (2008), «The Big Sort: Why the Clustering of Like-Minded America is Tearing Us Apart», Editorial Houghton Muffin.
5. See K. Bialik (2018), «Key findings about American life in urban, suburban and rural areas», American Pew Research.

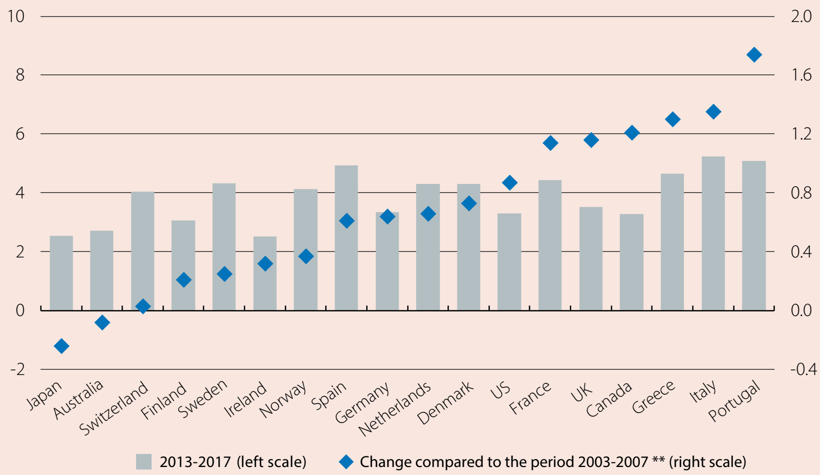
Polarisation: the legacy of the financial crisis and other contextual forces

- **The 2008 financial crisis and the recent waves of migration are two of the factors that have contributed to an increase in political polarisation in Europe.**
- **The impact of the financial crisis on the phenomenon of polarisation is considered greater than that of immigration.**
- **Social cohesion policies could explain why immigration has had a lower impact on polarisation.**

Political polarisation is a phenomenon on the rise, especially in Western economies. Various structural trends are proving to be catalysts for this phenomenon: globalisation, technological change and demographic change are some of them. But beyond these structural elements, certain contextual developments have favoured the rapid increase in polarisation which, as can be seen in the first chart, has increased sharply and become more widespread over the last decade. In particular, there seems to be a clear consensus that the global financial crisis of 2008 and the waves of migration seen in recent years in many European countries are two of the factors that have increased political polarisation in the Old Continent.

Polarisation of the vote: political polarisation index *

Polarisation index (min. = 0, max. = 10) *Change (points)*



Notes: ** The Dalton polarisation index provides a measure of how different a country's political parties are, weighted by their parliamentary representation. As a guide, a parliament with a low level of polarisation – such as Germany's in 2002 (in which structural reforms were carried out) – had an index of 2.7 points, while a more polarised parliament, such as Greece's after the 2015 election, obtains a score of 4.6 points. Based on Dalton's methodology (2008), we have updated the data available in the CSES for Spain, Italy, Greece, France, the US, the Netherlands, Denmark and Hungary. ** 2013-2017 corresponds to the average figures for that period. The change, meanwhile, refers to the difference between the average for the period 2003-2007 and that of the period 2013-2017.*

Source: *CaixaBank Research, based on data from the CSES and from R.J. Dalton (2008). «The quantity and the quality of party systems: Party system polarization, its measurement, and its consequences». Comparative Political Studies, 41(7), 899-920.*

From financial crises to political polarisation

Various empirical analyses show that the increase in polarisation is a very common phenomenon after a financial crisis. As an example, one of the benchmark articles on this topic, written by Atif Mian, Amir Sufi and Francesco Trebbi, shows that the increase in polarisation in the US Congress is a process that has been ongoing and uninterrupted for more than 70 years, but it also points out that financial crises have increased polarisation substantially.[1] Contextual factors, therefore, appear to play an important role in the phenomenon in question.

