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ECONOMIC & FINANCIAL ENVIRONMENT

DOSSIER: OUTLOOK 2017

CaixaBank Research

MONTHLY REPORT - ECONOMIC AND FINANCIAL MARKET OUTLOOK
December 2016

CaixaBank, S.A.
Strategic Planning and Research

Av. Diagonal, 629, torre I, planta 6
08028 BARCELONA
www.caixabankresearch.com
research@caixabank.com

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Enric Fernández
Corporate Director,
Strategic Planning and Research

Oriol Aspachs
Director, Macroeconomics

Avelino Hernández
Director, Financial Markets

INDEX

Outlook 2017: «It's politics, stupid!»

During the 1992 Presidential campaign in the United States, James Carville, Bill Clinton's lead strategist, coined the famous saying «it's the economy, stupid!» to make sure debate focused on the economic situation while, in his speeches, President Bush concentrated on achievements in foreign policy, such as the victory by the US and its allies in the Gulf War. The phrase became very popular in the US and is currently used, with some variations, to underline what is truly important in an issue. For the economic outlook of 2017, we have no doubt: it is politics.

The cover of this *Monthly Report* features the four large capital cities where political events will undoubtedly determine our economic future in 2017: Washington D.C., London, Berlin and Paris.

In Washington D.C. we will discover the stance to be adopted by President Trump's administration. Ironically, it would be better if he does not keep his electoral promises. Now close to full employment, the US economy does not need such a strong fiscal impulse as the one endorsed by Trump during his campaign while in trade, imposing import duties on goods from China and Mexico would more than likely trigger trade wars that would be extremely costly for the world economy. Fortunately we do not expect either to come about. Now that he has been elected, Trump has started to tone down his discourse and we expect the administration to adopt a pragmatic stance under the influence of the Republican Party's more moderate wing. The reaction by financial markets in the last few weeks, generally positive, confirms that this is the most widely held hypothesis but it would be useful if the first steps taken by the new administration could bear this out.

In London, the British government is about to fire the opening salvo in negotiations to leave the EU by triggering Article 50 of the Lisbon Treaty. This process looks like being lengthy and complex but it would be in the best interests of all those concerned to minimise any damage caused by uncertainty and the final agreement reached. The UK is unlikely to be able to remain in the single market while it refuses to accept the free movement of people but the ideal solution would be some middle ground that allows the country access to the single market under reasonable terms. For this to be the case, the UK will surely have to grant concessions in its control of European immigration.

Berlin and Paris will form new governments after the French go to the polls in May and the Germans in September. Both elections, together with those of the Netherlands and surely also Italy, will be yet another test for the rise in populism and euro-scepticism. There is no doubt that the European project needs good leadership from both countries. To be able to count on such leadership, both governments must be committed to Europe and have a clear electoral mandate to fulfil this commitment. Current circumstances advise against an overly pro-European discourse but it is vital to instil enthusiasm once again in the European project. The EU cannot allow itself to be perceived as essentially the guardian of fiscal orthodoxy.

In Spain, the formation of a government has represented a very positive step but the political challenge to be tackled in 2017 is still substantial: to demonstrate that governability and important agreements are possible, for example in the area of labour, education and also in the territorial sphere, in spite of the new context of political fragmentation. To achieve such ends requires dialogue, concessions, agreement and finding a compromise that can be accepted by the majority. In other words, Politics with a capital P.

Enric Fernández
Chief Economist
30 November 2016

CHRONOLOGY

NOVEMBER 2016

8 Donald Trump is elected President of the US.
30 OPEC members reach an agreement to cut oil production to 32.5 million barrels a day.

OCTOBER 2016

29 Mariano Rajoy is sworn in as President of the Spanish government.

SEPTEMBER 2016

21 The Bank of Japan readjusts its ultra-expansionary monetary policy instruments in order to achieve a sharper interest rate curve.

AUGUST 2016

4 The Bank of England cuts its official interest rate to 0.25% and surprises by introducing more expansionary measures than expected.

JULY 2016

11 The Japanese Prime Minister, Shinzo Abe, approves a new package of fiscal stimuli.
27 The European Council annuls its fines on Spain and Portugal for not having taken effective measures to correct their excessive deficits and sets new budget targets.
29 The results of the EBA's stress tests are published.

JUNE 2016

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

AGENDA

DECEMBER 2016

2 Registration with Social Security and registered unemployment (November).
5 Industrial production index (October).
8 Governing Council of the European Central Bank.
13 Fed Open Market Committee.
15-16 European Council.
16 Quarterly labour cost survey (Q3).
19 Loans, deposits and NPL ratio (October).
20 State budget execution (November).
22 International trade (October).
29 Household savings rate (Q3).
30 Flash CPI (December).
Balance of payments (October).
Net international investment position (NIIP) (Q3).

JANUARY 2017

11 Industrial production index (November).
16 Financial accounts (Q3).
18 Loans, deposits and NPL ratio (November).
19 Governing Council of the European Central Bank.
26 Labour force survey (Q4).
27 US GDP (Q4).
29 Flash GDP (Q4).
31 Balance of payments (November).
CPI flash estimate (January).
Fed Open Market Committee.
GDP of the euro area (Q4).

2017: growing in an uncertain world

The global economy is having to tackle a more uncertain environment but is still posting good rates of growth. It now looks like growing by 3.1% in 2016, a very similar rate to the 3.2% registered in 2015, and will accelerate notably in 2017 with growth predicted to reach 3.5%. However, the uncertainty surrounding the macroeconomic scenario has increased after Donald Trump's victory and will remain high at least until the stance of the new US government becomes clear. In the short term this impasse could bring about a more pronounced upswing in long-term interest rates and financial instability in key emerging countries. Nonetheless, the bulk of the evidence suggests that the agenda applied by the new US President will be pragmatic as he needs the support of the Republican Party's moderate wing in Congress to be able to implement his measures.

Moderate upward revision in growth and inflation forecasts for the US. After Donald Trump's election, the new CaixaBank Research scenario assumes a fiscal impulse of approximately 1 pp between 2017 and 2018 and predicts a moderate impact on growth and inflation. Specifically, the new forecasts place growth in 2017 and 2018 at 2.3% and 2.4%, respectively. This improved economic outlook strengthens the scenario of interest rate hikes by the Fed. In fact, after Trump's victory the market has quickly adjusted its expectations regarding the Fed's actions and now assumes it will raise interest rates on two more occasions in 2017, in addition to a hike in December 2016. This scenario is very similar to the one produced by CaixaBank Research, assuming three fed funds hikes next year.

The emerging financial environment is faltering given the new political scenario in the US. The combination of expansionary fiscal measures and less accommodative monetary policy does not help emerging assets to perform well and this can be seen in the reaction of the emerging stock markets and currencies over the last few weeks. It should be noted, however, that the emerging bloc as a whole is taking on this less favourable environment in a much stronger position than in previous episodes of instability. Especially relevant are the good activity figures posted over the last few months, which continue to show a notable acceleration in growth. The moderate recovery in oil prices, which is expected to continue after the different OPEC countries have reached an agreement to cap production, should also help the emerging countries to recover as many of them still depend on commodity exports.

The euro area continues to recover at a moderate rate, supported by the ECB's expansionary monetary policy, low oil prices and the structural reforms carried out by different countries in the euro area. The impact of Brexit on growth has also been more subdued than initially expected, at least for the time being, although this does not mean it will not have a more significant impact in the medium term. Inflation is also showing a relatively favourable trend, supported by the growth in domestic demand and recovering oil prices. Nonetheless, it is still at a relatively low level and far from the ECB's target (in November, inflation was 0.6%). Given this situation, attention has once again turned to the ECB's actions as most of the evidence suggests that, over the coming months, the monetary authority will announce an extension to its asset purchase programme, which was initially meant to end in March 2017. At present, expectations that the ECB will enlarge QE, together with the market assuming a faster pace of interest rate hikes by the Fed, are substantially depreciating the euro against the dollar.

The Spanish economy stands out for its positive performance within Europe, with GDP growing strongly and better growth prospects for 2016 and 2017. In 2016 Q3, the Spanish economy grew by 0.7% quarter-on-quarter (3.2% year-on-year), in line with the CaixaBank Research forecast. However, the revision of the historical series, which states that, in the first half of 2016, the Spanish economy grew slightly more than previously announced, and the acceleration in activity shown by the early indicators for Q4, particularly in the labour market, have led us to revise upwards our GDP growth forecast for the whole of 2016 from 3.1% to 3.3%. This revision is also notable for 2017, namely from 2.4% to 2.6%. The bulk of the evidence therefore suggests that growth will remain strong and considerably higher than the advances made by most other developed countries. According to CaixaBank Research forecasts, this good rate of growth means that, in 2017, the Spanish economy will exceed the level of GDP achieved in 2008, before the recession started. Moreover, it should be noted that, although 2017's growth rate will be slightly lower than in 2016, this will be due to dwindling tailwinds and the trend in the underlying factors will still be favourable.

FORECASTS

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

International economy

	2015	2016	2017	2018	2016 Q2	2016 Q3	2016 Q4	2017 Q1	2017 Q2	2017 Q3
GDP GROWTH										
Global	3.2	3.1	3.5	3.6	3.0	3.1	3.2	3.5	3.6	3.5
Developed countries	*2.1*	*1.6*	*1.8*	*2.0*	*1.5*	*1.6*	*1.7*	*1.8*	*1.9*	*1.8*
United States	2.6	1.6	2.3	2.4	1.3	1.6	1.9	2.2	2.4	2.2
Euro area	1.9	1.6	1.4	1.6	1.6	1.6	1.5	1.3	1.4	1.4
Germany	1.5	1.8	1.4	1.6	1.7	1.7	1.8	1.3	1.3	1.6
France	1.2	1.2	1.1	1.3	1.2	1.1	1.1	0.8	1.2	1.2
Italy	0.6	0.9	0.8	0.8	0.7	0.9	0.9	0.7	0.9	0.7
Portugal	1.6	1.2	1.0	1.3	0.9	1.6	1.5	1.4	1.3	0.7
Spain	3.2	3.3	2.6	2.2	3.4	3.2	3.0	2.9	2.6	2.4
Japan	0.6	0.7	1.1	0.8	0.7	0.8	1.4	1.1	1.3	0.9
United Kingdom	2.2	2.0	1.0	1.5	2.1	2.3	1.9	1.6	1.1	0.7
Emerging countries	*4.0*	*4.2*	*4.7*	*4.8*	*4.2*	*4.2*	*4.2*	*4.7*	*4.7*	*4.7*
China	6.9	6.6	6.3	5.9	6.7	6.7	6.5	6.6	6.5	6.2
India [1]	7.6	7.3	7.6	7.7	7.1	7.3	7.4	7.5	7.6	7.6
Indonesia	4.8	5.1	5.4	5.6	5.2	5.0	5.3	5.3	5.4	5.4
Brazil	–3.8	–3.3	1.1	2.1	–3.6	–2.9	–1.3	0.5	1.2	1.3
Mexico	2.6	2.1	2.0	2.5	2.6	2.0	1.6	1.8	1.9	2.1
Chile	2.3	1.7	2.0	2.5	1.6	1.6	1.5	1.8	1.9	2.1
Russia	–3.7	–0.7	1.3	1.6	–0.6	–0.5	–0.4	1.0	1.3	1.4
Turkey	3.9	3.2	2.9	3.4	3.1	2.2	2.8	2.2	2.7	3.2
Poland	3.6	2.7	3.3	3.5	3.0	2.1	3.1	3.4	3.4	3.4
South Africa	1.2	0.5	1.3	1.9	0.7	0.9	1.0	1.1	1.2	1.3
INFLATION										
Global	2.8	2.8	3.3	3.3	2.8	2.7	2.9	3.3	3.3	3.4
Developed countries	*0.3*	*0.8*	*1.8*	*1.9*	*0.6*	*0.7*	*1.1*	*1.8*	*1.8*	*1.9*
United States	0.1	1.2	2.3	2.4	1.0	1.1	1.6	2.4	2.3	2.4
Euro area	0.0	0.2	1.4	1.6	–0.1	0.3	0.7	1.4	1.4	1.5
Germany	0.1	0.3	1.6	1.7	0.0	0.4	0.7	1.5	1.5	1.7
France	0.1	0.3	1.5	1.6	0.1	0.4	0.6	1.4	1.4	1.6
Italy	0.1	–0.1	1.1	1.4	–0.3	–0.1	0.1	0.9	1.1	1.2
Portugal	0.5	0.7	1.3	1.5	0.5	0.7	1.1	1.2	1.3	1.3
Spain	–0.5	–0.3	1.7	1.5	–0.9	–0.2	0.8	2.0	1.9	1.7
Japan	0.8	–0.1	0.9	0.8	–0.3	–0.5	0.5	1.0	0.8	1.2
United Kingdom	0.0	0.7	2.5	2.6	0.4	0.7	1.2	2.1	2.4	2.7
Emerging countries	*4.7*	*4.4*	*4.4*	*4.3*	*4.5*	*4.3*	*4.2*	*4.3*	*4.4*	*4.4*
China	1.4	2.0	2.0	2.1	2.1	1.7	2.1	1.5	2.0	2.3
India	4.9	5.1	5.5	5.4	5.7	5.2	4.4	5.9	5.5	4.9
Indonesia	6.4	3.6	4.1	5.0	3.5	3.0	3.5	3.6	4.3	4.0
Brazil	9.0	8.8	6.5	5.3	9.2	8.7	7.3	6.7	6.5	6.5
Mexico	2.7	2.9	3.4	3.3	2.6	2.8	3.4	3.4	3.4	3.4
Chile	4.3	4.0	3.2	3.3	4.2	3.8	3.3	3.0	3.1	3.2
Russia	15.5	7.2	5.7	5.4	7.3	6.8	6.1	5.7	5.8	5.6
Turkey	7.7	7.9	7.7	6.8	6.9	8.0	8.1	8.1	7.9	7.6
Poland	–0.9	–0.6	1.7	2.4	–0.8	–0.8	–1.1	–1.1	–0.8	0.4
South Africa	4.6	6.4	5.9	6.0	6.2	6.0	6.8	6.1	5.5	5.7

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

Forecasts

Spanish economy

	2015	2016	2017	2018	2016 Q2	2016 Q3	2016 Q4	2017 Q1	2017 Q2	2017 Q3
Macroeconomic aggregates										
Household consumption	2.8	3.1	2.5	2.0	3.2	2.8	2.8	2.7	2.6	2.5
General government consumption	2.0	1.3	1.0	0.8	0.8	1.4	1.0	0.7	1.6	0.8
Gross fixed capital formation	6.0	3.6	2.9	2.9	3.6	3.1	2.8	2.8	2.4	3.1
Capital goods	8.9	5.7	2.8	2.8	6.2	5.0	4.0	3.6	2.1	2.6
Construction	4.9	2.3	3.1	3.0	2.0	2.0	2.3	2.5	2.8	3.4
Domestic demand (contr. Δ GDP)	3.3	2.8	2.2	1.8	2.9	2.6	2.3	2.2	2.3	2.2
Exports of goods and services	4.9	4.2	3.7	4.1	6.4	2.8	3.6	4.2	2.1	4.5
Imports of goods and services	5.6	3.1	3.0	3.2	5.1	0.9	1.5	2.5	1.4	4.2
Gross domestic product	**3.2**	**3.3**	**2.6**	**2.2**	**3.4**	**3.2**	**3.0**	**2.9**	**2.6**	**2.4**
Other variables										
Employment	3.0	2.8	2.3	2.0	2.7	2.7	2.9	2.6	2.5	2.3
Unemployment rate (% labour force)	22.1	19.7	18.0	16.7	20.0	18.9	18.7	19.0	18.2	17.4
Consumer price index	–0.5	–0.3	1.7	1.5	–0.9	–0.2	0.8	2.0	1.9	1.7
Unit labour costs	0.2	–0.2	0.6	1.3	–0.3	–0.4	0.2	0.2	0.5	1.1
Current account balance (cum., % GDP)[1]	1.4	2.2	1.8	1.6	1.8	1.9	2.2	2.1	2.0	1.9
Net lending or borrowing rest of the world (cum., % GDP)[1]	2.0	2.8	2.4	2.2	2.4	2.4	2.8	2.7	2.6	2.5
Fiscal balance (cum., % GDP)[2]	–5.0	–4.6	–3.4	–2.5						

Financial markets

INTEREST RATES										
Dollar										
Fed Funds	0.26	0.52	1.04	1.94	0.50	0.50	0.58	0.75	1.00	1.08
3-month Libor	0.32	0.75	1.42	2.21	0.64	0.79	0.93	1.12	1.32	1.52
12-month Libor	0.79	1.37	2.00	2.63	1.25	1.46	1.61	1.76	1.92	2.08
2-year government bonds	0.67	0.82	1.62	2.71	0.77	0.72	0.94	1.21	1.48	1.76
10-year government bonds	2.13	1.81	2.76	3.49	1.75	1.56	2.04	2.47	2.68	2.86
Euro										
ECB Refi	0.05	0.01	0.00	0.08	0.00	0.00	0.00	0.00	0.00	0.00
3-month Euribor	–0.02	–0.26	–0.21	0.20	–0.26	–0.30	–0.30	–0.28	–0.25	–0.20
12-month Euribor	0.17	–0.03	0.05	0.53	–0.02	–0.05	–0.06	–0.03	0.01	0.06
2-year government bonds (Germany)	–0.24	–0.56	–0.24	0.38	–0.52	–0.64	–0.60	–0.43	–0.34	–0.19
10-year government bonds (Germany)	0.53	0.11	0.76	1.79	0.12	–0.12	0.14	0.34	0.57	0.95
EXCHANGE RATES										
$/€	1.11	1.11	1.03	1.05	1.13	1.12	1.09	1.06	1.02	1.02
¥/€	134.33	119.55	113.01	116.69	121.91	114.26	115.00	113.67	111.99	113.04
£/€	0.73	0.82	0.88	0.87	0.79	0.85	0.89	0.90	0.89	0.88
OIL										
Brent ($/barrel)	53.61	45.24	59.32	65.79	47.35	47.49	50.41	56.17	58.57	60.50
Brent (€/barrel)	48.30	40.78	57.63	62.86	41.94	42.57	46.21	53.25	57.21	59.31

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

Forecasts

FINANCIAL OUTLOOK · **Limited impact from the upswing in political uncertainty**

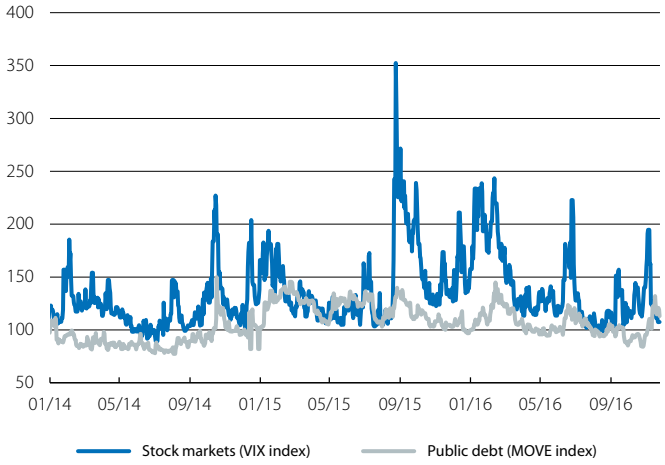
Global markets handle the second shock of uncertainty for the year to date with relative success. Political events have once again surprised a large proportion of the international community. Donald Trump's victory in the US elections, against all predictions, has once again highlighted the growing importance of the political factor as a prime source of risk. As expected, the Republican candidate's election has triggered quite large fluctuations in the main types of assets, although the direction of some of these movements has also come as a surprise ex post. The climate of high risk aversion and volatility has faded quickly; stock markets have managed to make up their huge losses and yields on long-term sovereign debt have reversed their initial falls. This risk-on dynamic, characterised by a sharp upswing in risk-free interest rates, gains in developed stock markets and the appreciation of the dollar, has remained in the weeks after the electoral outcome but it is not sure whether this pattern will continue for long.

Post-electoral uncertainty will not disappear and will remain high, especially in areas related to economic policy. Once D. Trump moves into the White House, several questions will emerge which, in the short and medium term, investors will have to live with. These concern almost all public policies, from immigration, trade, foreign policy and regulation to economic policy. But market attention is focussing particularly on the last area, economic policy, at least in the short term. As of today it seems very likely that the new Administration will carry out a moderately expansionary fiscal policy involving tax cuts and more spending on infrastructures and defence and we expect this fiscal impulse to bring about slightly higher rates of GDP growth and inflation in the US than previously expected, both in 2017 and 2018 (see the section on the International Economy in this *Monthly Report* for more details). Nevertheless, the high uncertainty will continue until the new Administration actually takes over and starts to specify its measures.