Besides the case of the US, these same authors show that, based on a sample of a quarter of a million individuals from a total of 60 countries, financial crises tend to radicalise the political position of voters. In particular, following a financial crisis, the percentage of centrist and moderate voters decreases, while the percentage of more radical left or right-wing voters increases. Similarly, two researchers from the German think tank the Kiel Institute draw a connection between the 2008 financial crisis and the rise in right-wing populist parties in the European political arena.[2] Finally, in a very interesting piece of ongoing research on Germany in the 1930s, it is shown that the financial crisis that hit the country at the beginning of the decade made a decisive contribution to the rise of the National Socialist Party in the inter-war period.[3]

The causal relationship between financial crises and polarisation is empirically well founded, and all the indicators suggest that this relationship operates through three channels: the loss of trust in institutions and the established political class, the debt-conflicts that emerge and the increase in inequality.

In particular, in the stated order, financial crises tend to be perceived as a failure of regulation and/or public policies. As a consequence, they tend to result in a loss of trust in the ruling class and, ultimately, an increase in votes in favour of more extreme political options.

1. See A. Mian, A. Sufi and F. Trebbi (2014). «Resolving debt overhang: political constraints in the aftermath of financial crises». American Economic Journal: Macroeconomics, 6(2), 1-28.
2. See M. Funke and C. Trebesch (2017). «Financial Crises and the Populist Right». Ifo DICE Report, 15(4), 6-9.
3. See S. Doerr, S. Gissler, J. Peydro and H.-J. Voth (2019). «From Finance to Fascism: The Real Effect of Germany's 1931 Banking Crisis». CEPR Discussion Paper n° 12806.

Secondly, numerous studies point out that the resolution of situations of excessive debt also ends up leading to an increase in political polarisation. In particular, debt restructuring processes that affect people with fewer resources tend to provoke a rejection of the political status quo.

Finally, the increase in social inequality, which tends to be particularly intense during financial crises, also leads to an increase in electoral polarisation.[4]

Migration and polarisation

The second cyclical factor that is causing polarisation to rise is immigration. In the case of Europe, for instance, the increase in immigration (and in the number of refugees arriving) in the 2000s coincided with a considerable rise in support for political parties that oppose this phenomenon. In fact, in some countries this relationship had already been observed for some years.

For example, in an exhaustive study for the city of Hamburg, Otto and Steinhardt[5] documented a causal relationship between the increase in immigration and the rise of the far right. Specifically, between 1987 and 1998, the city received a significant number of immigrants, mainly refugees and asylum seekers. With the information on the electoral results in 103 districts of the city for a total of seven elections, and taking into account the characteristics of the different areas of the city, the researchers demonstrate a relationship between the rise of extreme right-wing parties in different districts and the level of immigration.

As in the case of financial crises, the causal relationship between migratory flows and political polarisation seems to be proven, but there is not always consensus among experts on the channels through which this link operates. In general, the economic literature identifies four relevant channels: labour, social benefits, the non-economic channel and politics.[6]

The labour channel refers to the fact that domestic workers may perceive immigrants as competitors. In order to eliminate part of this competition, voters support anti-immigration political parties.[7]

The channel of social benefits highlights both the competition for the use of public services that immigrants pose for pre-established population groups and the new redistribution of benefits that is required when faced with the arrival of new citizens with needs that may be very different.[8] Again, the desire to expel the competition encourages support for anti-immigration forces.

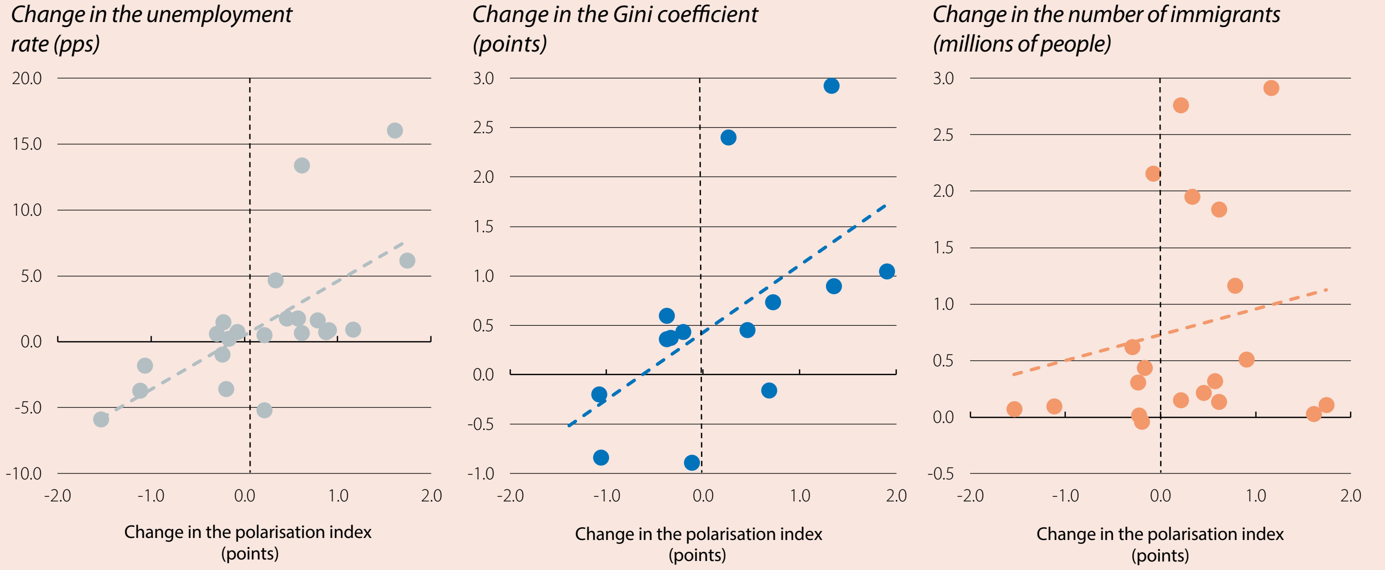
The non-economic channel emphasises that the arrival of immigrants awakens a greater awareness of ethnic or cultural identity and a hostility towards those who are perceived as different. This greater awareness and hostility is exploited by political parties with clearly anti-immigration discourses.

The last channel, the political one, refers to the fact that the arrival of immigrants can generate greater polarisation to the extent that the political orientation of those arriving substantially differs from that of the pre-established population. This occurs either more or less rapidly depending on how quickly new citizens are given the right to vote. In any case, this is a very different channel from the previous ones, as it does not generate a direct increase in anti-immigration forces.

Before bringing the topic of immigration to a close, it is worth mentioning the specific case of refugees and their effects on polarisation. The reason for this is that some recent studies point towards a weak relationship between these two elements if policies that strengthen social cohesion are implemented. For example, between 2014 and 2015, some regions of Austria that received significant flows of refugees did not suffer the marked increase in votes for the far right that occurred in other regions of the country. University of Munich researcher Andreas Steinmayr attributes this result to the efforts carried out by local authorities to explain the refugees' situation to the resident population affected and to encourage contact between the two groups. This led to what some have come to call the «contact effect». In contrast, regions that did not receive refugees only learned of the situation through the media and through political groups that were more opposed to immigration.[9]