Expectations concerning a change in direction for fiscal policy trigger sharp upswings in sovereign bond yields. The rise in long-term sovereign yields has been substantial. In the US, the yield on the 10-year bond has increased by 50 bps since the Presidential election, up to 2.35%, while the yield on the 30-year bond has risen by 40 bps to 3%. Although sovereign debt in Europe and Japan has been less affected, it has not remained on the margins of this dynamic. The IRR for the bund has risen to 0.25% and the rate for Japan's 10-year bond to 0.05%. This readjustment in sovereign yields is largely due to increased expectations of growth and inflation, in turn because of the outlook for fiscal stimuli. Particularly important

Implied volatility in financial markets

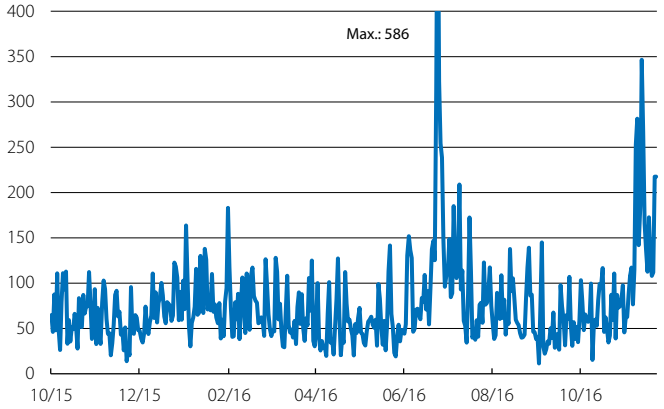
Index (100 = January 2007)



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

*US: economic policy uncertainty index **

Level



Note: ** Index calculated based on the number of times the word «uncertainty» or a similar word appears in a newspaper article.*
Source: *CaixaBank Research, based on data from Baker, Bloom, Davis and Bloomberg.*

US: yields on sovereign debt

(%)

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

is the correction recorded in long-term inflation expectations in the US, close to 30 bps.

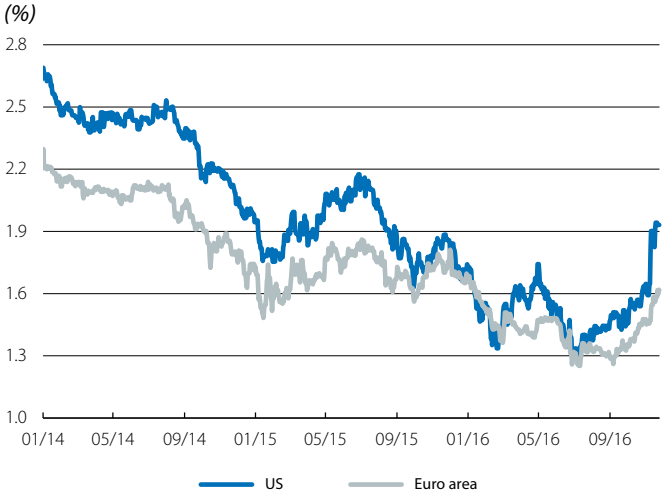
Various factors suggest this upswing in yields will be more permanent than temporary. The shift in the Trump Administration's policy mix towards more expansionary fiscal policies and increased risk due to its protectionist measures suggests a scenario of somewhat higher long-term interest rates. This has probably had an effect on the normalisation of the risk premium for longer-term Treasury bills, which has recently fallen to unusually low levels. In the medium term the pressure that may be exercised by expansionary fiscal policy on public finances will also be important. With public debt ending this year close to 110% of GDP, investors are increasingly concerned about such high levels.

In this environment, the Federal Reserve (Fed) will not alter the next steps in its normalisation strategy. Given the large amount of uncertainty in the political sphere, the Fed will choose to provide some clarity through its messages and future actions. With a view to its December meeting, the CaixaBank Research scenario assumes that the central bank will raise the fed funds rate to 0.50%-0.75% at the same time as repeating the conditions for future hikes, namely the trend in business indicators, prices and wages. In this respect, given that a moderate acceleration in growth and inflation is expected for 2017 and 2018, monetary policy is also likely to take a less accommodative stance. The US money market has also followed the same lines, assuming one interest rate hike in 2017 and two in 2018 compared with none and one, respectively, before the US elections.

High expectations regarding the adjustments to be announced by the ECB in its asset purchase programme (QE). After its meeting in October, when no great changes were made, the bulk of the evidence suggests that the ECB's Governing Council (GC) will announce significant modifications to QE in December. Attention will be focused on the likely extension of the asset purchase programme beyond March 2017, as well as on possible references to the start of tapering. In the last few weeks statements made by different GC members, at times conflicting, have not helped to make the ECB's intentions any more certain. Nonetheless, the tone of the minutes to October's meeting suggests Draghi will be cautious and focus his speech on reinforcing the ECB's commitment to achieve its inflation target. Such caution seems appropriate given the political uncertainty, both at a global level and also in Europe. Events such as Italy's referendum on 4 December and general elections in the Netherlands, France and Germany next year mean that political risk will not subside.

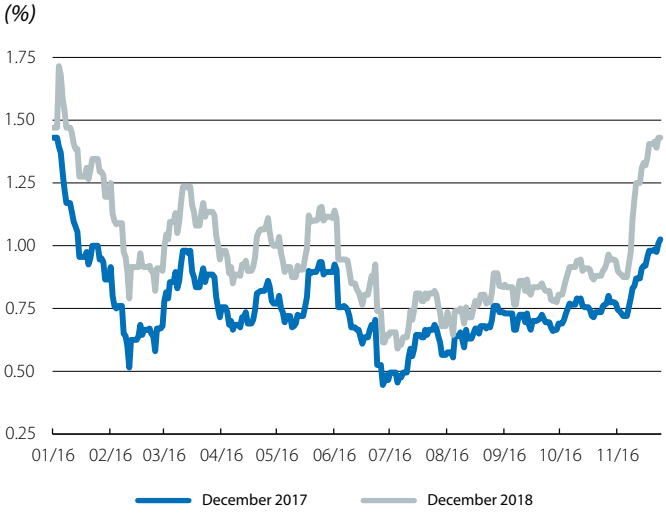
Equity takes advantage of the upswing in volatility in sovereign bond markets. One of the most visible consequences of the outcome of the US elections has been the shift in flows observed from fixed-income securities towards the equity of the advanced bloc. This is somewhat

*US and euro area: inflation expectations **



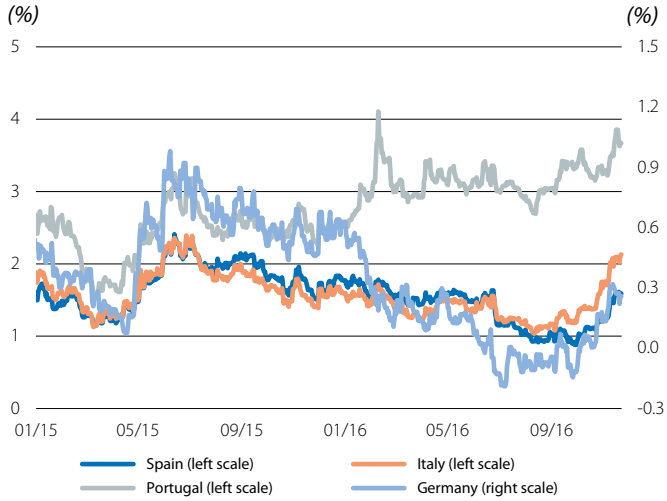
Note: ** Inflation Swap Forward 5Y5Y.*
Source: *CaixaBank Research, based on Bloomberg data.*

US: fed funds futures



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

Euro area: yields on 10-year sovereign debt



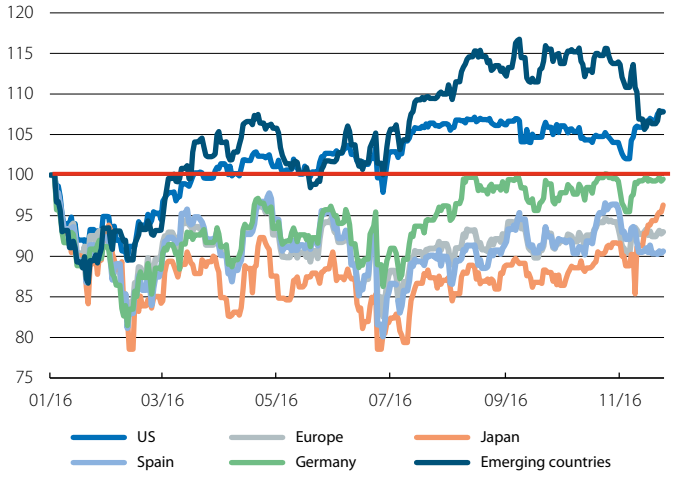
Source: *CaixaBank Research, based on Bloomberg data.*

paradoxical if we remember that, in the eyes of most investors, a victory for Trump represented a notable risk. The S&P 500 is more than 2% above its pre-election level, the Nikkei is almost 7% higher while the Eurostoxx is only 0.5%. However, it is not sure whether this positive pattern will continue as it is vulnerable to changes in how investors perceive the factors that seem to support this solid performance by the US stock market. A closer look at the post-election rally shows it has been caused by gains in those sectors that could most benefit, a priori, from the decisions taken by a Trump Administration, such as finance, energy, industry and infrastructures while the gains made by US firms with a more domestic focus are also revealing. Beyond short-term movements, the truly important question is whether the policies adopted by the Trump Administration will be able to promote long-term growth without generating notable imbalances or whether, on the other hand, their effects will be temporary.

The emerging financial environment is faltering given the new political scenario in the US. The combination of expansionary fiscal measures and less accommodative monetary policy in the US does not help emerging assets to perform well. Emerging stock markets and currencies have been hit hard by this change in the US policy mix and there has been a sharp increase in capital outflows from the emerging stock and bond markets, albeit to a greater or lesser extent depending on the country concerned. The appreciation of the dollar, which in nominal effective terms exceeds 4% since Trump won the election, and the upward trend in yields on US sovereign debt are increasing the risks to financial stability for some countries. However, the emerging bloc as a whole is taking on this less favourable environment in a much stronger position than in previous episodes of instability. For example, today macroeconomic vulnerability is substantially lower thanks to many countries reducing their internal imbalances (see the Dossier article in this *Monthly Report* «Outlook for the emerging markets in 2017» for a more in-depth analysis of the strengths and weaknesses of the macroeconomic and financial situation of the emerging countries). Lastly, additional support could also come from rising oil prices. The agreement reached by OPEC members to reduce the production of crude should help in this respect, although its implementation will have to be credible and orderly for oil prices to become more stable.

Main international stock markets

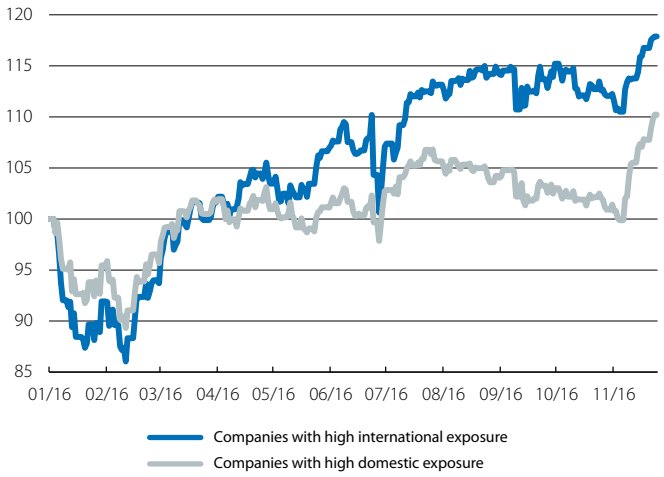
Index (100 = January 2016)



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

S&P 500: stock market trend by type

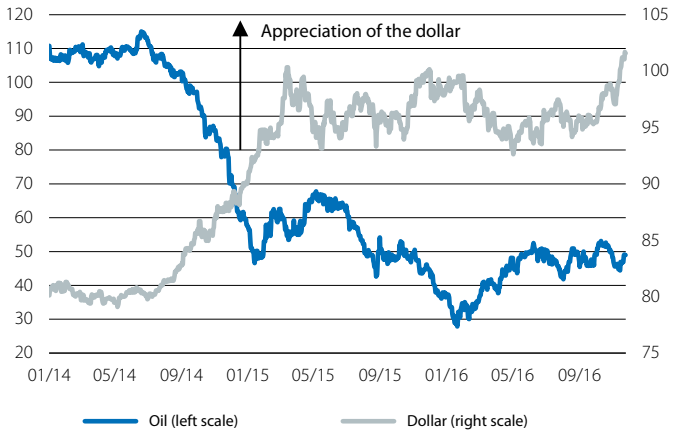
Index (100 = January 2016)



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

*Dollar index and Brent oil **

(Dollars per barrel) *Index*



Note: ** Dollar index: nominal effective exchange rate of the dollar compared with a basket of from the 10 main trading partners of the US.*
Source: *CaixaBank Research, based on Bloomberg data.*

FOCUS · The reform of the money funds market in the US

On 14 October the latest reform came into force of the money funds market in the US (MFM hereafter), the most ambitious for the last few decades. One example of the importance of the changes involved in this new regulatory framework is the considerable rise in short-term private financing costs, both corporate and for the financial sector. Since January 2016, the 3-month Libor in dollars and yield on 3-month commercial paper have risen by 30 bps to 0.94% and 0.88%, respectively.

Before detailing the reform of the MFM regulatory framework and assessing its impact, we first need to briefly review how this market works and show just how important it has become for the US financial sector to function properly.

Money market funds (MMF hereafter) are investment vehicles that invest in short-term securities with high liquidity and ratings. Securities that meet these requirements are, for instance, Treasury bills, some corporate bonds, certificates of deposit and repos. The volume of MFMs is considerable: 2.9 trillion dollars in September 2016, representing close to 16% of GDP in the US. With regard to their type, there are two broad categories: government funds, which invest in government securities and agency debt, and prime funds, which principally invest in debt instruments issued by companies and financial institutions. Both of these categories are classified, in turn, according to the investor type: institutional or retail.

Broadly speaking, MMFs have two functions. On the one hand they offer a savings product with a similar level of liquidity and security as bank deposits but slightly higher yields. In fact, MMFs fix a stable net asset value (NAV), normally one dollar per share, even when their market value is lower. Their capital can also be immediately redeemed. On the other hand, these investment funds have become an important source of liquidity for money markets. According to IMF estimates, prime MMFs cover 35% of the short-term gross borrowing needs of US banks.

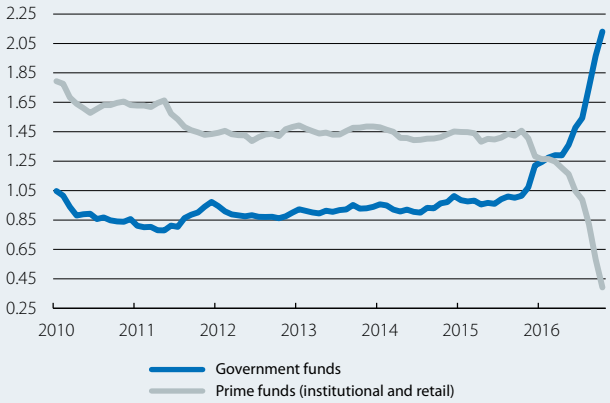
As these funds have become increasingly important providers of finance, fears have also increased of them becoming a potential source of financial instability. In this respect, one of the scenarios that most concern the US capital market regulator, the SEC, is a shock occurring that fuels a sudden, widespread rise in requests to redeem MMFs, as this would have serious consequences for the stability of the financial system in general and, ultimately, for the economy as a whole.

This is precisely the scenario the latest reform of the MFM regulatory framework hopes to prevent. Under the new regulatory requirements, prime MMFs from the institutional segment must leave the fixed NAV system and adopt a floating NAV one that reflects the market value of the securities in the fund. In addition, prime funds (both institutional and retail) can establish fees for redeeming funds of up to 2% and temporarily suspend redemption during periods of financial stress. Government MMFs are exempt from these new regulations.

The impact of this MFM reform on the US money market has been as stealthy as it has been intense. With the aim of avoiding fluctuations in NAVs and potential fees and restrictions on redeeming funds, there has been an exodus of over 1 trillion dollars from prime funds to government funds. This has led to a considerable de facto reduction in the demand for corporate and financial bonds. As a consequence, bank and corporate short-term financing costs have seen notable rises in the last few months. Although the readjustment of flows between money market funds can now be deemed to be over, these costs are unlikely to return to their levels of a few months ago given the structural nature of the changes in the regulatory framework. In the short term, the tightening up of financial conditions resulting from this process may cause temporary tensions in some banks or companies with a greater dependence on MFMs. However, this should not discredit the progress made by adopting these measures, both in terms of how they improve the transparency of MMFs and also help to mitigate systemic risk.

US: assets in money market funds by type

(Trillion dollars)



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

FOCUS · Oil prices will remain highly volatile

The slump in the price of crude oil at the end of 2014 came as very good news for households and for most companies in the main developed countries. However, although the price of black gold has remained relatively low, there has been a sharp upswing in its volatility, reaching levels not seen since the outbreak of the Great Recession. A brief review of the factors behind this increased volatility suggests this pattern will tend to continue, at least in the short term.

One initial source of uncertainty and therefore of this rise in volatility is the demand for oil. Specifically, in the last few years doubts have increased concerning the medium-term growth forecasts, particularly because of two factors: more uncertainty regarding the potential growth of economic activity in the developed countries and, at the same time, greater uncertainty regarding the intensity of growth in oil consumption. This second factor has become more accentuated in recent years with the emergence of new technologies and China's shift in its production model which promotes the development of services in detriment to industry.

Although demand factors are important, and in spite of the fact that some of these have intensified in the last few years, they cannot really explain the sudden change occurring in the volatility of oil prices since 2014. We must therefore look for the reason behind this change in pattern in aspects of oil supply. Here the outstanding factor is the emergence of shale, a disruptive change in production technology that is evolving very quickly, therefore complicating its valuation by economic agents. Given the events since 2014, the effects of shale are much greater than had been expected and this has raised two questions that have yet to be answered: at what price is shale profitable and what strategy will the OPEC countries take to counter this new threat?

Regarding the first question, although no concrete answer has been found, in recent years shale producers have appeared to be more resistant to falling oil prices than initially expected. In spite of the fact that most sites are not considered to be profitable once the oil price goes below 65-70 dollars, several producers are achieving earnings at today's prices and, in fact, investment is now starting to pick up again. This trend is consistent with recent analyses that suggest a profit threshold of around 60 dollars. All these questions undoubtedly fuel the rising volatility.

The answer to the second question largely depends on the uncertainty surrounding the price at which shale producers become profitable. The slump in oil prices occurred partly because Saudi Arabia decided to stop acting as a swing producer (adjusting its production to keep prices stable). The resulting increase in supply led to a large adjustment in price, intended to force shale producers out of the market.

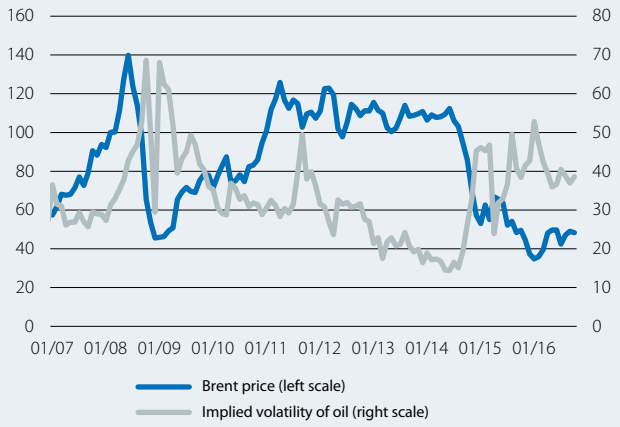
However, after several quarters of low oil prices, now the OPEC countries also urgently need the price to rise as their public finances have deteriorated considerably. These opposing tensions; the desire to push shale producers out of the market without knowing the price at which they would be ousted, and the pressure exercised by low prices on their own public finances, are what have kept oil prices particularly volatile over the last few quarters.

That is why the agreement reached by the OPEC countries on 30 November in Vienna is so important. After a long time some of the questions are now starting to be answered. In this agreement, cartel members have undertaken to reduce their production by 1.2 million barrels a day, down to a total of around 32.5 million. It therefore seems that, after several quarters of tension between the different countries that make up the cartel, they have finally all agreed that a price slightly above the present one, albeit not too high, is the most beneficial for them.

In any case, given the fact that the economies of most of the OPEC members are quite weak, encouraging them to violate the agreement and increase their production, the uncertainty regarding the viability of this agreement will remain extremely volatile until it becomes clear it has been adhered to. To confirm this we will have to wait for the production figures to be published throughout 2017. Volatility is therefore guaranteed for some time yet.