4. The increase in inequality has been observed for several decades in most advanced countries, but it was accentuated a priori temporarily with the arrival of the financial crisis (see the article «Political polarisation: the phenomenon that should be on everyone's lips» in this same Dossier and the article «Inequality and populism: myths and truths» in the Dossier of the MR01/17).
5. See A.H. Otto and M.F. Steinhardt (2014). «Immigration and election outcomes-Evidence from city districts in Hamburg». Regional Science and Urban Economics, 45, 67-79.
6. Among the articles that analyse this topic for the European case, particularly noteworthy is the study by D. Card, C. Dustmann and I. Preston (2012). «Immigration, wages, and compositional amenities». Journal of the European Economic Association, 10(1), 78-119.
7. The economic impact of immigration is much more complex than the simplified version of a supply shock, since it depends on the country's productive structure, among other elements (see article «The economic impact of immigration» in the Dossier of the MR10/16). However, this simplification is what usually lies behind many citizens' voting decision.
8. In both cases, this can be a simple perception. In the case of the United Kingdom, the total effect of immigration on the public finances is positive, since their contribution through taxes is greater than what they receive in social benefits (see C. Dustmann and T. Frattini (2014). «The fiscal effects of immigration to the UK». The economic journal, 124(580), F593-F643).
9. See A. Steinmayr (2018). «Contact matters: Exposure to refugees and voting for the far-right». Working Paper. For an example relating to France, see P. Vertier and M. Viskanic (2018). «Dismantling the "Jungle": Migrant Relocation and Extreme Voting in France». Working Paper.

Correlation at the country level between polarisation of the vote * and the unemployment rate, the Gini index ** and immigration



***Notes:** The changes reflect a comparison between the average data for the periods 2017-2013 and 2003-2007. * The Dalton polarisation index provides a measure of how different a country's political parties are, weighted by their parliamentary representation. Based on Dalton's methodology (2008), we have updated the data available in the CSES for Spain, Italy, Greece, France, the US, the Netherlands, Denmark and Hungary. ** The Gini coefficient measures the difference between a symmetrical distribution of income in the population (each inhabitant has the same level of income) and the observed income distribution. Therefore, high values of the Gini coefficient reflect greater inequality.*
***Source:** CaixaBank Research, based on data from the CSES, the IMF, the World Inequality Database, the World Bank and R.J. Dalton (2008). «The quantity and the quality of party systems: Party system polarization, its measurement, and its consequences». Comparative Political Studies, 41(7), 899-920.*

Quantitative exercise

At this juncture, and to illustrate in a simple manner the role of the 2008 financial crisis and the recent waves of migration on the increase in polarisation in advanced economies, we use the country-level polarisation index developed by Russell J. Dalton[10] and plot it against the unemployment rate, the Gini index and the number of immigrants.

Intuitively, we tend to identify the countries that suffered the most from the effects of the last financial crisis as those that registered the highest increases in their unemployment rate. If we analyse the changes in these two indicators (polarisation and unemployment) from before the crisis up to the present day by country, we indeed note that there is a positive correlation between them (see the first panel of the second chart). Secondly, as a measure of inequality, we refer to the Gini coefficient (which reflects how equal or unequal income distribution is among a country's inhabitants)[11] in order to precisely show inequality at the outset. The correlation is also positive for changes in these two measures: countries with greater increases in inequality are also the ones that have shown greater increases in the polarisation index (see the second panel of the second chart). Similarly, greater flows of immigration also appear to be associated with bigger increases in the level of polarisation (see the third panel of the second chart).

Lastly, we perform a simple exercise to estimate the sensitivity of the polarisation index to changes in the contextual factors we have just defined as a whole.[12] The results of our exercise suggest that the effect of the economic crisis, measured through the increase in the levels of unemployment and inequality, explained around 35% of the surge in polarisation observed since the crisis began in 2007. Increases in migratory flows, meanwhile, often have an insignificant effect. This would be in line with the weaker relationship between refugees and polarisation suggested by some of the research mentioned above.

In short, the increase in polarisation in the European political arena should not come as a surprise in an environment of considerable migratory flows and, in particular, after a financial crisis without precedent in recent memory. Nevertheless, this lack of surprise should not lead to conformity.