Oil market: price and volatility

(Dollars per barrel) *(Implied volatility index)*



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

KEY INDICATORS

Interest rates (%)

	30-Nov	31-Oct	Monthly change (bps)	Year-to-date (bps)	Year-on-year change (bps)
Euro area					
ECB Refi	0.00	0.00	0	–5.0	–5.0
3-month Euribor	–0.31	–0.31	0	–18.3	–20.0
1-year Euribor	–0.08	–0.07	–1	–14.0	–12.8
1-year government bonds (Germany)	–0.80	–0.69	–11	–42.2	–42.1
2-year government bonds (Germany)	–0.73	–0.62	–11	–38.5	–31.5
10-year government bonds (Germany)	0.28	0.16	12	–34.9	–19.3
10-year government bonds (Spain)	1.55	1.20	35	–22.1	2.9
10-year spread (bps)[1]	127	104	23	12.8	22.2
US					
Fed funds	0.50	0.50	0	0.0	25.0
3-month Libor	0.93	0.88	5	31.7	51.4
12-month Libor	1.64	1.58	6	46.2	65.9
1-year government bonds	0.77	0.64	13	17.3	29.1
2-year government bonds	1.11	0.84	27	6.2	18.0
10-year government bonds	2.38	1.83	55	11.1	17.4

Spreads corporate bonds (bps)

	30-Nov	31-Oct	Monthly change (bps)	Year-to-date (bps)	Year-on-year change (bps)
Itraxx Corporate	80	73	7	2.3	9.7
Itraxx Financials Senior	107	97	10	30.4	39.2
Itraxx Subordinated Financials	245	223	22	89.1	102.6

Exchange rates

	30-Nov	31-Oct	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
$/€	1.059	1.098	–3.6	–2.5	0.2
¥/€	121.190	115.100	5.3	–7.2	–6.8
£/€	0.847	0.897	–5.6	14.9	20.7
¥/$	114.460	104.820	9.2	–4.8	–7.0

Commodities

	30-Nov	31-Oct	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
CRB Commodity Index	421.0	403.6	4.3	12.3	9.6
Brent ($/barrel)	49.9	46.7	6.8	39.5	16.4
Gold ($/ounce)	1,173.3	1,277.3	–8.1	10.5	10.2

Equity

	30-Nov	31-Oct	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
S&P 500 (USA)	2,199	2,126	3.4	7.6	5.7
Eurostoxx 50 (euro area)	3,052	3,055	–0.1	–6.6	–13.0
Ibex 35 (Spain)	8,688	9,143	–5.0	–9.0	–16.4
Nikkei 225 (Japan)	18,308	17,425	5.1	–3.8	–7.3
MSCI Emerging	863	905	–4.7	8.6	6.0
Nasdaq (USA)	5,324	5,189	2.6	6.3	4.2

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

ECONOMIC OUTLOOK · The expansion continues but uncertainty grows after Donald Trump's victory

Global growth continues to progress at a good pace after the positive data posted in Q3. The Q3 growth indicators have been positive and somewhat higher than expected in the advanced countries while an acceleration in growth has been confirmed in the emerging ones, in line with our forecasts. The world economy is now expected to grow by 3.1% in 2016, a very similar figure to the 3.2% recorded in 2015, and will accelerate notably in 2017 with a predicted growth of 3.5%.

However, the uncertainty surrounding the macroeconomic scenario has increased after Donald Trump's victory and will remain high at least until the stance of the new US administration becomes clear. In the short term this stalemate could bring about a more pronounced upswing in long-term interest rates and financial instability in key emerging countries. After D. Trump's victory, capital outflows from the emerging countries to levels not seen since the taper tantrum of 2013 and the depreciation of these countries' currencies, particularly the Mexican peso and Turkish lira, illustrate such fears. However, the bulk of the evidence suggests that the agenda applied by the new US President will be pragmatic as he needs the support of the Republican Party's moderate wing in Congress to be able to implement his measures. Consequently, the most likely outcome is that the Trump administration will only carry out a moderated more expansionary fiscal policy since a large proportion of the Republican Party will not allow public debt to increase much further (it will end 2016 very close to 110% of GDP) while some specific protectionist measures will probably be implemented, such as anti-dumping measures aimed at specific countries and products.

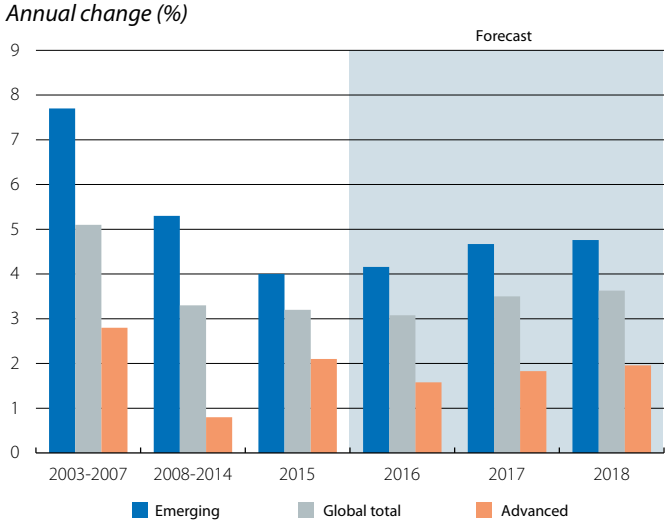
UNITED STATES

Upward revision of GDP growth in 2017 and 2018. The new scenario assumes a fiscal impulse of approximately 1 pp between 2017 and 2018 with a moderate impact on growth and inflation. The uncertainty is expected to dissipate quite quickly and should not substantially affect the macroeconomic scenario. According to the new CaixaBank Research forecasts, in 2017 growth will be 2.3% (previously 2.1%) and in 2018 it should be 2.4% (previously 2.0%). This upward revision is in line with a somewhat more expansionary fiscal policy than assumed for the scenario with a H. Clinton presidency, and includes tax cuts for higher income brackets and companies together with more spending on infrastructures. On the other hand, in this scenario inflation will also accelerate slightly faster than predicted, reaching 2.3% in 2017 and 2.4% in 2018, a revision of +0.1 and +0.2 pps, respectively.

The new macroeconomic situation strengthens expectations of interest rate hikes by the Fed. Inflation

World GDP

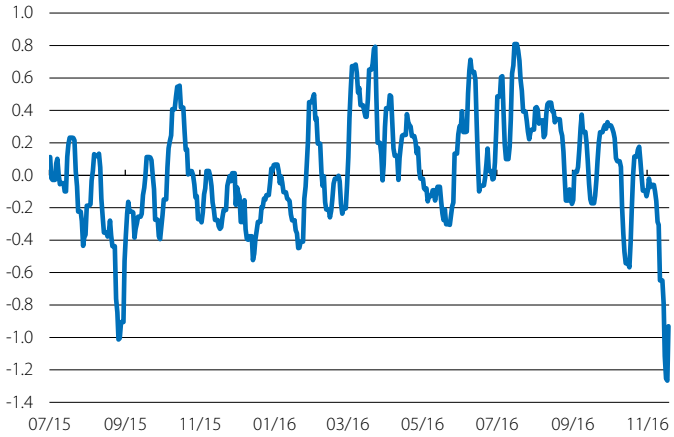
Annual change (%)



Source: *CaixaBank Research.*

Daily net portfolio inflows to emerging markets * (debt and shares)

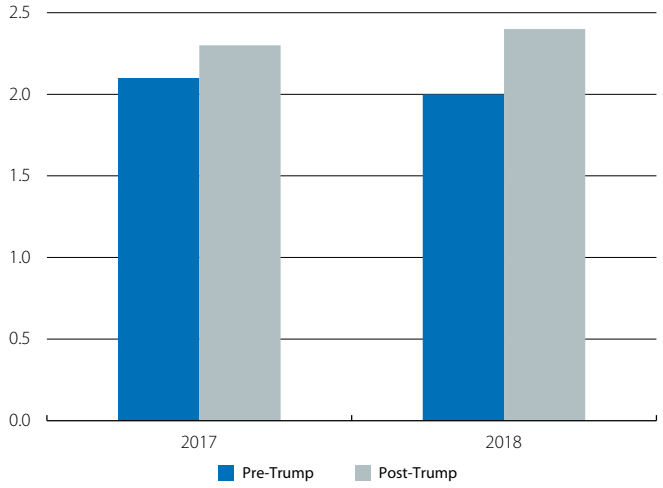
7-day moving average (billion dollars)



Note: ** Countries included: Indonesia, India, Korea, Thailand, South Africa, Brazil, Turkey, Hungary and Mexico.*
Source: *CaixaBank Research, based on data from the IIF.*

US: GDP growth forecasts

Annual change (%)



Source: *CaixaBank Research.*

gradual recovery towards levels closer to 2% and better growth prospects have dispelled doubts regarding the Fed's future actions while the fact that the labour market trend is still positive and activity indicators have been favourable further reinforce this scenario. 161,000 jobs were created in October, putting the monthly average for the year to date at a healthy 181,000. The ISM business sentiment index for manufacturing reached 51.9 points, consolidating the strong upswing registered in September, while the ISM indicator for services also remained at a high level (54.8 points). These buoyant economic indicators along with good GDP growth data in Q3, bolster the accuracy of a growth rate forecasted at 1.6% in 2016.

Investors readjust their expectations regarding the speed with which the Fed will raise interest rates. Donald Trump's victory and good economic indicators have prompted the market to increase the pace at which it expects the fed funds rate to increase: from no hike to one in 2017 (0.75%-1%) and from one to two hikes in 2018 (1.25%-1.5%). The price of US financial assets, particularly long-term sovereign bonds, therefore reflects a scenario for interest rates that is more similar to the CaixaBank Research one, which has remained unchanged: namely a second hike in December 2016, three additional hikes in 2017 (1.25%-1.5%) and three more in 2018 (2%-2.25%).

JAPAN

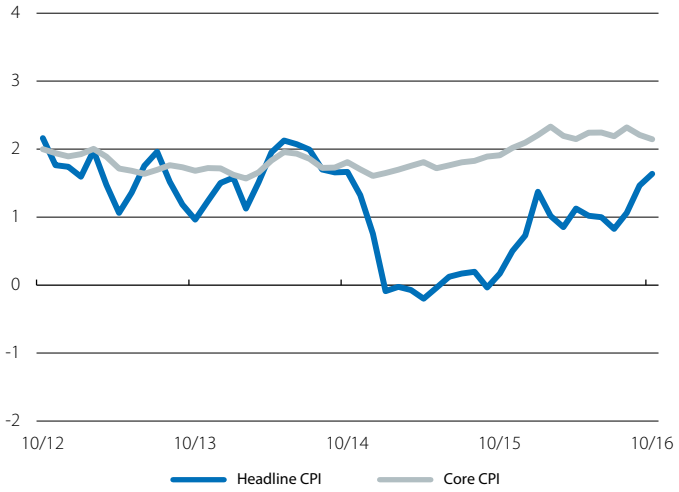
GDP growth was surprisingly high in Q3, advancing much more than expected, both by CaixaBank Research and by the consensus of analysts. In quarter-on-quarter terms it grew by a significant 0.5% while in year-on-year terms growth was 0.8%. However, this pleasant surprise has been offset to some extent by the fact that GDP's composition was not so encouraging: the acceleration was due to a solid contribution made by exports but this contrasted with weak growth in private consumption and the modest progress of capital goods investment. After this good data in Q3, CaixaBank Research forecasts have been revised slightly upwards, both for 2016 (from 0.6% to 0.7%) and for 2017 (from 1.0% to 1.1%) but the benchmark scenario, in the medium term, remains unchanged. On the other hand inflation is still depressed in Japan, making it more difficult to achieve the monetary authority's target of 2%. The headline CPI grew in October by 0.1% while the benchmark CPI for the Bank of Japan (without fresh foods) fell for the eighth consecutive month (–0.4% year-on-year).

EMERGING ECONOMIES

Unease in Mexico due to D. Trump's victory. The Republican candidate's victory represents a shock of uncertainty in the short term and potential moderate effects in the medium term, prompting a revision of CaixaBank Research benchmark scenario. Although no extreme change is expected to NAFTA or to migratory relations between Mexico and the US, it is true the countries' political relations have probably been damaged (financial turmoil is likely, particularly related to the exchange

US: CPI

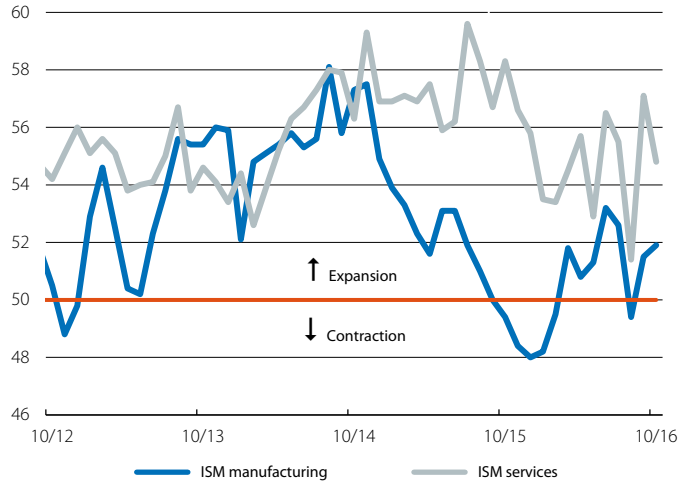
Year-on-year change (%)



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

US: activity indicators

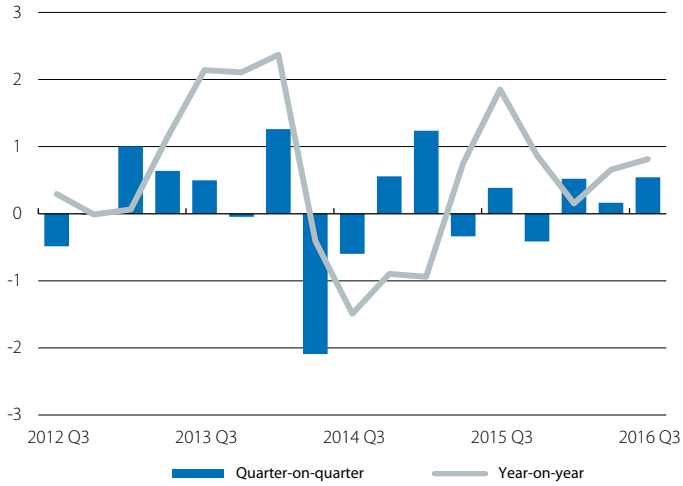
Level



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

Japan: GDP

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



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

rate, and the peso's strong devaluation after Trump's victory illustrates this risk). We have therefore made a moderate downward adjustment to our growth forecasts of –0.1 pps in 2016 (from 2.2% to 2.1%) and of –0.5 pps in 2017 and 2018 (from 2.5% to 2.0% in 2017 and from 3.0% to 2.5% in 2018). We also expect that the Bank of Mexico will be more aggressive with its interest rate hikes in order to keep inflation under control.

Good performance of the economic indicators for the emerging countries as a whole. The predicted growth for the rest of the emerging countries remains unchanged as business indicators continue to show an acceleration in their growth rate, in line with CaixaBank Research scenario. It is worth noting the aggregate economic growth index compiled by the IIF, which points to growth of around 4.5%, clearly above the 3.5% posted at the beginning of the year.

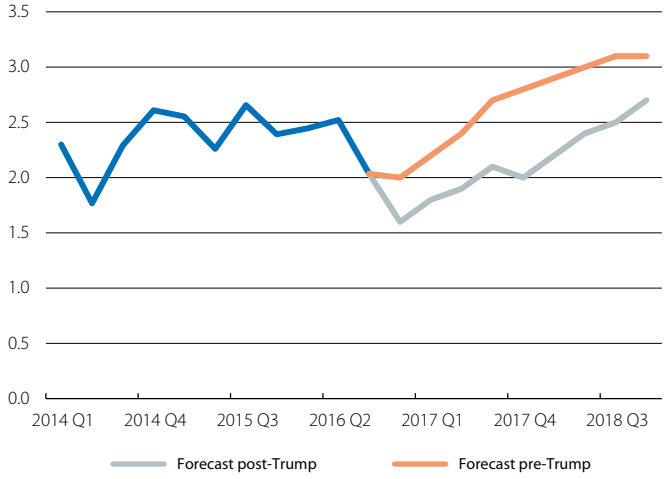
China's economy is stabilising but doubts remain regarding its willingness to reform. Economic indicators in October confirm that China's economy is stabilising and the foreign sector was the only element still showing signs of weakness (see the Focus «Slowdown in world trade and investment» in this *Monthly Report*). However, beyond this short-term perspective there are still important sources of risk. In particular, November's surprising dismissal of the country's Finance Minister and defender of structural reforms, Lou Jiwei, seems to indicate that the Chinese government prioritises short-term growth over reforms. This is particularly worrying because, in the last few years, Chinese growth has gone hand in hand with increasing corporate debt, which is now at a level difficult to sustain, as well as strong pressure on the real estate sector. These elements illustrate the need to carry out far-reaching structural reforms to ensure growth is balanced and can be sustained over the long term.

Brazil, India and Russia: three countries that epitomise different emerging dilemmas. In Brazil, GDP suffered a considerable decline in Q3 with a fall of –2.9% (–3.6% in the second half of the year), affected by a sharp drop in investment. This figure confirms that it is still complicated for the country to exit its recession. For its part, India's economy grew by a significant 7.3% (7.1% in the previous quarter) thanks to dynamic consumption, which offset a fall in investment. Lastly, the end of economic weakness is starting to be glimpsed in Russia: in 2016 Q3 GDP fell by 0.4% year-on-year (–0.6% in Q2). This figure is slightly better than expected and confirms that the country is slowly exiting its recession. The outlook for 2017 is promising as the economy is expected to return to positive growth (1.3% for the year as a whole).

Commodities: no change in the scenario for oil after the OPEC agreement. In response to the agreement reached on 30 November that limits the daily production of crude oil to 32.5 million barrels, the price of Brent quality oil went up more than 8% and reached 50 dollars per barrel. The price is expected to continue rising gradually over the coming months, although volatility is also likely to remain high (see the article «Oil prices will remain highly volatile» in this *Monthly Report*).

Mexico: GDP

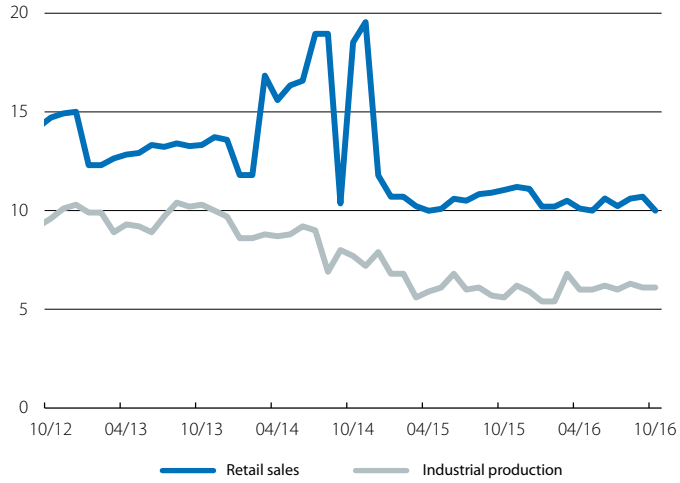
Year-on-year change (%)



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

China: activity indicators

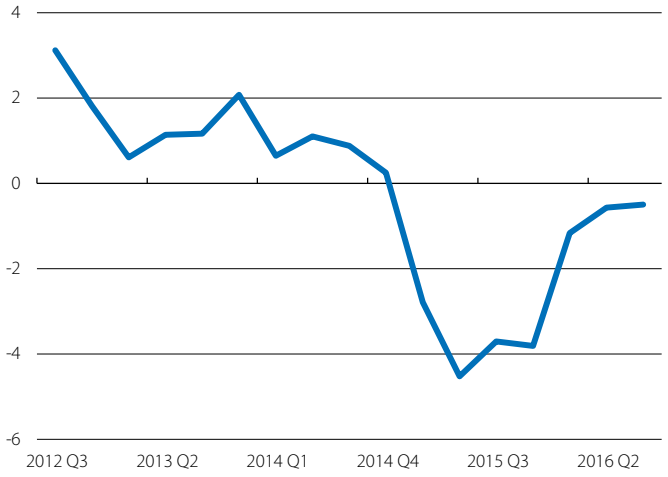
Year-on-year change (%)



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

Russia: GDP

Year-on-year change (%)



Source: *CaixaBank Research, based on data from the Federal Service for State Statistics.*

FOCUS · Slowdown in world trade and investment

The weak trend in global trade is a key cause of concern, particularly in developed countries. In the years before the crisis, trade grew at a rate far above that of GDP but, after the ups and downs occurring at the peak of the recession, world trade's performance has not been very dynamic. Many developed countries are fearful of this new pattern as they were hoping external sector could be a potential source of growth, given the poor recovery in domestic demand. Hence, the ongoing debate: will this change in trend observed in global trade continue over the next few years or is it temporary?

As this is a relatively new phenomenon, the debate regarding which factors might be altering the trend in worldwide trade is still ongoing among economists but there is some consensus that this is due to the convergence of several elements, especially increased protectionism and a slowdown in the formation of global value chains.

Another factor that seems to be crucial to understanding the recent trend in trade is the poor performance by investment over the last few years, a relatively widespread phenomenon in developed countries but also in some emerging economies.[1] Specifically, different studies attribute around 50% of the slowdown in world trade to lower growth in investment.[2]

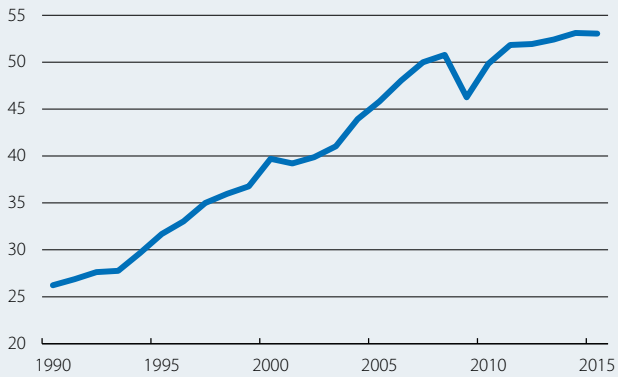
In developed countries, this poor trend in investment over the last few years is due to several factors such as the high leveraging of the corporate sector and the financial sector's reduced credit capacity at the start of the recession, as well as the rise in uncertainty due to a number of shocks. However, to a greater or lesser extent depending on the country in question, these elements have tended to fade in the last few years but nevertheless investment has yet to liven up. That is why various studies suggest that, in addition to these temporary factors, this lower growth in investment is also due to the impact of new technologies. For example, those sectors most closely related to new technologies, which are also those enjoying the highest growth, invest a lot less that the classic industrial sectors.[3] Although investment should become more dynamic in the short term as the aforementioned temporary factors continue to wane, the long-term growth prospects have also been reduced.

Regarding the emerging countries, this change in the pattern of investment can particularly be seen in China. The Asian giant is currently going through a far-reaching shift in its economic production model, moving away from an investment-export pattern and encouraging household consumption and the services sector. The impact of this change on world trade is not insignificant as the Asian country has been one of the driving forces behind growing trade flows (both in commodities and manufactured goods). The dynamism of Chinese investment, focused on infrastructures, meant that the country became the main demander of most basic metals in the 2000s, in many cases consuming almost 50% of the world's production. However, the slowdown in the Asian giant's investment has pushed down demand for commodities and, consequently, global trade flows. Although this is a less relevant factor than the weak investment trend in developed countries, its structural nature will have long-lasting implications for trade.

In short, the weakness of investment has been a key factor in the slowdown of global trade flows. Two conclusions result from this analysis. In the short term, the recovery in investment in developed countries will once again boost trade flows at a global level. However, in the medium term the change in China's production model and the increasing importance of new technologies will limit such trade flows.

International trade

Imports (% of GDP)



Note: *Aggregate imports of goods and services and GDP based on the exchange rate and in constant terms (in 1980 dollars).*
Source: *CaixaBank Research, based on data from the IMF and the WTO.*

1. Investment is one of the GDP components with the highest import intensity. For example, for the average of OECD countries, for each euro of investment spent, 32 cents correspond to imported intermediate inputs.
2. Different studies suggest that weak investment may lie behind 40% to 75% of the slowdown in world trade. See, for example, the IMF, «Global Trade: What's Behind the Slowdown», WEO, October 2016, Chapter 2; OECD «Cardiac arrest or dizzy spell: why is world trade so weak and what can policy do about it?», Economic Policy Paper, September 2016, no. 18.
3. For a more detailed discussion of the impact of new technologies on investment, see the articles in the Dossier «The Digital Economy:», published in MR07/2015.

FOCUS · Emerging oil company debt: adding fuel to the fire

Since 2006 global debt, both public and non-financial private, has grown by 35%. This trend has been widely commented but perhaps what is not so well-known is the fact that companies from the emerging countries have played an important part in building up this debt, accounting for 40% of the rise. Given this situation, one sector causing concern is that of the oil companies from emerging countries. These are firms that have not only taken advantage of accommodative international financial conditions, as have many other companies in the emerging countries, but are also in a sector that has been severely shaken by a slump in prices. Besides these two factors, if we also add the fact that these companies are very often public corporations, it becomes even more important to have an accurate diagnosis of their situation.

Although precisely gauging the solvency of a company requires a detailed analysis of its balance sheet, we can get an initial idea from three fundamental indicators. A company will be in a comfortable debt position if it can easily meet the financial costs of its debt with its operating profit; if its debt is not excessive in relation to its equity, and if its volume of debt is not very high compared with its profit.[1]

Looking at the major oil companies listed on the stock market, the average solvency of those from emerging countries is below that that of their peers from the advanced countries because, as can be seen from the table below, they present worse figures for all three of the indicators mentioned.[2] Given this situation, the question is whether these indicators for emerging oil companies are so bad as to imply a relatively high risk to their solvency.

One initial answer to this question is provided by the credit rating given by rating agencies: of the 14 companies analysed, seven are below «investment grade». However, as the relationship between a country's rating and that of its companies is not entirely separate, sometimes a firm's intrinsic credit rating can be slightly different. To fine-tune our analysis, we can establish a correspondence between the current levels of debt and the credit ratings. Conventionally, a company is deemed to be clearly below «investment grade» when its interest coverage ratio is less than 2 or when its debt to EBITDA ratio is more than 7. Four of the 14 emerging companies analysed are in one of these two situations, two of which have been rated below «investment grade» but the other two not.

Although this may seem a low percentage, the diagnosis is more worrying when we consider that these firms account for 60% of the total debt of the group of emerging oil companies. It should also be noted that, if the need ever arose to recapitalise them using public funds, the potential impact on public finances could be considerable given that the debt of the aforementioned four companies with the poorest solvency account for between 1% and 7% of the GDP of their respective countries.

A second analysis that can be carried out to assess the financial situation of companies is stress testing; i.e. estimating the solvency situation in the case of a series of adverse shocks. Although there is no specific stress test for the oil industry, the IMF has carried out such an analysis of commodities companies (energy and non-energy) in the emerging countries. Specifically, it has studied how debt at risk would evolve (defined as a company's debt whose ICR is 2 or lower) if a triple shock occurred: an increase in financing costs (of 30%), a drop in earnings (of 20%) and a depreciation in emerging currencies (of 30%).[3] In this scenario, the IMF estimates these companies' debt at risk would amply exceed 30% of corporate debt in the case of Brazil; would be close to 15% in that of Indonesia; would exceed 10% in Hungary and would be around 5% in Argentina and the Philippines.

In summary, when we move from an analysis of general corporate debt to one of the oil sector in particular, perceived risk increases. Nonetheless, and as we have already mentioned, accurately assessing the individual solvency of companies is beyond the overall aim of this article. Moreover, we must also remember that, should the expectations come about of a recovery in oil in 2017-2018, this will ease the pressure on the solvency of oil companies.

Corporate bonds of emerging oil companies

	ICR	Debt/Capital (%)	Debt/EBITDA
Emerging oil companies	2.4	41.4	11.2
Advanced oil companies	4.8	33.2	5.1

Note: *The ICR is the quotient of the EBIT and expense on debt interest. In the three indicators, the weighted average of each firm's volume of debt as a percentage of the total debt of its benchmark group (emerging or advanced).*
Source: *CaixaBank Research, based on Bloomberg data.*

1. These three measures take the specific form of three ratios, the interest coverage ratio (ICR), calculated as the quotient of earnings before interest and tax (EBIT) and interest expense; the quotient between debt and capital and, lastly, the quotient between debt and earnings before interest, tax, depreciation and amortisation (EBITDA).
2. Weighted average by volume of debt for each firm compared with the total debt of its benchmark group (emerging or advanced).
3. The stress test was carried out with data up to 2014; i.e. before the slump in oil in 2015, but it should be noted that debt ratios had already been worsening since the mid-2000s. The shocks considered are similar to those occurring during the Great Recession of 2008-2009 in the area of financial costs and earnings and to events in the 1990s with regard to currency depreciation.

KEY INDICATORS

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

UNITED STATES

	2014	2015	2015 Q4	2016 Q1	2016 Q2	2016 Q3	10/16
Activity							
Real GDP	2.4	2.6	1.9	1.6	1.3	1.6	–
Retail sales (excluding cars and petrol)	4.5	4.3	3.5	4.0	4.4	3.6	4.4
Consumer confidence *(value)*	86.9	98.0	96.0	96.0	94.8	100.7	100.8
Industrial production	2.9	0.3	–1.6	–1.6	–1.1	–1.0	–0.8
Manufacturing activity index (ISM) *(value)*	55.6	51.3	48.6	49.8	51.8	51.2	51.9
Housing starts *(thousands)*	1,001	1,108	1,135	1,151	1,159	1,145	1,323
Case-Shiller home price index *(value)*	171	179	183	187	188	188	...
Unemployment rate *(% lab. force)*	6.2	5.3	5.0	4.9	4.9	4.9	4.9
Employment-population ratio *(% pop. > 16 years)*	59.0	59.3	59.4	59.8	59.7	59.7	59.7
Trade balance [1] *(% GDP)*	–2.8	–2.8	–2.8	–2.7	–2.7	–2.7	...
Prices							
Consumer prices	1.6	0.1	0.5	1.1	1.0	1.1	1.6
Core consumer prices	1.7	1.8	2.0	2.2	2.2	2.2	2.1

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

JAPAN

	2014	2015	2015 Q4	2016 Q1	2016 Q2	2016 Q3	10/16
Activity							
Real GDP	–0.1	0.6	0.9	0.2	0.7	0.8	–
Consumer confidence *(value)*	39.3	41.3	42.2	41.4	41.2	42.1	42.3
Industrial production	2.1	–1.2	–1.1	–3.2	–1.7	0.5	0.3
Business activity index (Tankan) *(value)*	13.5	12.8	12.0	6.0	6.0	6.0	–
Unemployment rate *(% lab. force)*	3.6	3.4	3.3	3.2	3.2	3.0	3.0
Trade balance [1] *(% GDP)*	–2.6	–0.6	–0.6	–0.2	0.1	0.5	0.9
Prices							
Consumer prices	2.8	0.8	0.2	0.0	–0.3	–0.5	0.1
Core consumer prices	1.8	1.0	0.7	0.6	0.6	0.2	0.2

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

CHINA

	2014	2015	2015 Q4	2016 Q1	2016 Q2	2016 Q3	10/16
Activity							
Real GDP	7.3	6.9	6.8	6.7	6.7	6.7	–
Retail sales	12.0	10.7	11.1	10.3	10.2	10.5	10.0
Industrial production	8.3	6.1	5.9	5.9	6.1	6.1	6.1
PMI manufacturing *(value)*	50.7	49.9	49.7	49.5	50.1	50.2	51.2
Foreign sector							
Trade balance [1] *(value)*	383	608	608	601	602	585	573
Exports	6.0	–2.3	–5.2	–11.5	–5.0	–6.2	–7.3
Imports	0.4	–14.2	–11.8	–13.7	–6.8	–4.6	–1.4
Prices							
Consumer prices	2.0	1.4	1.5	2.1	2.1	1.7	2.1
Official interest rate [2] *(value)*	5.60	4.35	4.35	4.35	4.35	4.35	4.35
Renminbi per dollar *(value)*	6.2	6.3	6.4	6.5	6.5	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.*

ECONOMIC OUTLOOK · The euro area improves its tone at the end of the year

In spite of Brexit, the euro area continues to recover at a moderate pace, supported by the ECB's expansionary monetary policy, the fall in oil prices and the depreciation of the euro. The impact of Brexit on growth has been more subdued than initially expected, as the widespread improvement in economic indicators over the last few months shows. Moreover, the European Commission Autumn forecasts for 2016 and 2017 do not include any substantial changes. For 2016, euro area growth is expected to be 1.7%. For 2017, the Commission forecasts a slightly lower but similar rate of growth (of 1.5%, almost in line with the 1.4% forecasted by CaixaBank Research), due to lower support from favourable tailwinds (such as the recovery in oil prices) and increased political uncertainty derived from the upcoming elections in France, the Netherlands and Germany. The Commission also stressed that its forecast scenario is still highly dependent on a favourable resolution of external risks such as slower global growth, weaker world trade and a worsening of geopolitical tensions.

Growth continues to vary considerably across countries, and the periphery's growth stands out. Eurostat confirmed euro area Q3 GDP growth at 0.3% quarter-on-quarter, the same rate as in the previous quarter. Across countries, strong growth was posted by Portugal (0.8%, a 0.5 pps improvement with regards to Q2), as well as by Spain and Greece. Although Germany grew less than expected (0.2% quarter-on-quarter), the increase in domestic demand, with a contribution to growth of 0.4 pps, suggests that the underlying trend is still positive. For the coming quarters, we expect the euro area as a whole to maintain a similar rate of growth, of between 0.3% and 0.4% quarter-on-quarter, although with significant differences across countries.

Temporary growth slowdown in Emerging Europe. GDP data for Q3 show that growth remained strong, albeit at a slower pace than in Q2. Across countries, Romania and Slovakia continue to stand out with growth rates above 4% and 3% year-on-year, respectively, while Poland, Hungary and the Czech Republic disappointed with lower growth than expected. Nevertheless, in line with a scenario of continued euro area recovery, the growth outlook of these economies is positive. Growth is expected to be around 3.0% in most of these countries, both in 2016 and 2017.

Business indicators point to a slight acceleration in the fourth quarter. This is reflected in the PMI composite index which has remained comfortably in the expansionary zone (above 50 points) and in November it accelerated to 54.1 points, the highest level in the past 11 months, while the economic sentiment index (ESI) for Q4 has

Euro area: European Commission GDP forecasts

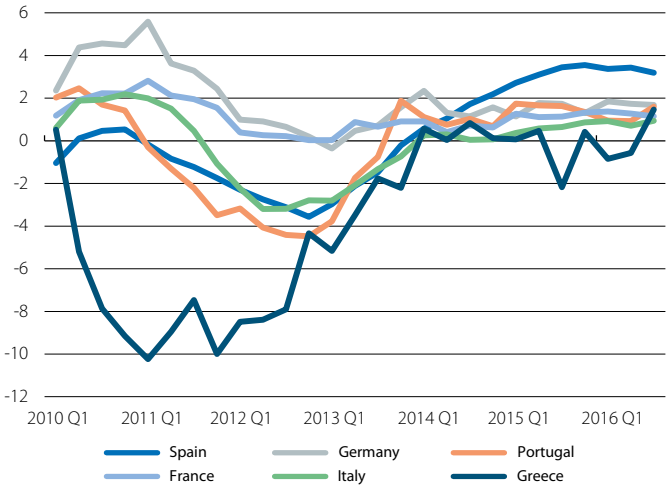
Annual change (%)

	Forecast			Change compared with May 2016 forecast	
	2016	2017	2018	2016	2017
Euro area	1.7	1.5	1.7	▲ 0.1	▼ 0.3
Germany	1.9	1.5	1.7	▲ 0.3	▼ 0.1
France	1.3	1.4	1.7	=	▼ 0.3
Italy	0.7	0.9	1.0	▼ 0.4	▼ 0.4
Spain	3.2	2.3	2.1	▲ 0.6	▼ 0.2
Portugal	0.9	1.2	1.4	▼ 0.6	▼ 0.5

Source: *CaixaBank Research, based on data from the European Commission (European Economic Forecast, autumn 2016).*

GDP

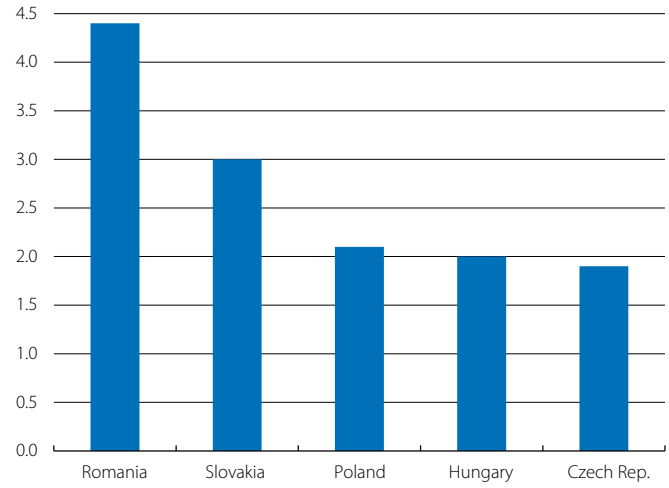
Year-on-year change (%)



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

Emerging Europe: GDP in 2016 Q3

Year-on-year change (%)



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

remained at its annual peak (106.5 points). Across countries, Germany stands out with an average PMI for October and November of 55 points and an IFO business sentiment indicator that in November reached its highest level in the past three years.

Domestic demand is still driving the economic recovery. Retail sales rose by 1.3% year-on-year in September, and the Q3 average stood at 1.5% year-on-year. This advance, although slightly smaller than the figure for Q2 (1.9%), continues to make private consumption one of the main drivers of the economic recovery in the euro area. The consumer confidence index for the euro area as a whole rose considerably in November, reaching –6.1 points (–8.0 in October), the highest level in 2016. Over the coming months, household consumption is expected to remain strong, supported by the improvements in the labour market and low interest rates, helping to push up inflation.

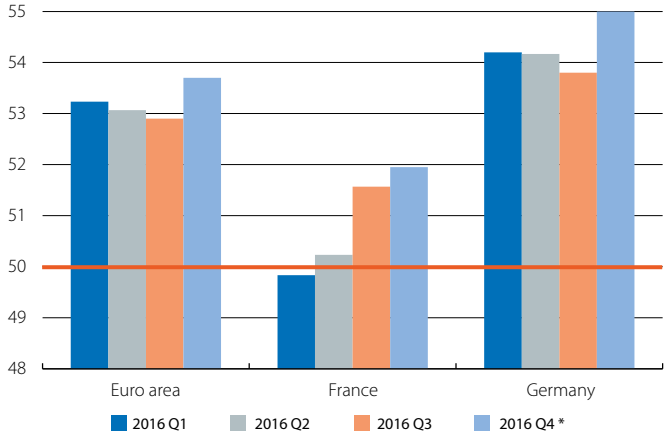
Inflation no longer in the red. Euro area headline inflation, as measured by the harmonised index of consumer prices (HICP), stood at 0.6% in November, 0.1 pps above October's figure (0.5%), while core inflation speeded up slightly to 0.8%, an increase of 0.1 pps. Over the coming months, we expect headline inflation to continue to recover as oil prices increase, and core inflation to rise gradually along with the growth in activity. In this respect, the recovery in inflation expectations for the euro area is a particularly encouraging sign.

The euro area's current account balance remains positive. The euro area current account surplus (cumulative over 12 months) amounted to 337 billion euros (3.2% of GDP), above the 322.5 billion euros recorded in September 2015. This increase is mostly due to a larger surplus in the balance of goods (368.1 billion euros, equivalent to 3.5% of GDP), boosted by low oil prices and the depreciation of the euro. For the coming quarters, we expect the external surplus to gradually decline as oil prices recover and imports increase with the recovery in investment in the euro area.

The European Commission asked countries that have fiscal space to use it appropriately and provide more support to the ECB's monetary policy. The Commission recommended a moderately expansionary fiscal stance in the euro area as a whole in order to support the recovery. Moreover, the Commission stressed that it is important that countries that have fiscal space use it in order to boost growth, while asking those which do not have fiscal space to improve their public finances so as to support public and private investment and to use the resources available to improve the economy's growth potential. However, the European Commission's message has been received with some scepticism. The euro area fiscal stance in 2017 is expected to be neutral again, after the mild expansion of 2016. In fact, the Commission expects the euro area public deficit to continue to fall, from 1.8% in 2016 to 1.5% in 2017, and public debt to shrink from 91.6% of GDP in 2016 to 90.6% in 2017. It is worth mentioning that the

Euro area: composite PMI activity indicator

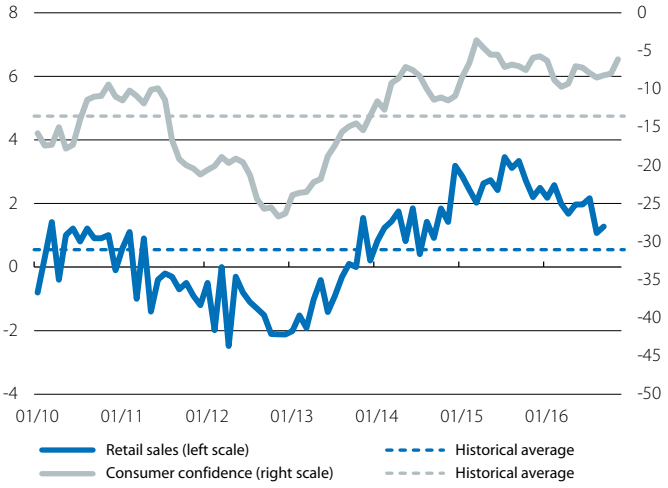
Level



Note: ** 2016 Q4 includes data from October and November.*
Source: *CaixaBank Research, based on data from Markit.*

Euro area: consumption indicators

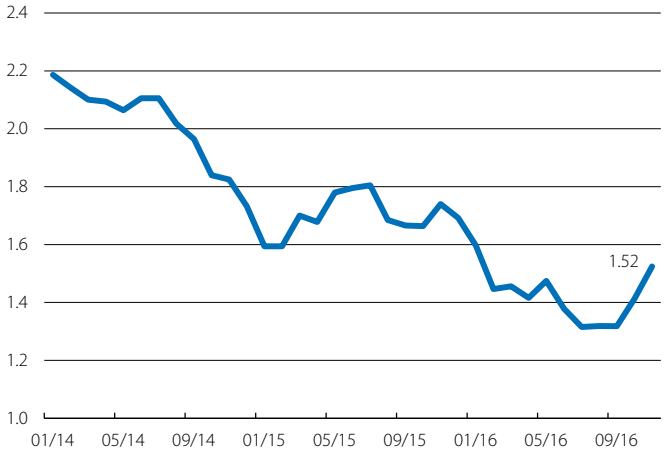
Year-on-year change (%) *Level*



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

*Euro area: inflation expectations **

(%)



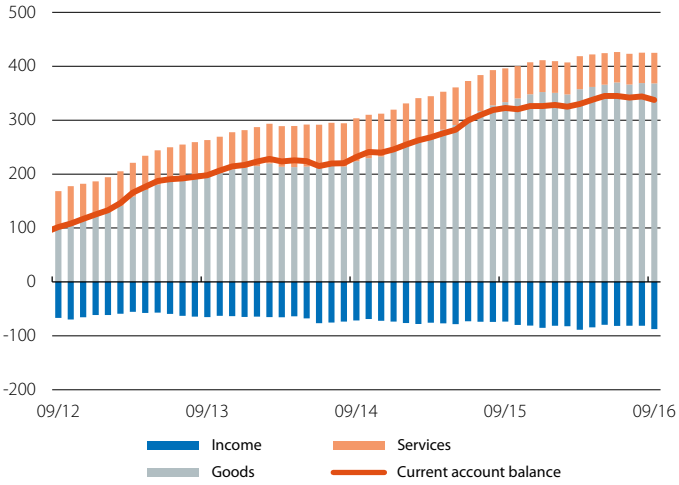
Note: ** Market expectations regarding the average level of inflation at 5 years in 5 years' time (5Y5Y inflation swap).*
Source: *CaixaBank Research, based on Bloomberg data.*

Commission, on analysing the budgets of the member states, asked Spain to make an additional effort in order to meet its deficit target for 2017 and warned Italy and Portugal of the importance of maintaining a credible medium-term budgetary plan given their high level of public debt. On the other hand, the Commission asked Germany to increase its investment spending on infrastructure, education and R&D since the country has the fiscal space to do so.