Clàudia Canals and Javier Ibáñez de Aldecoa

10. The polarisation index used provides a measure of how different a country's political parties are, weighted by their parliamentary representation. The data is obtained from the Comparative Study of Electoral Systems, and for Spain, Italy, Greece, France, the US, the Netherlands, Denmark and Hungary we complete the last wave using the methodology explained in R.J. Dalton (2008) «The quantity and the quality of party systems: Party system polarization, its measurement, and its consequences». Comparative Political Studies, 41(7), 899-920.
11. High values reflect a high level of inequality in terms of income.
12. We estimate the following regression in differences: $\Delta Polarisation\ index_{i,t} = \alpha + \Delta X_{i,t}\,\beta + \xi_{i,t}$, where the matrix $X_{i,t}$ contains the unemployment rate, the Gini coefficient and the number of immigrants for the country i in the period *t*. The constant α reflects the growing linear trend in polarisation (the non-contextual factor), thereby taking into account possible spurious correlations caused by the trend in the variables. To test the robustness of our results, we have estimated different specifications, including specific temporal trends by region.

The deep roots of polarisation, or on the need to recover the lost narrative

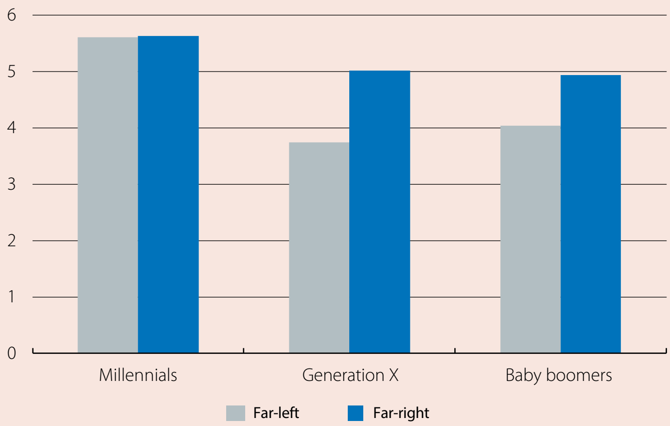
- **Historically, when there have been profound economic changes, political polarisation has increased.**
- **The rise in political polarisation that we are witnessing today has its roots in technological change, globalisation and demographic change.**
- **Liberal democracies face the enormous challenge of rebuilding a common story.**

Political polarisation has increased. In some countries, the phenomenon takes the form of the emergence of new parties whose presence in parliaments makes them more fragmented than in the past. In others, polarisation is primarily reflected in a greater dispersion within traditional parties on issues that are central to society. Finally, some combine both expressions of the phenomenon. In Europe, the first and third variants have arisen, while the US is the prime example of the second (Democrat voters are more progressive and Republican voters more conservative than in the past).[1] Although the public sometimes perceives the rise of political polarisation as a recent phenomenon, the academic literature tends to endorse the view that, although it has accelerated in the last two decades, the rising trend has been detectable as far back as the late 1970s. We are, therefore, facing a long-term phenomenon which, no matter how you look at it, represents a structural change in liberal democracies.

Now, does a structural change mean a decisive challenge? Does the increase in polarisation bear fundamental risks to the workings of democracy itself? In short, can we thoroughly address a question that is as important as it is complex and come to a somewhat clearer conclusion on the matter, albeit not a definitive answer, in order to contribute to the social debate? Well, let us at least try.

Political polarisation by generation

Percentage of respondents (%)



Source: *CaixaBank Research, based on data from the World Values Survey, using the sample available from OECD countries.*

The past as a guide

First of all, let us see what historical experience tells us. A first observation is that, in the past, a significant increase in political polarisation has been an element present in many profound economic and social changes. Although the contemporaries of each episode did not use our terminology, the increase in the dispersion of citizens' preferences can be identified in the crisis of the Greek polis, in the Roman republic's transition into an empire, in the crisis of the Late Middle Ages, in the bourgeois revolutions of the 18th and 19th centuries and, of course, in the debacle of the 1930s. But history can tell us more: in all of these cases, the changes of political regime that occurred were accompanied by a series of profound structural transformations.

Specifically, these episodes of increased fragmentation of political preferences saw a combination of some or all of the following elements: an enlargement of the area that was economically relevant to the society of the time (which we can assimilate to a certain form of globalisation), a significant change in demographic trends and a technological transformation. So, for instance, in the transition from the classical world to the Hellenic, we detect globalisation; in the fall of the Roman republic, we see demographics and globalisation; in the crisis in the Late Middle Ages, demographics and globalisation; in the bourgeois revolutions, technological change, demographics and globalisation, and finally, in the crisis of the 1930s, we once again see all three. Therefore, in this first, historical exploration, we note that political polarisation appears to be present in many systemic political changes, while polarisation also seems to coexist with the three phenomena we have referred to as globalisation, technological change and demographics.

The next step in this intellectual journey must be precisely to try to clarify the relationships that can be established between globalisation, technological change and demographics, on the one hand, and increased political polarisation on the other. After all, if they were important in the past, they should be even more so today, as all three trends are fully present. So, what does the literature on this issue tell us? The main conclusion is that all three trends play a significant part in explaining polarisation, and we can make this statement based on empirical evidence which, although not yet abundant, does offer some rather strong support for the observations mentioned above.

Revisiting the complex relationship between technological change and political polarisation

Technological transformation affects the rise of polarisation through two main channels, that of the labour market and through the media. Let us start with the first of these mechanisms. In advanced countries, studies have shown that technological change puts pressure on wages, increasing the gap between those of highly-skilled workers and those of low-skilled workers. This, in

1. For an in-depth description of the phenomenon of political polarisation, see the article «Political polarisation: the phenomenon that should be on everyone's lips» in this same Dossier.

turn, is reflected in an increase in the so-called educational premium: if technological change intensifies the relative demand for high-skilled staff, and acquiring the necessary skills also requires relatively higher educational levels, such higher educational levels will logically result in a more-than-proportional increase in earning potential. In short, technological change contributes to generating «winners» and «losers», who will probably have different political preferences to a greater extent than in the past.[2]

However, the relationship between wage inequality and political polarisation must be treated with caution. Certainly, some measure of inequality is usually one of the determining factors included in empirical exercises that seek to establish the causes behind polarisation.[3] The results are varied and, by extension, not without controversy. In general terms, we can say that, although the apparent association between inequality and polarisation is high, determining the causal factors with certainty is not easy. The most serious studies undertaken on this topic suggest the possibility of a two-way relationship between inequality and polarisation.[4] This result seems logic, since in the long term it is possible that changes in polarisation, which may be due to different causes, can result in public policy responses that affect inequality. A prime example of this is the US, where the increase in polarisation among voters of the two major parties has made it more difficult to defend redistributive measures.

Wage inequality, in turn, leads to a phenomenon that is perhaps less key but which, in the US, has nevertheless proven to carry some weight in the debate in question: namely, shifting trends in marriage that could have an impact on the increase in polarisation. Specifically, the existence of the aforementioned educational premium also seems to translate into a trend that is more closely related to demographics, since some authors, such as Fernández and Rogerson (2001),[5] suggest that there is an increase in marriages occurring between people with similar educational levels. Ultimately, this means that society becomes more dominated by couples composed of only «winners» and only «losers» of technological change, and few «mixed» couples. The foreseeable result is that the political demands that will emerge in this more demographically fragmented society will also be more polarised.

Alongside the labour market, and as mentioned above, the second area that is important for understanding how technological changes affect political preferences is the media. This is a question that has been studied extensively in recent times, with hot topics such as the rise of digital media, the crisis of the conventional media business model and the difficulty in establishing the veracity of information in this new ecosystem. Although we are far from reaching definitive conclusions, the literature seems to agree that, once the fragmentation of supply and demand (or in terms specific to the sector, the media and the audience) has been established, the two sides of the market feedback into one another through two mechanisms. The first is what is sometimes referred to as the «silo effect», which is that the public seeks out media with a bias that tends to reinforce their preconceptions, thus contributing to an increase in the polarisation of society. A second element is what we might call «content bias», that is, the shift that has been observed in recent decades towards entertainment content, to the detriment of informative and political programmes and spaces (with clear caveats both in time and by location, of course). Given the prevalence of this type of content in what we view, it should be remembered that this trend is not something that has arisen with the birth of the internet, which by the way is not so new anymore, but rather with the introduction of cable channels in the US.