France: a slow recovery before the Presidential elections. The French economy's growth is still modest and the composition is both fragile and vulnerable to shocks. Specifically, domestic demand has remained positive but muted, and both private and public consumption have continued to show signs of weakness. On the other hand, investment, after a long period of lethargy, is finally starting to show some signs of recovery. Given that indicators have improved, growth in the fourth quarter is expected to increase slightly, resulting in 1.2% growth by the end of the year. For 2017, and in line with euro area forecasts, most evidence suggests that growth will continue at a similar pace. France's economic situation therefore makes it more important than ever for a President to be chosen in next year's elections with an ambitious agenda of reforms in order to improve the country's long-term growth capacity. However, greater fragmentation of vote means that the outcome is highly uncertain, at least at present, and not all those candidates who are most likely to win have economic agendas that contain such priorities. In this respect, the rise of the National Front stands out, which endorses a protectionist economic policy both in the area of import tariffs and immigration, as well as wanting to hold a referendum on France leaving the euro. It will therefore be very important, over the coming months, to see how the main candidates firm up their economic agendas, as well as monitoring any developments in the polls, although these have not been very reliable in other recent elections.

Euro area: current account

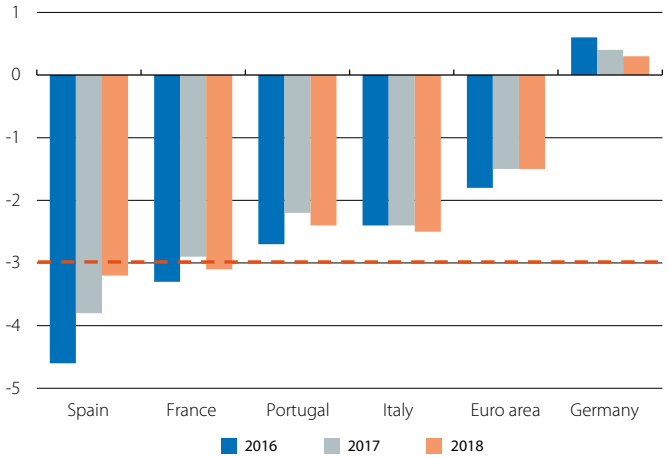
Cumulative over 12 months (billion euros)



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

Euro area: forecasts of a public surplus (+) or deficit (–) by the European Commission

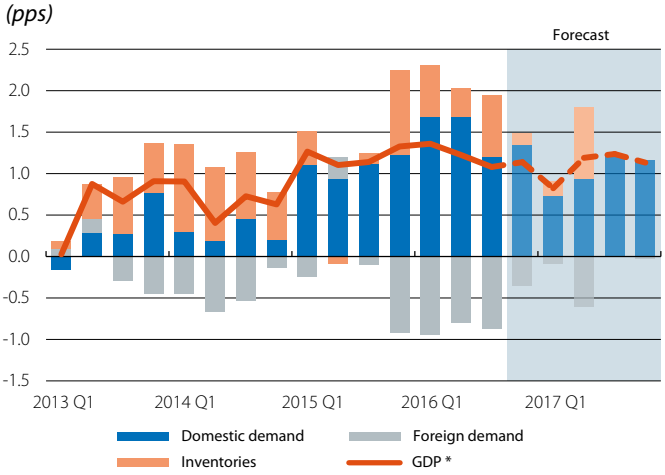
(% of GDP)



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

France: contribution to year-on-year growth in GDP

(pps)



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

FOCUS · Core inflation scenarios: activity, periphery and oil

Core inflation started to pick up in the euro area as a whole as from the beginning of 2015, in line with the improvement in economic activity. This promising trend has not been replicated in the last few quarters, however. This article analyses the trend in core inflation in the main euro area countries and shows how it depends on the cyclical position of the economy, particularly in the periphery, and on the indirect effects of oil.

As can be seen in the first graph, while Germany has above-average levels of core inflation (over 1% during the last year), Spain, Italy and France all have much lower levels. This disparity can largely be explained by the different cyclical position of the economies in the euro area. While Germany is close to full employment, a situation which tends to push up wages and ultimately the price of goods that make up the underlying consumer price index, the other three countries still have relative high unemployment rates (10.3% in France, 11.6% in Italy and 18.9% in Spain). As activity grows in the coming quarters, this is likely to lower unemployment rates and core inflation will probably recover as the European periphery approaches a cyclical position more similar to Germany's. Moreover, the disappearance of the indirect effects of oil prices, which have kept core inflation low over the last few months, should also be added to this scenario.

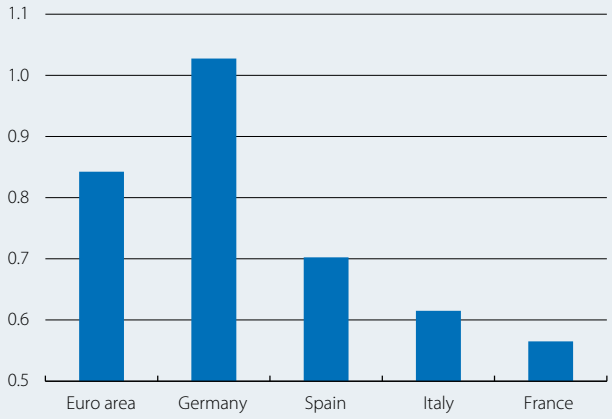
Based on CaixaBank Research's forecasts for GDP growth and unemployment rates in each country, as well as for oil prices, we can calculate the likely contribution made by each of these factors to the recovery in core inflation for the euro area as a whole.[1] Specifically, we have broken down core inflation into two scenarios. The first (the «activity scenario») shows how the recovery in economic activity will affect core inflation. More specifically, we expect a gradual reduction in the unemployment rate in France and Italy between 2016 and 2018 (–0.8 pps for France and –1.4 pps for Italy). In the case of Spain, although a larger drop in unemployment is expected (–3 pps), the level will still be relatively high (16.2% in 2018 Q4). The second scenario («activity scenario + indirect effects of the energy component») includes the indirect, second round effects of the expected price of oil.[2]

As shown by the second graph, in the «activity scenario» the recovery in economic activity in the different countries results in core inflation approaching 1.3% by the end of 2018 for the whole of the euro area. Moreover, when the indirect effects of the recovery in the energy component are included, in «activity scenario + indirect effects of the energy component», core inflation speeds up to 1.5% by the end of 2018.[3]

Although core inflation is not an official target for the ECB, in practice it indicates the underlying trend in headline inflation and is therefore a relevant variable in monetary policymaking. As we have seen in this Focus, core inflation will pick up in the coming quarters but will still remain far from the ECB's target.

Core inflation by country

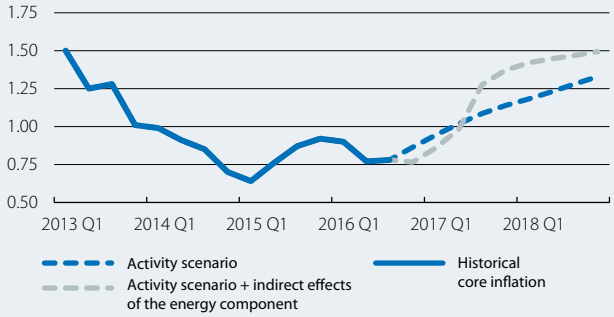
Average from 2015 Q4 to 2016 Q3 (%)



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

Euro area core inflation in different scenarios

(%)



Note: *The «activity scenario» is based on GDP growth forecasts by CaixaBank Research. The «activity scenario + indirect effects of the energy component» includes the indirect impact of variations in the price of crude oil on core inflation.*
Source: *CaixaBank Research, based on data from Eurostat and the ECB.*

1. The following regression is estimated: $\pi_t = ß_0 + ß_1 \pi_{t-1} + ß_2 U_t + ß_3 (\pi_{t-1}^{ene.} - \pi_{t-1}) + ß_4 D (\pi_{t-1}^{ene.} - \pi_{t-1}) + \varepsilon_t$, where π is core inflation; U is unemployment, $\pi^{ene.}$ is inflation for the energy component and D is a binary variable valued at 1 as from 2007 Q3.
2. See ECB «The relationship between HICP inflation and HICP inflation excluding energy and food». Economic Bulletin, Issue 2/2016.
3. The effect of oil price variations on the price of the rest of the goods is passed on gradually. Consequently, core inflation initially records a slight downward trend due to the continuing negative impact of the slump in oil prices on the price of the goods that make up the core index.

FOCUS · The pound's depreciation: the thermometer that measures the impact of Brexit

After the victory of the Brexit camp in the referendum held last July, on the whole analysts predicted that the increased uncertainty would quickly result in a reduction in investment and consumption in the United Kingdom. This expectation was supported by an initial drop in most activity indicators. For instance, the composite PMI went from an area in line with economic expansion in June to an area in line with economic contraction in July and both the economic sentiment index and consumer confidence fell substantially.

However, in the following months indicators recovered from this slump and the economy continued to grow at a good rate. For example, GDP growth remained at a strong 0.5% quarter-on-quarter in Q3, bolstered by the good evolution of private consumption. It therefore seems that, for the moment, the impact of Brexit is much less than initially predicted.

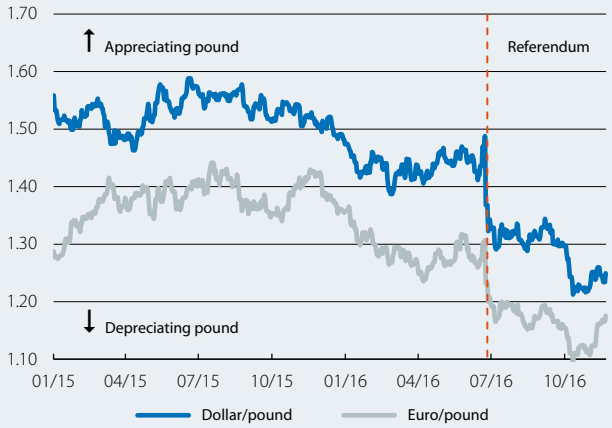
Nevertheless, although activity has not suffered too much from the outcome of the referendum, this does not mean that Brexit will not end up having a significant impact over the medium term. One of the elements suggesting this is the strong depreciation of the pound which, to a large extent, reflects the UK's loss of appeal in the eyes of international investors. Specifically, the day after the referendum the pound lost more than 8% of its value against the dollar and 6% against the euro and, since then, has accumulated a depreciation of 16% against the dollar and 11% against the euro.

The pound's depreciation directly reduces the purchasing power of the British people. UK tourists already experienced this in the summer and, over the coming months, will end up noticing it on the domestic front as well, once they realise that the price of imported products has gone up more than their wages.[1] According to a study by Kristin Forbes from the Bank of England, the impact of the pound's depreciation on the end price of goods takes between 9 and 12 months to materialise.[2] It therefore comes as no surprise that the Bank of England and analysts on the whole have substantially revised upwards their inflation forecasts for the coming years (see the second graph). Given this scenario, Britons may find some comfort in the effect the pound's depreciation could have on exports. The conclusions reached by the studies analysing the relationship between the trend in exports of the United Kingdom and the pound over a long period of time are relatively encouraging. Specifically, they note that, with a depreciation in the real effective exchange rate such as the one occurring, namely 12%, growth in exports could increase by 2.4% in the short term and by 3.6% in the medium term.[3] Recent experience, however, suggests this impact might be less. Between 2007 and 2009, the pound depreciated by 25% and, in the following years, exports did not grow by any more than those of its European partners.

In summary, the pound's depreciation is a good thermometer for the impact Brexit might have on UK households. Although the effect is more gradual than initially predicted, the bulk of the evidence suggests that it will end up being noticed.

Exchange rate for the pound sterling

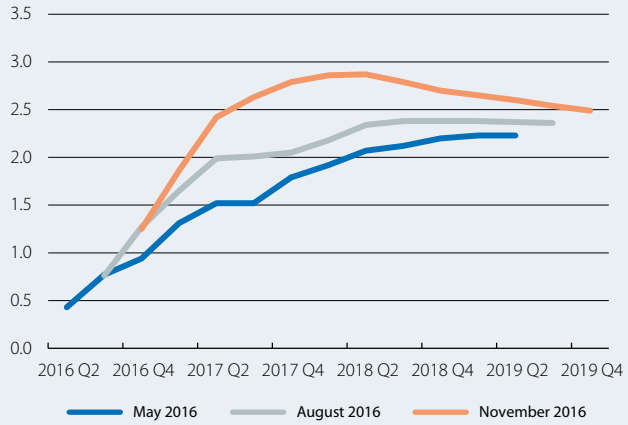
(Dollars per pound, euros per pound)



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

Bank of England inflation forecasts

(%)



Source: *CaixaBank Research, from various Bank of England Inflation Reports.*

1. See the National Institute Economic Review No. 238, November 2016.
2. Kristin Forbes, (2014), «The economic impact of sterling's recent moves: more than a midsummer night's dream», Bank of England Speech.
3. See the National Institute Economic Review No. 238, November 2016, for more details.

KEY INDICATORS

Activity and employment indicators

Values, unless otherwise specified

	2014	2015	2015 Q4	2016 Q1	2016 Q2	2016 Q3	09/16	10/16	11/16
Retail sales *(year-on-year change)*	1.4	2.8	2.6	2.3	1.8	1.4	1.1	...	...
Industrial production *(year-on-year change)*	0.9	2.0	1.8	1.3	1.0	1.0	1.2	...	...
Consumer confidence	–10.2	–6.2	–6.4	–8.3	–7.8	–8.2	–8.2	–8.0	–6.1
Economic sentiment	101.5	104.2	106.2	104.0	104.3	104.3	104.9	106.4	106.5
Manufacturing PMI	51.8	52.2	52.8	51.7	52.0	52.1	52.6	53.5	53.7
Services PMI	52.5	54.0	54.2	53.3	53.1	52.6	52.2	52.8	54.1
Labour market									
Employment (people) *(year-on-year change)*	0.6	1.0	1.3	1.4	1.4	...	–	–	...
Unemployment rate: euro area *(% labour force)*	11.6	10.9	10.5	10.3	10.1	10.0	10.0	...	...
Germany *(% labour force)*	5.0	4.6	4.5	4.3	4.2	4.1	4.1	...	...
France *(% labour force)*	10.3	10.4	10.2	10.2	9.9	10.3	10.2	...	...
Italy *(% labour force)*	12.6	11.9	11.6	11.6	11.6	11.6	11.7	...	...
Spain *(% labour force)*	24.5	22.1	20.9	20.4	20.1	19.4	19.3	...	...

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

Foreign sector

Cumulative balance over the last 12 months as % of GDP of the last 4 quarters, unless otherwise specified

	2014	2015	2015 Q4	2016 Q1	2016 Q2	2016 Q3	09/16	10/16
Current balance: euro area	**2.5**	**3.3**	**3.3**	**3.3**	**3.5**	**3.4**	**3.4**	**...**
Germany	7.3	8.3	8.3	8.5	8.9	8.7	8.7	...
France	–1.1	–0.2	–0.2	–0.8	–0.9	–1.4	–1.4	...
Italy	1.9	1.6	1.6	1.9	2.3	2.6	2.6	...
Spain	1.1	1.4	1.4	1.4	1.8	1.9	1.9	...
Nominal effective exchange rate[1] *(value)*	**101.8**	**92.3**	**92.4**	**94.1**	**94.8**	**95.1**	**95.3**	**95.4**

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

Financing and deposits of non-financial sectors

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

	2014	2015	2015 Q4	2016 Q1	2016 Q2	2016 Q3	09/16	10/16
Private sector financing								
Credit to non-financial firms[1]	–2.6	–0.4	0.4	1.2	1.6	2.0	2.0	2.1
Credit to households[1, 2]	–0.1	0.7	1.3	1.5	1.7	1.8	1.8	1.8
Interest rate on loans to non-financial firms[3] *(%)*	2.0	1.6	1.5	1.4	1.4	1.3	1.3	...
Interest rate on loans to households for house purchases[4] *(%)*	2.6	2.1	2.0	2.0	1.8	1.8	1.8	...
Deposits								
On demand deposits	6.0	11.1	11.6	11.2	10.1	9.5	9.3	8.7
Other short-term deposits	–2.0	–3.8	–3.8	–2.4	–1.8	–1.2	–1.0	–1.5
Marketable instruments	–7.2	2.8	0.7	–1.6	1.7	4.4	5.5	1.7
Interest rate on deposits up to 1 year from households *(%)*	1.3	0.8	0.7	0.6	0.6	0.5	0.5	...

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

ECONOMIC OUTLOOK · **A healthy end to 2016 for economic activity**

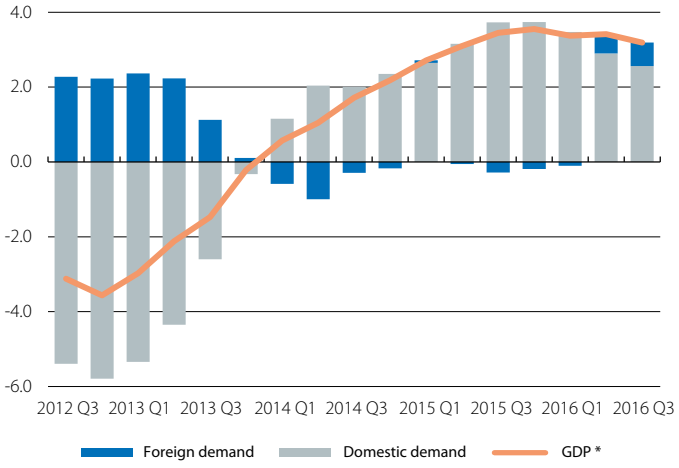
GDP growth remains strong and growth forecasts for 2016 and 2017 have improved. In 2016 Q3, the Spanish economy grew by 0.7% quarter-on-quarter (3.2% year-on-year), in line with the CaixaBank Research forecast. However, the revision of the historical series, which states that, in the first half of 2016, the Spanish economy grew slightly more than previously announced, and the acceleration in activity shown by the early indicators for Q4, particularly in the labour market, have led us to revise upwards our GDP growth forecast for the whole of 2016, from 3.1% to 3.3%. The upward revision for 2017 is also appreciable, from 2.4% to 2.6%. The bulk of the evidence therefore suggests that growth will remain strong and considerably higher than the advances made by most other developed countries. According to CaixaBank Research forecasts, this good pace of growth means that, in 2017, the Spanish economy will exceed its level of GDP achieved in 2008, before the recession started. We should also note that, although the rate of growth will be slightly lower than the figure posted in 2016 because of dwindling support from tailwinds (oil prices and the ECB's monetary policy), the trend for the underlying factors will continue favourable. Fiscal policy is also expected to be less expansionary than in recent years, which will strengthen the international community's confidence in the long-term sustainability of Spain's public finances.

Domestic demand fell as expected while external demand increased its positive contribution. The Spanish economy now has a model of growth that combines rising domestic demand with a positive contribution from the foreign sector. In fact, exports are the GDP component with the highest growth since 2007 (25.5%) while imports are still 10% below their pre-crisis level. The current economic expansion therefore contrasts with the period of 2000-2008, when the contribution made by exports was negative on average. Looking at the figures for Q3, the breakdown for GDP in terms of demand shows a gentle slowdown in domestic demand (with a 2.9 pps contribution to year-on-year growth in GDP in Q3, 0.3 pps less than in the previous quarter) and a greater positive contribution by exports, going from 0.5 pps to 0.6 pps.