Globalisation, a catalyst for polarisation

The impact of technological change on polarisation, therefore, operates through two major spheres, the labour market and the media. However, it also has an impact on the second of the structural determining factors we mentioned: globalisation. This is an area in which it is difficult to discern specific causal channels, given the close interaction between globalisation and technological change. This is particularly because one of the ways in which technological diffusion occurs is precisely through international trade and because globalisation itself is the result, at least in part, of technological change. Yet, despite this notorious difficulty, attempts have been made to quantify the specific importance of international trade on polarisation. The results, which are still tentative as this is a relatively new area of research, seem to point towards a significant effect in both the US and Europe. In the first case, as Autor and his co-authors argue (2016), it has been found that in the electoral districts most affected by increased trade with China there has tended to be a reduction in more moderate representatives. In Europe, meanwhile, according to Colantone and Stanig (2017), the growth of Chinese imports can be associated with greater support for more polarised political positions.[6]

In more general terms, one can argue that globalisation (more or less fuelled by technological change) is a factor that exacerbates pre-existing cracks in Western societies, rather than causing new ones. This is the thesis of Rodrik (2018),[7] among others, who points out some of these divisive point, such as the opposition between mobile professionals and local producers, between regions and sectors that are competitive in globalisation and those that are not or, as already mentioned above, between skilled and unskilled workers.

The demographic vector: generations and migrations

The third major structural area mentioned earlier is demographic change. This is an area fraught with traps that lends itself to simplistic readings, so it is important to be precise. First of all, it seems logical to think that if the population is more diverse than in the past in Western societies, the political expression of these societies could also be more heterogeneous. Two of the major

2. On this topic, see, for example, the article «Inequality and populism: myths and truths», in the MR01/2017.
3. Without looking any further, see the Dossier «Polarisation: the legacy of the financial crisis and other contextual forces», in this same *Monthly Report*.
4. See J.V. Duca and J.L. Saving (2016). «Income inequality and political polarization: time series evidence over nine decades», Review of Income and Wealth, 62(3), 445-466.
5. R. Fernández and R. Rogerson (2001). «Sorting and long-run inequality». The Quarterly Journal of Economics, 116(4), 1305-1341.
6. See D. Autor, D. Dorn, G. Hanson and K. Majlesi (2016). «Importing political polarization? The electoral consequences of rising trade exposure». National Bureau of Economic Research n° w22637; and I. Colantone and P. Stanig (2018). «The trade origins of economic nationalism: Import competition and voting behavior in Western Europe». American Journal of Political Science, 62(4), 936-953.
7. See D. Rodrik (2018). «Populism and the Economics of Globalization». Journal of International Business Policy, 1-22.

channels through which the diversity of society has materialised in recent decades are the greater polarisation of values and opinions between generations (which is usually referred to as the generation gap), and the fragmentation of preferences generated by the phenomenon of immigration. The first of these issues, the generation gap, has already been studied earlier in the pages of our *Monthly Report* (Murillo and Ruiz, 2018). Indeed, as to the question of whether millennials are more «extremist» than previous generations, it is noted that the most extreme positions on the spectrum of ideological preferences are more «populated» than in previous generations (known as Generation X and the baby boomers).[8] In addition, the figures suggest that the positions on both sides of the ideological spectrum are more extreme than in previous generations, but they are positioned to the left and right to practically the same degree. In any case, and to avoid reading too much into «extremism», it should be remembered that millennials on the far left or the far right represent a minority (slightly more than 11% of millennials, counting both extremes), as is the case in all the generations for which there are data.