The main components of domestic demand still show a good underlying trend. Private consumption remained strong in Q3, up by 0.6% quarter-on-quarter (2.8% year-on-year), which is nevertheless a slight slowdown in comparison with the vigorous growth of the first half of the year. The good performance by the labour market and the favourable credit conditions encouraged by the ECB's accommodative monetary policy and banks' greater capacity to grant loans to households will all help private consumption to maintain this good tone throughout 2017. With regard to investment,

GDP

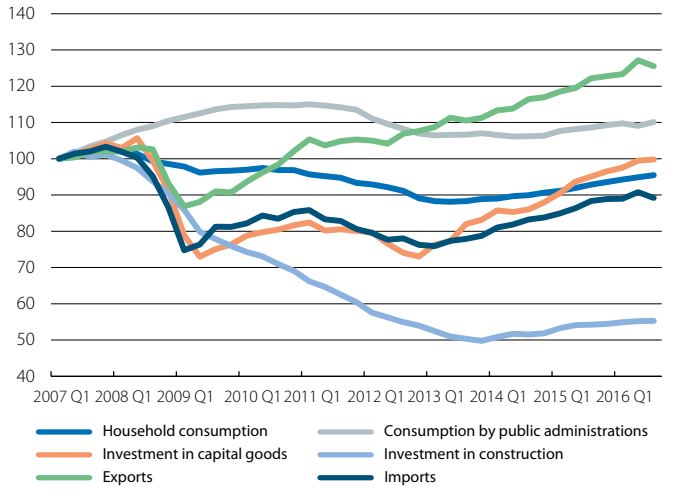
Contribution to year-on-year growth (pps)



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

GDP components

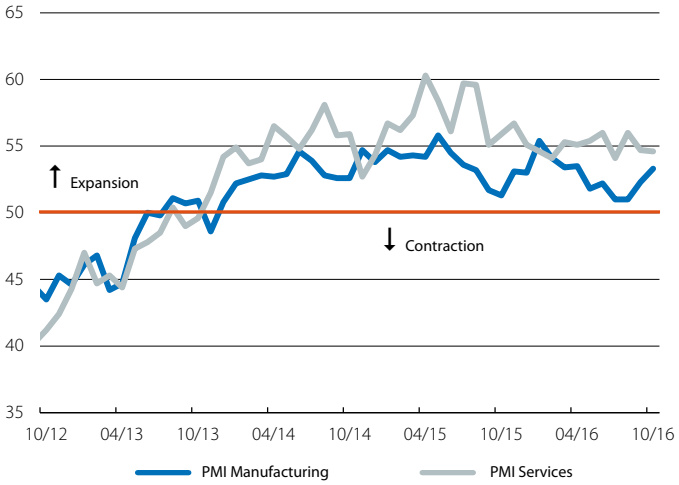
Index (100 = January 2007)



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

Activity indicators

Level



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

capital goods expenditure rose by 0.3% quarter-on-quarter (4.9% in year-on-year terms). A look at business confidence indicators and the PMI for economic sentiment suggests that capital goods investment, which is now at the same level as 2007, still has room to increase and that this slowdown in Q3 should be interpreted as a small break after a year and a half of uninterrupted strength. For its part, investment in construction grew by 2.0% year-on-year, continuing a cautious upward trend far from the excesses of the past.

Domestic demand is being supported by the recovery in the labour market, which accelerated in Q3 with a 0.8% increase in employment in terms of full-time equivalent jobs quarter-on-quarter, bringing the year-on-year rate to 2.9%, 0.1 pps higher than Q2's figure. This is in addition to the good figures posted by the Labour Force Survey for Q3 (226,500 new jobs, an increase of 2.7% year-on-year). It should be noted that the private sector still leads the job creation rate (3.7% year-on-year) while the public sector saw a slight slowdown (0.6% year-on-year). Permanent employment contracts also rose by 1.9% year-on-year.

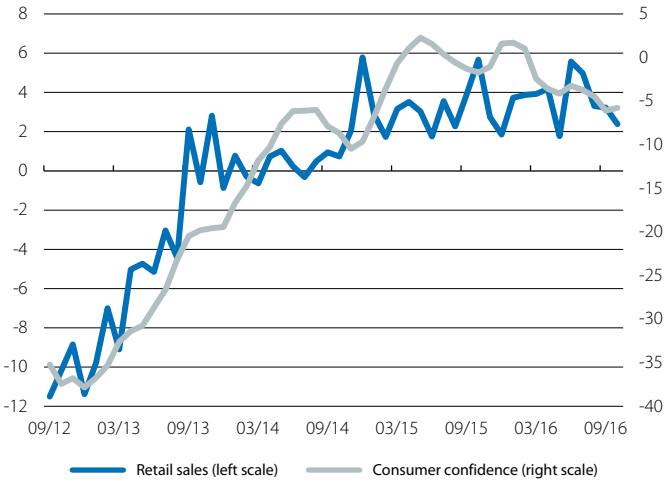
Job creation figures are still good in Q4. In October, the number of registered workers affiliated to Social Security was higher than expected with 107,457 new contributors, seasonally adjusted, while the pace of job creation speeded up to 3.4% year-on-year (3.0% in September). The rate of reduction in registered unemployment also increased to –9.9% (–9.1% in June) and the number of unemployed stood at its lowest level since September 2009. Although a certain moderation is expected in the job creation rate for the end of the year, these latest figures have led CaixaBank Research to revise upwards its forecast for the job creation rate for the whole of 2017 from 2.1% to 2.3% and consequently lower its forecast for the unemployment rate in 2017 from 18.2% to 18.0%.

The recovery in inflation is in line with expectations. The CPI posted a year-on-year change of 0.7% in November. The breakdown by groups, available up to October, shows that this recovery in inflation can be explained by higher electricity prices compared with the drop in 2015, and also by fuel prices (diesel and petrol). The year-on-year rate of change for these last two groups (in euros) has been picking up since August 2015 and will continue pushing up the CPI until mid-2017. Meanwhile core inflation (the general index without unprocessed food or energy products) rose by 0.8% year-on-year in October, continuing a gentle upward trend supported by dynamic private consumption, although the negative impact of the groups of food and leisure and culture meant that October's figure was slightly lower than that of August and September.

The foreign sector is performing very well. August's current account balance stood at 1.9% of GDP (cumulative over 12 months), clearly above the figure of 1.4% for the whole of 2015, and will more than likely end the year at 2.2%

Retail sales and consumer confidence

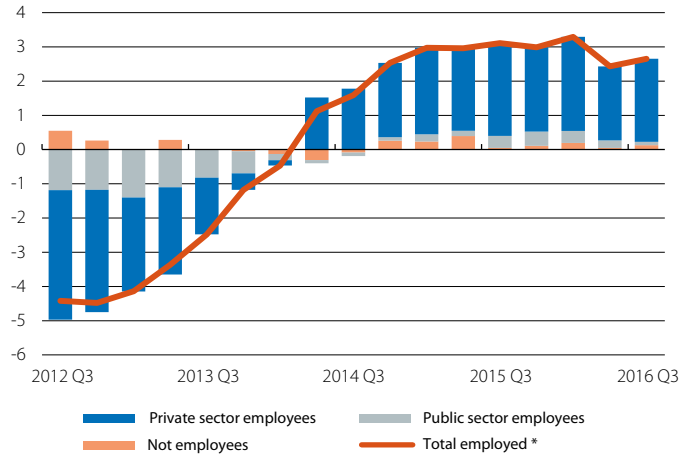
Year-on-year change (%) *Level*



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

Employment by employer

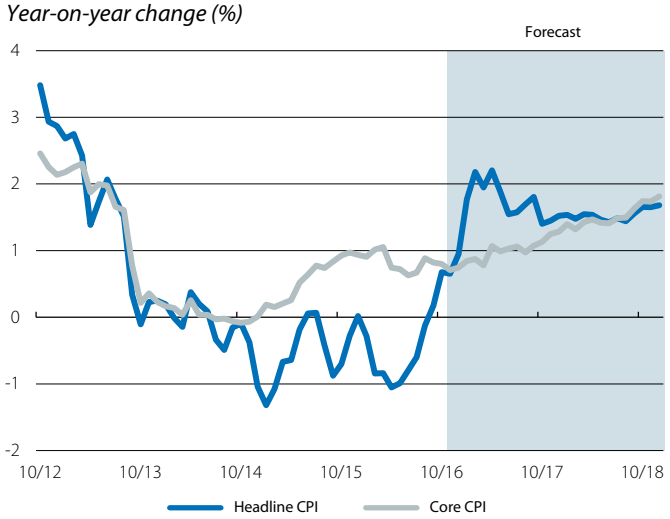
Contribution to year-on-year growth (pps)



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

CPI

Year-on-year change (%)



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

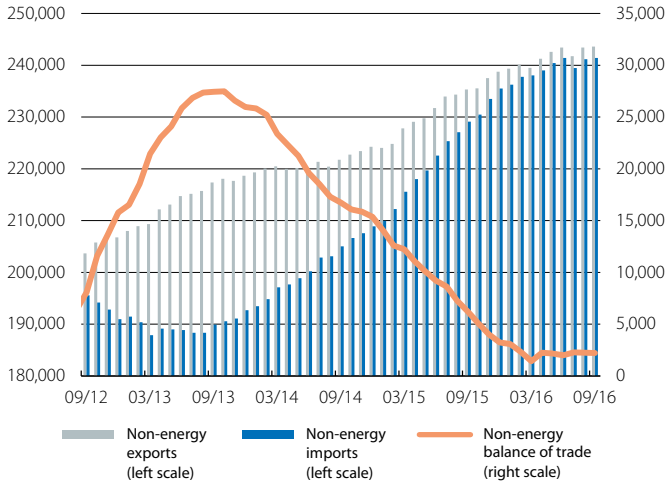
of GDP, the best figure for the historical series. This improvement in the current account balance reflects the reduction in the trade and income deficits (helped by low interest rates). The exports of goods in the last 12 months up to September increased by 1.8% year-on-year, boosted by the performance of non-energy exports (3.5% year-on-year) while imports of goods fell by 0.3% year-on-year as these are still being affected by the slump in oil prices. Regarding the services balance, the end of the summer did not stop the good performance by tourism this year. The number of international tourists arriving in Spain in the period January-September reached 60.3 million, up by 10.1% compared with the same period in 2015. In 2017 the current surplus will fall moderately in GDP terms, especially due to the expected rise in oil prices, which will push up the energy bill.

The government presents new budgetary measures to meet its deficit target of 3.1% of GDP in 2017. Most of these measures focus on the reform for corporation tax, which limits tax breaks and is expected to increase revenue by 4.3 billion euros (of the 7.5 billion estimated). Also important is the hike in special taxes and a new tax on sugary drinks. The target for the fiscal deficit in 2016, namely 4.6% of GDP, seems feasible. Up to September, the fiscal deficit (excluding local government corporations) stood at 3.1% of GDP, 0.2 pps below August's figure (this does not include losses due to financial bail-outs). By administration, the central government budget improved its trend significantly, standing at 1.9% of GDP in October, 0.1 pp below the figure one year ago. This improvement in the last month is due to the recent return to split payments for corporation tax, which should help to achieve the 4.6% deficit target for 2016. The autonomous communities also posted a deficit of 0.2% of GDP, improving on September's figure by 0.9 pps.

The banking sector consolidates its improvement while the real estate sector continues to recover. The NPL ratio for the banking sector, which was 9.2% in September (1.5 pps lower than last year and 4.4 pps below the peak of December 2013), is continuing to fall, helped by the improvement in economic activity and particularly in the labour market, as well as by more dynamic sales of doubtful loans. Although this favourable trend could be affected in the short term by the implementation of the Bank of Spain's Annex 9 (a new accounting treatment for provisions to cover non-performing customers), it is still expected to continue. Regarding the real estate sector, house prices fell slightly in 2016 Q3 in quarter-on-quarter terms (–0.4%), pushing down year-on-year growth to 1.6% (2.0% in Q2). Nevertheless, this trend can partly be explained by the seasonal nature of prices in Q3. This, and the sharp rise in sales, which grew at a rate of 13.2% year-on-year in September (cumulative over 12 months), suggest that the sector's recovery will continue to gain traction over the coming quarters.

Non-energy balance of trade

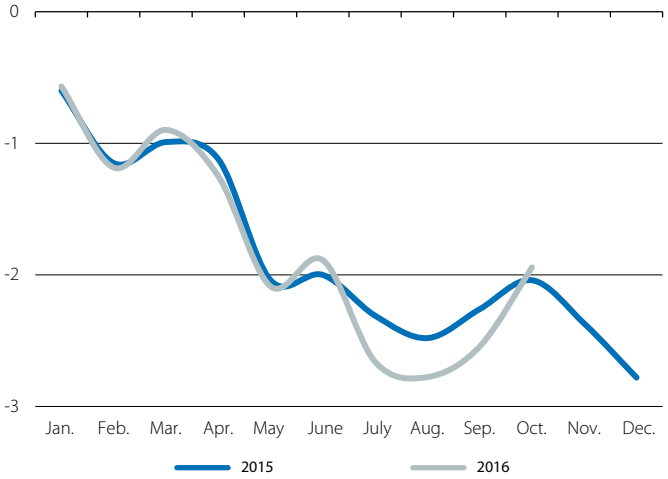
Cumulative over 12 months (billion euros)



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

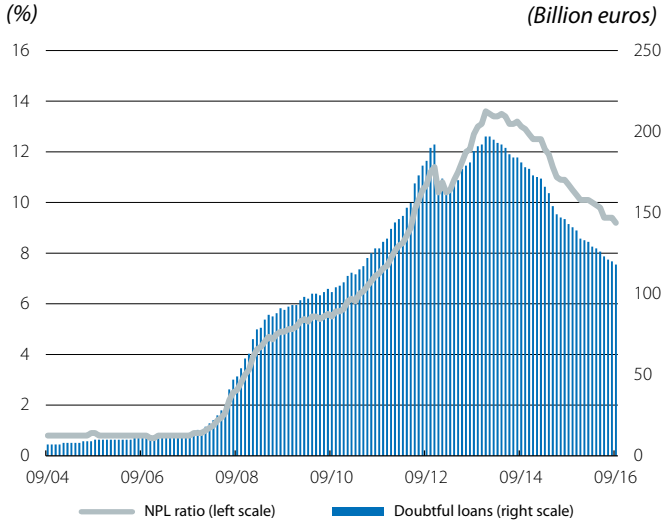
Central government budget

Cumulative for the year (% of GDP)



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

NPL ratio and doubtful loans



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

FOCUS · Productivity and job quality

Low growth in productivity[1] is a common problem in the euro area as a whole but is particularly important in the periphery countries.[2] In the case of Spain, productivity fell continuously over the period 2000-2014 with an average annual reduction of 0.7% while in countries such as Germany productivity grew by 0.5% annually over the same period. So what lies behind such disparity?

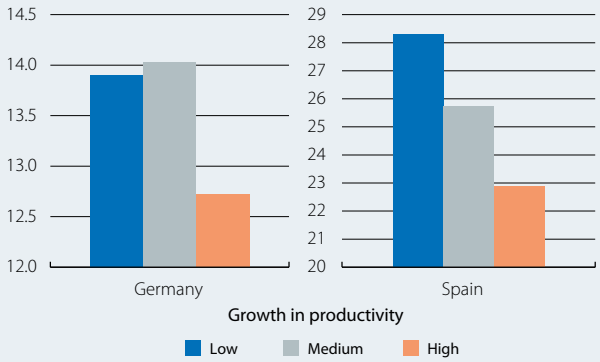
There are many different factors that determine the evolution of productivity, including aspects as varied as technology, demographics, the degree of market competition and the quality of labour market institutions, among others. In this Focus we will look at one of these elements: employment conditions. The different ways that the employment relationship can affect productivity has been examined extensively by the academic literature. For example, a stable, long-lasting employment relationship encourages company investment in training and the accumulation of human capital and effort on the part of employees.[3] In fact, if we classify different sectors of activity into three groups according to their growth in productivity between the years 2000 and 2009 (the latest figures available at a sector level), we can see a negative relationship between the share of temporary employment and the growth in productivity, both in Germany and Spain (see the first graph).[4] However, in Spain this temporary nature of employment is more accentuated in all activity sectors, resulting in a worse trend in productivity at an aggregate level.

These problems in Spain's labour market are not only visible at high levels of temporary employment as there are other aspects of the employment relationship related to job quality which can also affect growth in productivity.[5] As can be seen in the second graph, involuntary part-time employment is higher in those sectors with less growth in productivity. In these sectors, the percentage of employees who would like to work more hours is 14.6% compared with 9% in sectors with average or high growth in productivity. Moreover, the percentage of workers receiving non-official training from the company is much lower in those sectors with low productivity growth, showing that less investment in specific human capital tends to be associated with less professional development of employees and ultimately lower growth in productivity. Lastly, it should also be noted that the problem of over-qualification, which affects 16% of workers, does not seem to be greater in low productivity sectors.

It therefore seems clear that job quality is higher in those sectors where productivity has grown the most. Taking into account the fact that an economy's productivity is the only source of real GDP growth per capita in the long term, any improvement in well-being therefore depends on solving the problems affecting the labour market. Good quality jobs and productivity are an inseparable duo.

Share of temporary employment and productivity by sector

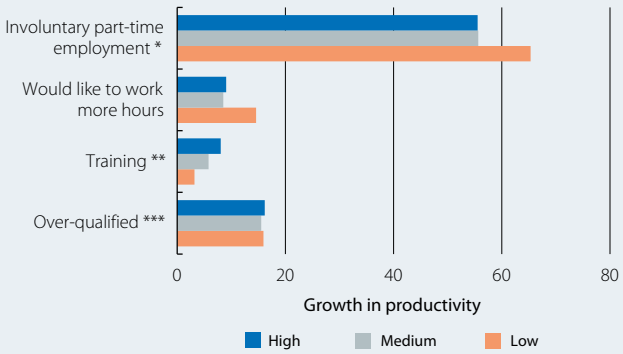
Temporary employment (% of total employment)



Note: *Share of temporary employment in 2015. The 17 activity sectors are classified into three groups according to growth in productivity (TFP) between 2000 and 2009.*
Source: *CaixaBank Research, based on data from Eurostat and the EU KLEMS.*

Productivity and job quality

(% of total employment)



Notes: *Data for 2016 Q3. The 17 activity sectors are classified into three groups according to growth in productivity (TFP) between 2000 and 2009. * Percentage of all workers employed part-time. ** Percentage of workers receiving non-official training from the company; data from 2014. *** Percentage of workers with higher qualifications who carry out tasks requiring medium or low qualifications.*
Source: *CaixaBank Research, based on data from the INE (LFS) and EU KLEMS.*

1. In this article, productivity refers to the total factor productivity (TFP), calculated as the difference between an economy's growth and the contribution made to this growth by the labour factor and the capital factor.
2. See the Focus «Why is the euro area growing less than the US?» in MR12/2015.
3. For a more detailed description of these ways, see the Focus «How does the type of employment contract affect productivity?» in MR03/2016.
4. The same results are obtained when the impact of temporary employment is estimated on the TFP in a regression using annual data from 2000 to 2009 and with sector and time controls.
5. The dimensions chosen to estimate job quality are explained in the Focus «Job quality: Spain within the international context» published in MR11/2016.

FOCUS · A look at the government budgetary plan for 2017

Spain's public accounts are still in the red. By the end of the year, the fiscal balance will be almost –4.6% of GDP, meaning that the country will once again post a budget deficit, in fact for the ninth consecutive year, and the level of debt of public administrations will therefore remain close to 100% of GDP.

With the year about to end, it is a good time for the country to concentrate on preparing the accounts for 2017. In this respect, in October the caretaker government presented the budgetary plan (PGE in Spanish) for 2017, which is an extension of the 2016 budget, leaving the work of reducing the fiscal balance to economic growth. Specifically, according to the PGE, the 2.3% GDP growth forecast will help to reduce the fiscal balance by 0.8 pps to 3.6% of GDP.[1]

This improvement in the public accounts will come both from revenue and expenditure. In the case of revenue, the government estimates that the good trend in employment (2.2% in 2017) will boost Social Security contributions, which will grow by 2.5% in 2017, somewhat below the growth expected for 2016 but in line with the economic growth predicted. Regarding tax revenue, the PGE estimates that taxation on production and imports (mainly VAT) will increase by 3.7%, therefore maintaining a similar trend to the one observed in 2016 and in line with the macroeconomic scenario predicted by the PGE. The PGE also estimates that taxation on income and wealth will recover in 2017 after falling in 2016 due to the tax reforms passed in 2015. In this respect, the recently approved increase in advance payments of corporate tax will boost the recovery in the tax revenue collected in 2017 and will also offset the drop in revenue experienced in 2016.[2]

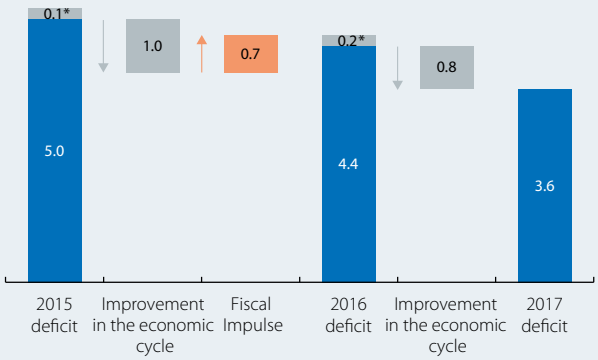
In the case of expenditure, the almost 2 pps drop in unemployment will reduce spending on unemployment assistance by 7% according to the 2017 budgetary plan, a figure somewhat lower than the one recorded up to September 2016 (–10%) but which is also in line with the expected trend in economic activity. Another item that is expected to decrease is expenditure on interest payments. Specifically, the government estimates this will fall by 0.3%. This forecast is actually quite conservative given that the average maturity of the country's public debt is seven years and interest rates are at a considerably lower level than those observed several years ago. In fact, up to September 2016, central government expenditure on interest payments had fallen by 5% compared with the same period in 2015.

In short, the estimates contained in the PGE, according to which economic growth will help to reduce the general government deficit to 3.6% of GDP in 2017, seem plausible. Moreover, with the aim of achieving the 3.1% target agreed with the European Commission, the government has passed a further package of budgetary measures to reduce spending and increase revenue, valuing the whole of these measures at 7.5 billion euros.

It should be noted that measures to reduce the fiscal balance are necessary in order for public debt to begin to fall. It is therefore prudent to take advantage of the good momentum enjoyed by the Spanish economy at present to sort out the country's accounts and thereby have more margin to tackle any future storms.

Budget deficit

(% of GDP)



Note: ** Losses due to bail-outs for financial institutions.*
Source: *CaixaBank Research, based on data from the 2017 budgetary plan.*

Forecast revenue and expenditure for all public administrations

Annual change (%)

		Forecast PGE 2017	
	2015	2016	2017
Total revenue	2.9	2.0	3.3
Taxation on production and imports (e.g. VAT)	6.0	4.1	3.7
Current taxation on income and wealth (e.g. Income Tax)	3.9	–2.6	4.2
Company contributions	1.7	2.9	2.5
Total expenditure	1.2	1.0	1.0
Payroll	3.3	3.0	0.6
Intermediate consumption	2.6	0.2	0.1
Social transfers	0.0	2.8	1.7
Interest	–6.1	–6.8	–0.3

Source: *CaixaBank Research, based on data from the 2017 budgetary plan.*

1. In December the government presented an update of the macroeconomic situation which includes an upward revision of GDP growth in 2017 to 2.7%.
2. In 2016 this measure was applied as from the second advance payment. In 2017 the measure will affect all three payments.

FOCUS · The improvement in Spain's competitiveness: by sector

The competitiveness of the Spanish economy has been on a return journey. Since the euro was introduced, which made nominal devaluation impossible, up to the time when the Great Recession began, unit labour costs rose more in the Spanish economy than in its main trading partners. One of the consequences of this loss of competitiveness was that, between 2000 and 2007, the current account deficit went from 4.4% to 9.6% of GDP. However, as from 2011 the Spanish economy has been making its way back, recovering a large part of the competitiveness it had lost. As a result, the current account balance will end 2016 with a surplus of around 2% of GDP.

On the outward journey, this loss of competitiveness could be seen in the increase in unit labour costs which, between 2000 and 2008, went up by 29% compared with a basket of 49 OECD countries. With regard to Spain's main trading partners in the euro area, unit labour costs rose by 34.8% compared with Germany and by 14.0% and 2.5% compared with France and Italy, respectively (see the first graph).

Around 70% of the competitiveness lost during these years was due to a higher increase in labour costs in Spain than in its trading partners and the rest to a poorer trend in labour productivity. Focusing on the trend in labour costs, between 2000 and 2011 these rose more in the Spanish economy than in its main trading partners in all sectors. Labour costs in Spanish manufacturing increased by 25% compared with Germany and by 8.8% and a 5.8% compared with France and Italy, respectively. In the construction sector, which is not subject to direct international competition and was enjoying a boom, labour costs grew even more compared with Germany: by 35%. In services this relative increase reached 25%, a deterioration that was offset slightly by the financial sector and especially computing and telecommunications performing slightly better.

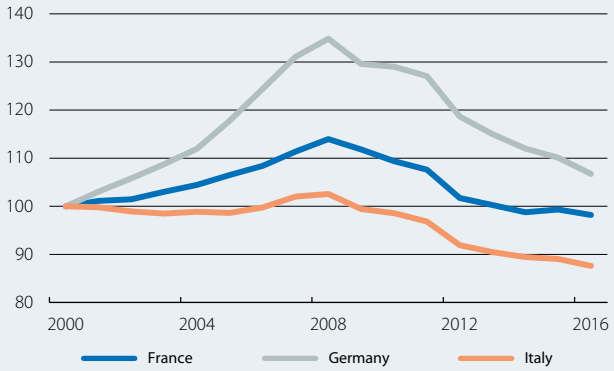
The journey back has been equally intense and widespread. According to the OECD, in the five years from 2011 to 2016 relative unit labour costs have returned to the levels achieved in 1998. In this case, 60% of the improvement in competitiveness results from less growth in labour costs in Spain than in its trading partners.

Focusing once again on the trend in Spanish labour costs compared with that of its main rivals, between 2011 and 2016 the improvement has been widespread in all sectors. Specifically, all sectors saw a reduction in their labour costs in relative terms compared with Germany. There has been considerable adjustment in the labour costs of Spain's manufacturing sector compared to German manufacturing while construction has seen a more modest improvement. Notable in services is the improvement in computing and telecommunications, in finance, and also in education and healthcare.

This recovery in the competitiveness of the Spanish economy helps to explain the good performance of exports. In absolute terms, Spanish exports rose by 240,577 million euros in August (cumulative over the year), 2.7% more than in August 2015. In relative terms, it is worth noting that Spanish exports have maintained their share of world exports while this figure has fallen in most advanced countries. Given these figures, there is no doubt that work must continue to preserve and, as far as possible, improve the competitiveness achieved over the last few years.

*Spanish unit labour costs compared with other countries **

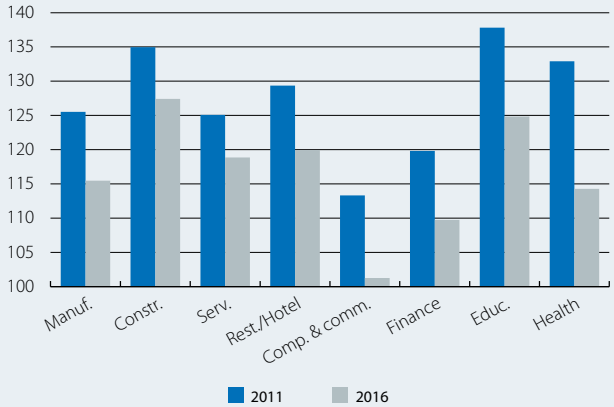
Index (100 = 2000)



Note: ** Ratio of the Spanish unit labour cost and the unit labour cost of each country.*
Source: *CaixaBank Research, based on OECD data.*

*Spanish labour costs compared with German labour costs, by sector **

Index (100 = 2000)



Note: ** Ratio of Spanish labour costs and German labour costs.*
Source: *CaixaBank Research, based on Eurostat data.*

KEY INDICATORS

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

Activity indicators

	2014	2015	2015 Q4	2016 Q1	2016 Q2	2016 Q3	09/16	10/16	11/16
Industry									
Electricity consumption	–0.1	1.6	2.5	–0.5	0.9	–0.1	3.7	1.2	...
Industrial production index	1.3	3.3	4.2	2.6	1.4	1.9	0.6	...	...
Indicator of confidence in industry *(value)*	–7.1	–0.3	0.3	–1.9	–2.8	–3.8	–3.0	–0.1	0.9
Manufacturing PMI *(value)*	53.2	53.6	52.5	54.3	52.5	51.4	52.3	53.3	...
Construction									
Building permits *(cumulative over 12 months)*	–7.7	20.0	31.1	45.2	48.1	44.8	41.2	...	...
House sales *(cumulative over 12 months)*	–5.6	10.9	11.9	10.6	14.1	13.3	13.2	...	...
House prices	–2.4	1.1	1.8	2.4	2.0	1.6	–	–	...
Services									
Foreign tourists *(cumulative over 12 months)*	7.2	5.4	9.3	13.7	10.4	8.4	10.2	...	...
Services PMI *(value)*	55.2	57.3	55.9	54.7	55.5	54.9	54.7	54.6	...
Consumption									
Retail sales	1.0	3.0	3.4	3.8	3.8	3.8	3.2	2.4	...
Car registrations	18.4	21.3	17.1	8.0	17.8	11.0	14.0	4.0	...
Consumer confidence index *(value)*	–8.9	0.3	1.6	–2.5	–3.2	–6.1	–7.3	–4.8	–2.2

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

Employment indicators

	2014	2015	2015 Q4	2016 Q1	2016 Q2	2016 Q3	09/16	10/16	11/16
Registered as employed with Social Security [1]									
Employment by industry sector									
Manufacturing	0.1	2.2	2.7	2.8	2.7	2.7	2.7	2.8	2.9
Construction	–1.6	4.7	4.1	2.6	2.1	2.7	2.6	2.8	3.3
Services	2.2	3.5	3.4	3.1	3.0	3.3	3.3	3.3	3.6
Employment by professional status									
Employees	1.4	3.5	3.6	3.4	3.1	3.5	3.5	3.5	4.0
Self-employed and others	2.2	1.9	1.4	1.2	1.0	0.9	0.9	0.9	1.0
TOTAL	**1.6**	**3.2**	**3.2**	**3.0**	**2.7**	**3.0**	**3.0**	**3.0**	**3.4**
Employment [2]	**1.2**	**3.0**	**3.0**	**3.3**	**2.4**	**2.7**	**2.7**	**–**	**...**
Hiring contracts registered [3]									
Permanent	18.8	12.3	7.6	8.3	17.4	17.9	30.9	11.8	10.0
Temporary	13.1	11.2	11.8	6.2	9.1	7.1	15.3	5.7	5.7
TOTAL	**13.4**	**11.3**	**11.5**	**6.4**	**9.8**	**7.9**	**16.3**	**6.2**	**6.1**
Unemployment claimant count [3]									
Under 25	–8.2	–11.0	–11.7	–10.9	–12.0	–14.4	–14.8	–14.0	–14.2
All aged 25 and over	–5.3	–7.2	–7.5	–7.8	–7.5	–8.6	–8.6	–8.7	–9.4
TOTAL	**–5.6**	**–7.5**	**–7.9**	**–8.1**	**–7.9**	**–9.1**	**–9.1**	**–9.1**	**–9.9**

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

Prices

	2014	2015	2015 Q4	2016 Q1	2016 Q2	2016 Q3	09/16	10/16	11/16
General	**–0.1**	**–0.5**	**–0.3**	**–0.7**	**–0.9**	**–0.2**	**0.2**	**0.7**	**0.7**
Core	0.0	0.6	0.9	1.0	0.7	0.8	0.8	0.8	...
Unprocessed foods	–1.2	1.8	2.5	2.1	2.7	3.5	1.2	0.2	...
Energy products	–0.8	–9.0	–10.2	–13.1	–13.6	–8.6	–4.8	0.1	...

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

Foreign sector

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

	2014	2015	2015 Q3	2015 Q4	2016 Q1	2016 Q2	2016 Q3	08/16	09/16
Trade of goods									
Exports *(year-on-year change)*	2.5	4.3	3.4	3.8	0.2	4.3	–1.1	8.9	0.0
Imports *(year-on-year change)*	5.7	3.7	3.3	3.3	–0.7	–0.3	–3.7	4.2	–1.4
Current balance	**11.2**	**14.7**	**16.0**	**14.7**	**15.4**	**19.4**	**21.1**	**21.0**	**21.1**
Goods and services	25.5	26.2	26.8	26.2	26.0	29.7	31.7	31.3	31.7
Primary and secondary income	–14.3	–11.5	–10.8	–11.5	–10.6	–10.3	–10.7	–10.3	–10.7
Net lending (+) / borrowing (–) capacity	**16.3**	**21.7**	**22.1**	**21.7**	**22.2**	**25.9**	**26.8**	**26.8**	**26.8**

Source: *CaixaBank Research, based on data from the Department of Customs and Special Taxes and Bank of Spain.*

Public sector

Percentage GDP, cumulative in the year, unless otherwise specified

	2014	2015	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2016 Q1	2016 Q2	2016 Q3
Net lending (+) / borrowing (–) capacity [1]	**–6.0**	**–5.1**	**–0.7**	**–2.9**	**–3.0**	**–5.1**	**–0.7**	**–3.1**	**...**
Central government	–3.7	–2.6	–0.8	–1.8	–2.1	–2.6	–0.8	–1.9	–2.6
Autonomous regions	–1.8	–1.7	–0.2	–0.9	–1.1	–1.7	–0.1	–0.7	–0.2
Local government	0.5	0.5	0.1	0.2	0.3	0.5	0.0	0.1	...
Social Security	–1.0	–1.2	0.3	–0.4	–0.2	–1.2	0.2	–0.6	–0.6
Public debt *(% GDP)*	**100.4**	**99.8**	**100.7**	**100.3**	**100.3**	**99.8**	**101.1**	**101.0**	**...**

Note: *1. Includes aid to financial institutions.*
Source: *CaixaBank Research, based on data from the IGAE, Ministry of Taxation and Bank of Spain.*

Financing and deposits of non-financial sectors

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

	2014	2015	2015 Q4	2016 Q1	2016 Q2	2016 Q3	08/16	09/16	Balance 09/16 [1]
Financing of non-financial sectors [2]									
Private sector	–5.8	–3.8	–3.0	–3.2	–2.9	–2.1	–2.1	–1.9	1,630.6
Non-financial firms	–6.3	–4.0	–3.0	–3.4	–3.2	–2.2	–2.1	–1.8	915.0
Households [3]	–5.0	–3.6	–3.1	–3.0	–2.5	–2.0	–2.0	–2.0	715.7
General government [4]	5.9	4.0	3.7	3.5	4.3	4.5	4.6	3.5	1,104.9
TOTAL	**–1.8**	**–1.0**	**–0.5**	**–0.6**	**–0.2**	**0.4**	**0.5**	**0.2**	**2,735.6**
Liabilities of financial institutions due to firms and households									
Total deposits	–0.9	–1.0	–0.5	–0.4	–0.3	–0.3	–0.1	–0.1	1,155.4
On demand deposits	10.8	18.5	17.7	16.2	16.0	16.4	17.3	16.5	434.6
Savings deposits	5.8	12.9	15.2	13.4	12.1	11.5	11.7	11.1	272.5
Term deposits	–7.6	–15.3	–15.8	–15.4	–16.4	–17.4	–17.6	–17.4	426.8
Deposits in foreign currency	1.1	5.6	–2.3	–4.0	1.6	–1.9	–1.8	–1.4	21.5
Rest of liabilities [5]	–8.2	–13.0	–15.1	–16.7	–16.3	–11.3	–7.0	–14.2	89.2
TOTAL	**–1.7**	**–2.2**	**–1.9**	**–1.9**	**–1.7**	**–1.2**	**–0.7**	**–1.3**	**1,244.6**
NPL ratio *(%)* [6]	**12.5**	**10.1**	**10.1**	**10.0**	**9.4**	**9.2**	**9.4**	**9.2**	**–**
Coverage ratio *(%)* [6]	**58.1**	**58.9**	**58.9**	**59.0**	**58.7**	**59.3**	**58.9**	**59.3**	**–**

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

OUTLOOK 2017

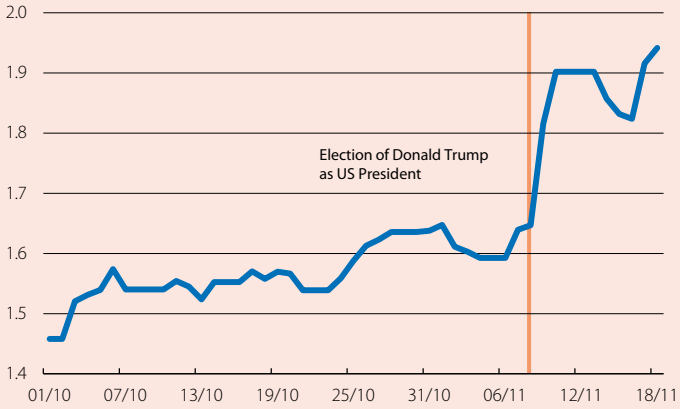
Monetary policy in 2017: a promising journey, but hurdles lie ahead

2016 was meant to be the year when the US Federal Reserve (Fed) took a definitive step towards monetary normalisation with a sustained pace of interest rate hikes. The Bank of England (BoE) would be the first to follow while the European Central Bank (ECB) and Bank of Japan (BoJ) would begin preparations to withdraw their asset purchase programmes (the first step towards raising interest rates).

However, having reached the end of the year, the Fed's interest rate hike has not progressed as quickly as expected and the other central banks have reinforced their expansionary measures even further. The macroeconomic indicators do not warrant such hesitation: in the US, unemployment is practically at its equilibrium level and core inflation is close to 2%, while the euro area and Japan have continued to progress gradually and the UK has seen a good rate of growth in spite of being burdened by Brexit. The decisions taken by these central banks have been based on a new and increasingly important factor, uncertainty, in the face of which they have chosen to act prudently.

Inflation expectations after the US elections

*Expectations 5Y5Y (%) **



Note: ** Resulting from TIPS and a model of the yield curve.*
Source: *CaixaBank Research, based on data from the US Federal Reserve.*

In 2017 the macroeconomic outlook for the advanced economies is once again favourable: we expect growth of 2.3% for the US and 1.4% for the euro area while inflation will consolidate at levels closer to central bank targets, boosted by activity and by the fact that the slump in oil prices is now behind us. 2017's macroeconomic scenario therefore underlines the need to continue with monetary normalisation in the US and opens the door to less intervention by the ECB. This scenario is not without its risks but one of the biggest, the expansionary fiscal policy which Donald Trump might implement, could actually accelerate monetary normalisation. To understand why, we need to examine the outlook for the advanced economies in greater detail.

The current expansionary phase of the US economy is the third longest since 1945, activity has been growing apace since 2010, unemployment is low and the underlying trend in prices reflects a sustained increase in inflation. Although the traditional rules of monetary policy have been recommending interest rate hikes for some time now,[1] the Fed has maintained an environment of extraordinarily accommodative financial conditions. There are good reasons for this. Firstly, the extent of the Great Recession removed workers from the labour market who are now joining it again, acting as a brake on wage pressures. Secondly, the Fed believed that the risks involved in an interest rate hike, which might have cooled the economy down, were greater than those of postponing such hikes. The Fed has applied this rule of asymmetrical risk for the episodes of uncertainty experienced in 2016 and this explains the slowness of its normalisation to date, particularly given the global repercussions of its decisions.[2]

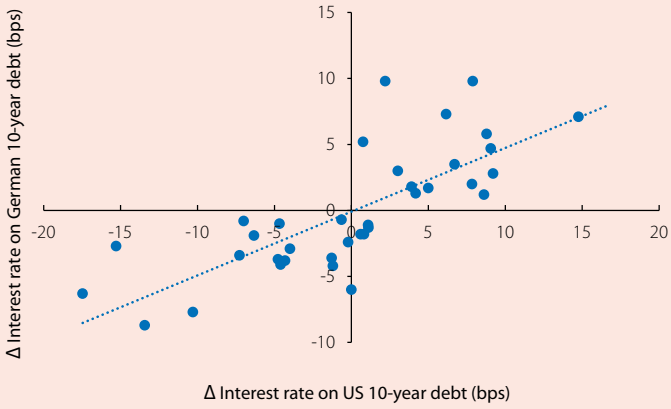
However, in the more mature phase of the cycle the US is currently going through, with a consolidated recovery, inflationary pressures are starting to be observed and, after years of accommodative monetary conditions, the risks of financial instability are gaining ground. Moreover, the transmission of monetary policy is not immediate and the Fed must therefore anticipate the economy's needs. Aware of this, in 2017 it will continue raising interest rates but at a more sustained pace, balancing the need to prevent the economy from overheating with the risk of growth cooling down. In reaction to the Fed's normalisation, it is particularly important for the adjustment of financial markets to be orderly.

1. See, for example, Knotek II *et al.* (2016), «Federal Funds Rates Based on Seven Simple Monetary Policy Rules», Economic Commentary, Federal Reserve Bank of Cleveland.
2. One additional reason given by the Fed is a fall in the equilibrium interest rate (the rate which neither slows down nor speeds up activity). This would put the value at which the Fed has currently set the effective rate closer to that of the equilibrium rate and conditions would therefore be more accommodative than they seem.

In fact, we already observed the first signs of this adjustment in financial markets after Donald Trump was elected as President of the US: given the expectations of a more expansionary fiscal policy the market has quickly assumed that, from now on, higher interest rates will prevail. This readjustment of expectations has led to an upswing in interest rates on US long-term debt which is largely due to an increase in inflation expectations (as can be seen in the first graph, the rise has been substantial, placing them almost at the Fed's target). At CaixaBank Research we expect a pragmatic implementation of Trump's agenda, given that he needs the support of Congress (at least the moderate wing of the Republican Party) and he won by a very slight margin. Moreover, the pace of legislative procedures will probably delay any substantial fiscal expansion until the end of 2017. We therefore expect a moderately expansionary fiscal policy without any huge impact on growth or inflation, which is in line with the reaction observed in the markets. Given this outlook, the Fed is free to continue with normalisation as planned (and even somewhat more confidently, given the respite provided by fiscal policy).