The second factor that has made Western societies more diverse is immigration. This is a field littered with prejudices and, therefore, we must be especially careful to separate what appears plausible from what we really know based on the empirical evidence. Firstly, it should be remembered that having a significant proportion of immigrants does not in itself lead to a high degree of political fragmentation. The most successful historical example of diverse populations being integrated into a community with relatively homogeneous values is that of the US. This is a nation that has managed to accommodate an increase in diversity without ceasing to achieve what Francis Fukuyama calls an identity, that is, having a set of shared values that make you a member of a community (the famous North American melting pot).

However, in the last few decades a shift seems to have occurred even in the US, since public perception of immigration has been fragmented – a trend that will make achieving that harmonious melting pot that once characterised the country more difficult. Thus, according to data from the Pew Research Center, in 1994, when Democrat and Republican voters were asked whether immigration was a burden in terms of lost jobs and social costs (this was the question posed in the survey), the issue raised almost the same percentage of affirmative answers in both groups (with only 2 points between the two). In contrast, in 2014 the proportion of Republican respondents that considered immigration a problem was 19 points higher than that of Democrat supporters.[9] Something similar could be happening in Europe, albeit with its own hues. According to data from the Pew Research Center in 2018, it was observed that, in a significant sample of European countries, negative opinions towards immigration were more common at the tail end of the right-wing ideological spectrum than in the centre or on the left.[10] When the difference between right-wing and left-wing respondents who consider immigration «a burden» is calculated, the former exceed the latter by 23 points. It seems, therefore, that the issue of immigration is an important factor in the way in which polarisation is manifesting itself within the two main US parties, as well as in the ideological spectrum of Europe.

Do these three factors (technological change, globalisation and demographics) exhaust all the possible explanations? For the sake of completeness, we must remember that there is a very rich debate over the relative importance of other, so-called cultural factors. In essence, the underlying idea is that secular changes in Western societies, such as the shift towards a tertiary economy, have led to a dual effect consisting of so-called economic insecurity (*de facto*, already implicit in the factors mentioned above in this article) and an increase in diversity. Combined with a shift in previous decades towards post-materialist and socially progressive values, these effects have generated what authors such as Pippa Norris and Ronald Inglehart refer to as a cultural backslash from segments that are more conservative on social matters in Western countries. This, in turn, has contributed to an increase in more ideologically polarised positions. Although this thesis is being subjected to an extensive academic debate and is far from being widely accepted, it is nevertheless suggestive of the idea that the strictly economic factors that are supposedly driving polarisation need to be considered in conjunction with other value-based and «soft» factors. In similar exercises in these same pages, we have reached similar conclusions: the increase in polarisation can be linked, to some extent, to cultural factors, meaning that it cannot be attributed exclusively to economic factors.

And despite everything... the future is not written

It is time to recap and to envision the future. If we were to end this article here, the summary could be as follows: history tells us that political polarisation is present in many secular political changes and that the underlying factors that have fuelled the increase in polarisation in the past (in particular, technological change, globalisation and demographics, as well as perhaps cultural factors) are active in our contemporary societies. So, what conclusion can we reach? Are we inevitably moving towards a new period of profound political change? Here, the reader could be waiting for a vague response, along the lines of «the future, as we know, is so uncertain...». But, for once, and without setting a precedent, we are going to step off the fence and draw a definitive conclusion: this outcome is not written in stone. The structural factors mark a direction, but they do not determine the destination, especially in societies fortunate enough to have democracy. Churchill was probably right: democracy is the worst form of government, except for all the others. In that same spirit, today's liberal democracies are imperfect and show signs of their age, there is no doubt about it. But their quality and, above all, their potential for improvement should ensure that, even in the face of growing polarisation, ways can be found to create consensus and revive the essential common story that every society needs in order to build its future.

Àlex Ruiz

8. See the article «Millennials and politics: mind the gap!» in the Dossier of the MR04/2018.
9. Pew Research Center (2014). «Political Polarization in the American Public».
10. Pew Research Center (2018). «In Western Europe, Populist Parties Tap Anti-Establishment Frustration but Have Little Appeal Across Ideological Divide».

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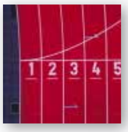

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