Monetary policy in the US and European financial conditions

Impact of the Fed's announcements on US and German sovereign yields (2006-2016)



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

However, this change of scenario in financial markets also reflects an increase in risk.[3] Specifically, a more expansionary fiscal policy could result in larger increases in inflation expectations for which the Fed would have to speed up the pace of its interest rate hikes. In a more extreme and less likely scenario, but which nevertheless affects market valuations, more aggressive action on the part of Donald Trump on all fronts (fiscal, commercial, immigration and international geopolitics) could lead to a loss of confidence at a global level and force the Fed to combat tougher financial conditions and, at the same time, inflationary pressures.

In the euro area, the scenario for monetary policy will be dictated not only by the domestic situation but also by the contagion caused by the US. At a domestic level we expect the recovery in activity to continue at a similar pace to that of 2016 and that, free from the burden of the energy component, inflation should end 2017 above 1.5% thanks to the growth in domestic demand. This outlook should allow the ECB to begin to withdraw QE during the year and plan the first interest rate hikes for the medium term. Given this solid domestic situation, the risks will be external. On the one hand, because of the global importance of the Fed, monetary normalisation in the US could produce contagion and toughen up financial conditions in the euro area. To gauge the size of this effect, we have analysed the impact of the Fed's monetary policy on the euro area's financial conditions. As shown by the second graph, the Fed's actions not only affect US long-term interest rates but, with a sensitivity of around 50%, also influence the interest rates of European countries: for example, a decision taken by the Fed that pushes up the yield on US 10-year debt by 10 bps typically results in an increase of 5 bps in the yield of 10-year German debt. However, our analysis also indicates that the short tranche of the European curve is not affected. Given this sensitivity and if the Fed's normalisation goes as expected, the ECB should not find it difficult to maintain appropriate financial conditions in the euro area if it communicates its monetary policy properly. On the other hand, the many different elections taking place in 2017 in Europe, together with populist parties that can influence the political agenda even if they are not elected to government, imply a higher likelihood of more expansionary fiscal policies in Europe as well. Given this situation, the ECB might also feel more comfortable about starting to withdraw its extraordinary stimuli of monetary policy.

In summary, 2017 is starting off with a reasonably good macroeconomic outlook which is therefore also favourable for an orderly normalisation of financial conditions. The uncertainty that still surrounds the macroeconomic scenario notwithstanding, we are approaching a situation in which monetary policy will not be as accommodative in the future as it has been over the last few years.

Adrià Morron Salmeron
Macroeconomics Unit, Strategic Planning and Research Department, CaixaBank

3. At the same time as the increase in interest rates and inflation expectations, there has also been an increase in the bond term premium.

Outlook for the emerging markets in 2017

The most positive surprise in 2016 has been provided by the financial assets of emerging countries, interrupting a bad patch that had lasted several years. Analysts are divided into those who believe this is only a temporary improvement and those who see a lasting turnaround. Both sides base their arguments on the conceptual framework of push and pull factors related to capital flows, which are certainly still very useful for analysing the performance of emerging markets. Pessimists believe the dominant factor will be the expected deterioration in global financial conditions, which will weaken the «push» of capital towards emerging assets. Optimists point to the improvement observed in these countries' macroeconomic situation over the last few quarters, which will «pull» capital towards them. These are obviously two opposing forces but their potential scope and how they will interact are not so clear: our assessment of the dynamics in operation leads us to opt for a moderately positive scenario.

2016 has been a veritable obstacle course for emerging assets, with fears regarding the Chinese economy in January, Brexit in June and Trump's victory in November, just to mention the most outstanding examples. Nevertheless the MSCI Emerging Markets index has recorded a 7% increase for the year so far, higher than the 2% achieved by the same index for the developed countries and in clear contrast with the drop of 17% suffered by the emerging bloc in 2015. In the bond market the spread for emerging bonds has narrowed by 30% since the peak reached in January, according to the global index produced by J. P. Morgan. Lastly, in the foreign exchange market, and in spite of some notable exceptions such as the Mexican peso and Turkish lira, 2016 has also been notable for the upward trend in emerging currencies. This overall positive performance has been supported both by push and pull factors. On the one hand, the search for yield by international investors, encouraged by the extremely accommodative tone of the G3 central banks, had a huge effect during the first half of the year whereas, since the summer, pull factors have started to play an increasingly important role thanks to signs of stabilisation in China and the improved situation in other important emerging economies (modest but enough to stand out in a context of weak growth by the developed bloc).[1]

Pessimists believe the most likely global financial climate in 2017 will be very hostile for the assets of developing countries, in particular for those with still excessive levels of debt.[2] They warn of two big risks in the external environment. The first comes from the normalisation of interest rates by the US Federal Reserve (Fed). This was already a cause for concern in the second half of 2015 when the Fed carried out its first interest rate hike after the Great Recession of 2008. That episode, together with doubts regarding the Chinese economy, hit emerging assets hard, a situation that lasted until February 2016. Normalisation is now very likely to occur in the near future,[3], arousing fears of a repetition of the events in 2015. In fact, some analysts are even resurrecting the taper tantrum of 2013 when the Fed announced its intention to reduce the rate of its asset purchase programme (QE), triggering huge turbulence in global markets: the yield on US 10-year bonds soared by more than 100 bps and numerous emerging markets saw a sharp and sudden deterioration in their financial conditions. Capital outflows, less liquidity, strong currency depreciation, a substantial increase in credit spreads and stock market losses were the main repercussions of that unexpected (verbal) first step towards normalising monetary policy in the US. These same effects have been seen in the past when the second factor worrying pessimists has come into play: an increase in global risk aversion. The three big episodes of 2016 mentioned above (China, Brexit and Trump) have been handled relatively successfully but, as yet, we cannot claim to have put them behind us. Moreover other sources of risk will emerge in 2017 that are substantial enough to cause an upswing in risk aversion, particularly the political uncertainty that could result from a very full electoral calendar in Europe.[4]

Optimists use five basic arguments to claim that the risks associated with a deterioration in the world's financial conditions will be manageable, predicting that emerging assets will be able to sustain the advances made in 2016. The first three arguments provide a direct response to the pessimists' concerns while the last two point to the current internal conditions of the emerging countries, which seem promising enough to attract investors.

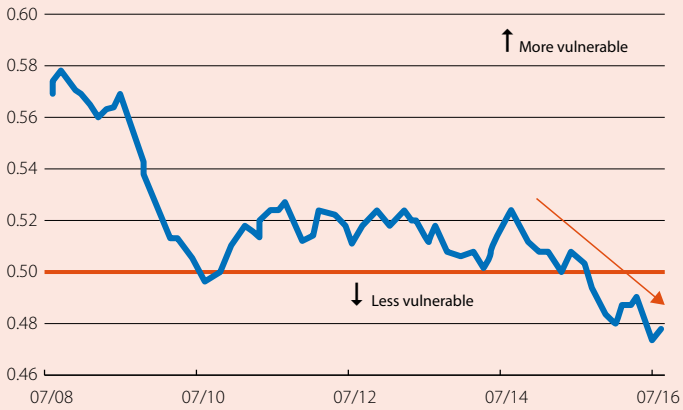
Firstly, although it is true that the conditions are right for the Fed to gradually adjust interest rates, investors seem to have already taken this normalisation on board, unlike the surprise represented by the hints of tapering in 2013. An abrupt change in financial conditions is therefore less likely, providing emerging countries with more flexibility to adjust to a less accommodative global environment. Moreover, 2016 has shown us that the Fed tends to prefer to err on the side of caution, taking the trends in the external environment very much into account, to the extent of revising the pace at which it normalises the fed funds rate to ensure this does not destabilise international markets (especially in the case of possible systemic repercussions).

1. For more details, see the Focus «Stock markets in the emerging countries: the turn of domestic factors» in MR11/2016.
2. For more details, see the Focus «Emerging debt: a weak flank given the Fed's monetary normalisation» in MR11/2016.
3. For this issue, see the article «Monetary policy in 2017: a promising journey, but hurdles lie ahead» in this Dossier.
4. For more details, see the article «Politics and economics in 2017: an inseparable duo» in this Dossier.

Secondly, although it is true that political uncertainty can fuel nervousness at all latitudes, such a risk is higher in the developed countries. In this respect, investor reaction to Brexit is revealing as this resulted in a better performance for emerging assets in relative terms. In other words, Brexit showed that greater global risk aversion originating in the advanced countries does not always negatively affect, and can even boost, emerging financial markets. The stance taken by the Trump Administration in terms of its commercial policy perhaps represents the most likely risk factor for the emerging economies but we can expect the US Congress to be play a moderating role on this front, as well as on others.

Macroeconomic vulnerability of the emerging economies

*Level **



Note: ** Index from 0 to 1, where 0.50 is the historical median. This index reflects the economic fragility of the emerging countries based on key variables related to (i) macroeconomic stability (economic growth and inflation); (ii) the level of leveraging in the private sector (trend in credit, private debt and real interest rates); (iii) external imbalances (current account, reserves and exchange rate), and (iv) sovereign risk (fiscal balance and public debt).*
Source: *CaixaBank Research, based on data from Deutsche Bank.*

Thirdly, and related to the previous two points, the vulnerability arising due to the likely deterioration in global financial conditions is now less than in 2013 or 2015 because international investors' exposure to emerging financial assets is much more limited than before. For example, data regarding the composition of western investment and pension fund portfolios show that, at present, emerging assets account for 12% of the total, very close to the minimum figure of 11% reached at the beginning of 2016 or after the Great Recession of 2009 (i.e. after the impact of the panic sell-off). On the other hand, just before the taper tantrum this figure was 17%, almost an all-time high. This leads us to believe that, even if global financial conditions deteriorate more sharply than expected, it should not result in disruptive events for the emerging markets.

Fourthly, emerging financial assets are currently reasonably attractive in terms of price. First of all, different calculations of the equilibrium exchange rates suggest that the emerging currencies are mostly priced below their intrinsic value, with the P/E ratio close to 11.5 for the MSCI Emerging Markets index, lower than the 12.5 average recorded since early 1990. The situation is a little tighter in the bond market from a historical perspective, in line with the situation throughout the world due to the impact of unconventional policies implemented by central banks. The sovereign credit spread is almost 1 pp below its historical average since the end of the 1990s (although it is in the higher part of the range observed since 2009, the start of these unconventional policies).

Last, but by no means least, the improvement in the macroeconomic situation of most of the emerging economies in the last few years has made them more attractive and also resilient in the face of adverse financial conditions. Since mid-2014 the emerging countries have managed to substantially reduce their macroeconomic vulnerability (see the previous graph). Several studies have shown that the impact of a change in monetary policy by developed economies on the financial conditions of the emerging countries mainly depends on the underlying macroeconomic fundamentals of each country itself.[5] Similarly, other studies highlight the fact that, when these fundamentals are solid, they can substantially mitigate the negative effects of an upswing in global risk aversion.[6] Moreover, the importance of fundamentals per se has increased since the mid-2000s.[7] In other words, international investors increasingly discriminate between the different countries in the heterogeneous group of emerging economies (as could be seen during the taper tantrum).

In summary, pessimists are not wrong when they warn of the risks facing the emerging markets in 2017. These undoubtedly exist. But the counter-arguments put forward by optimists regarding the positioning of portfolios and investor expectations are convincing and encouraging. Ultimately, the slow but sure improvement observed in underlying economic fundamentals is crucial for the gains made in 2016 to continue in the coming year. Let us hope this is the case.

Mathieu Fort
Financial Markets Unit, Strategic Planning and Research Department, CaixaBank

5. See, for example, Santacreu, A. M. (2015), «The Economic Fundamentals of Emerging Market Volatility», Federal Reserve Bank of St. Louis, Economic Synopses, No. 2, 2015.
6. Yildirim, Z. (2016), «Global financial conditions and asset markets: Evidence from fragile emerging economies», Economic Modelling, Volume 57, September 2016, Pages 208-220.
7. Ahmed, S., Coulibaly, B. and Zlate, A. (2015), «International Financial Spillovers to Emerging Market Economies: How Important Are Economic Fundamentals?», Board of Governors of the Federal Reserve System, International Finance Discussion Papers 1.135, April.

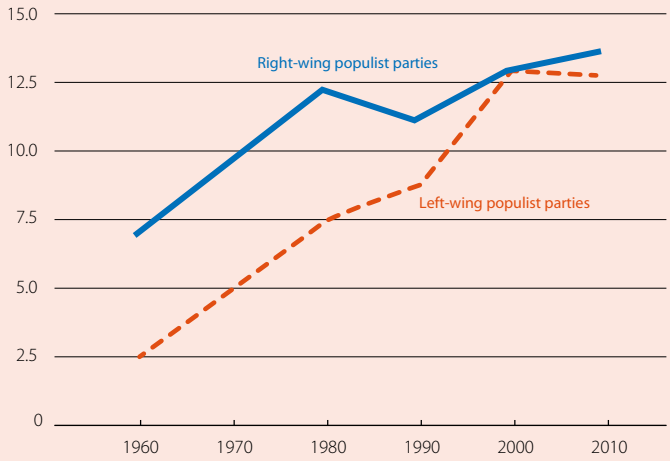
Politics and economics in 2017: an inseparable duo

In the last few months we have seen how political events have become a key variable when analysing economic prospects. The science of economics has taken on board this new situation to such an extent that some economists now talk about political business cycles and study not only the classical technological and monetary shocks but also shocks of a political nature. This situation will intensify in 2017 and the duo of politics and economics will become inseparable. After being sworn in as US President, Donald Trump will start his mandate on 20 January while the EU will have to tackle negotiations with the UK and a political agenda packed with important elections, especially those of France, Netherlands and Germany.

There are two factors related to the political sphere that are a particular cause for concern due to their possible repercussions on the economy at a global level. The first is the observed rise of political polarisation or, in other words, increased support for extreme economic or populist policies, either on the right or the left wing. The second is the intensification of political instability. As can be seen in the enclosed graphs, in the last few years there has been a substantial increase both of polarisation and political instability in Europe. This greater polarisation has also occurred in the US: according to the PEW Research Center, in 2014 92% of Republican voters had a more conservative stance than the average Democrat voter (64% in 1994) and 94% of Democrat voters held more left-leaning views than the average Republican voter (70% in 1994).

Electoral support for populist parties in Europe

Percentage of votes (%)



Source: *CaixaBank Research, based on data from Inglehart, R. and Norris, P., (2016), «Trump, Brexit, and the Rise of Populism».*

There is broad consensus in the economics literature regarding the negative consequences of both political polarisation and political instability for economic progress. Focusing on the first factor, political polarisation, according to the classic definition coined at the beginning of the 1990s by the renowned MIT economist Rudiger Dornbusch, populism is a set of policies that prioritise short-term economic growth without taking into account the potential risks, such as damaging public accounts in the medium term. According to Dornbusch, populism can have a positive impact in the short term although this is misleading since, in the medium term, economic imbalances result in very severe adjustments for the economy.

An increase in political polarisation can also damage economic growth through two other channels. On the one hand, polarisation makes it difficult for different agents in society to reach agreements and, in many cases, political leaders end up choosing to implement the economic policy that benefits their potential electorate even when this might not be the right one for society as a whole. This factor is especially important during economic booms as the larger volume of available resources means that political leaders can carry out their agenda more easily. Moreover, this gives rise to pro-cyclical fiscal policies when the ideal approach would be to implement counter-cyclical fiscal policies; in other words, saving during booms to be able to spend more during recessions and thereby revitalise the economy.

The second channel through which an increase in political polarisation can damage growth is the fact that, in general, this tends to be associated with the surge of political instability and therefore uncertainty.

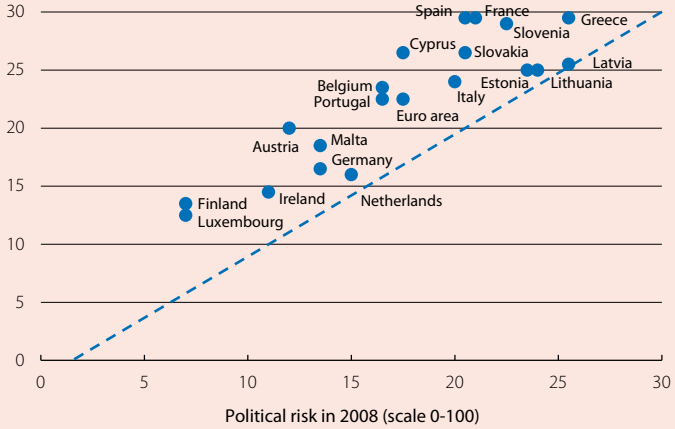
In a recent article, an economist from the Federal Reserve of Philadelphia, Marina Azzimonti,[1] has attempted to quantify the impact on the economy of the rise of political polarisation in the US between 2007 and 2012. The results obtained highlight that this is not a minor phenomenon. According to the author, due to the increase in political polarisation, 1.75 million jobs were lost, investment fell by 8.6% and GDP contracted by 2%.

1. See Azzimonti, M. (2013), «The Political Polarization Index», Working Paper No. 13-41, Federal Reserve Bank of Philadelphia.

The second factor of concern is growing political instability, beyond that caused by the increase in polarisation. Greater instability has a negative effect on the economy because, as has already been mentioned, it fuels uncertainty, leading to the delay of investment decisions and of the hiring of new workers. One example of how the uncertainty caused by political instability affects economic decisions is that, in the developed countries, private investment tends to fall by 1 pp in the quarter prior to elections.[2] This figure is important to bear in mind given the large number of elections which will be held in Europe in 2017. Similarly, the IMF economists Ari Aisen and Francisco José Vega[3] have shown that political instability tends to be associated with lower growth and that this is particularly due to a reduction in productivity growth.

Political risk ratings in the European Union *

Political risk in 2016 (scale 0-100)



Note: ** The level of political stability is one of the most important variables in calculating these ratings.*
Source: *CaixaBank Research, based on data from the European Central Bank and the PRS Group.*

Looking now at Europe, and in addition to the increase in polarisation and political instability, the condensed electoral calendar for 2017 could also temporarily increase the pressure on public finances. The fact is that, as explained by the Harvard economists Alberto Alesina and Matteo Paradisi in a recent study,[4] governments tend to implement more expansionary fiscal policies in the run-up to elections in order to improve their chances of being re-elected; a phenomenon that increases especially when the outcome of the election is up in the air. And if there is one thing that characterises the elections to be held in Europe next year, it is precisely that the outcome seems quite uncertain, at least at present. In this respect, a recent study by Goldman Sachs suggests that this factor will lead to remarkable fiscal easing in France, Germany and Italy.

In short, 2017 will be a crucial year in political terms both in the US and in Europe, and this will have considerable repercussions at the economic level. In particular, there are legitimate concerns regarding how political polarisation and instability might result in greater economic uncertainty and an increase in macroeconomic imbalances. Should the political situation get worse, the common European project may falter, aggravating the loss of mechanisms for multilateral cooperation. Avoiding such a situation will require great political care and everyone concerned will have to show a great deal of high-mindedness.

Javier Garcia-Arenas
Macroeconomics Unit, Strategic Planning and Research Department, CaixaBank

2. See Canes-Wrone, B. and Ponce de Leon, C. (2015), «Electoral Cycles and Democratic Development», Princeton Working Paper.
3. See Aisen, A. and Veiga, F. J. (2011), «How Does Political Instability Affect Economic Growth», IMF Working Paper.
4. See Alesina, A. and Paradisi, M. (2014), «Political Budget Cycles: Evidence from Italian Cities», NBER Working Paper.

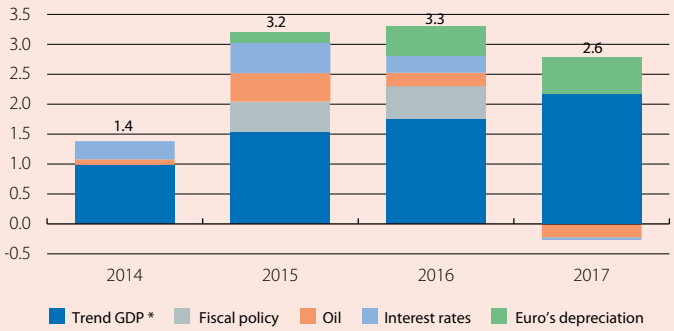
The Spanish economy in 2017: growing with fewer tailwinds

The Spanish economy's growth was very strong in the two-year period of 2015-2016: more than 3% both years and outperforming the forecasts of most analysts. This extraordinary achievement is due to the convergence of temporary support factors, both external (low oil prices and the ECB's incredibly accommodative monetary policy) and also internal (fiscal impulse) in addition to the economy's cyclical recovery. In the second half of 2016 these tailwinds started to abate, reflected in the slight slowdown in the rate of GDP growth. With a view to 2017, the trend in these support factors will largely determine the rate at which the Spanish economy will advance next year.

Let us begin by going back a little in time, to when a barrel of crude oil cost around 100 dollars, one euro was worth 1.33 dollars and the yield on Spanish 10-year bonds was 2.7%. Although these figures may seem very far from the current economic situation[1] they come from the averages for 2014, just two years ago. GDP growth that year was 1.4%, a little above the growth rate for trend GDP,[2] thanks especially to the lower financing costs the Spanish economy was starting to benefit from after the ECB's expansionary measures and, to a lesser degree, to the slight reduction in the price of oil (see the first graph). These support factors intensified in 2015: oil prices slumped to 35 dollars in December and financing costs continued to fall as the ECB intervened more decisively, eventually beginning its sovereign bond purchases. This slump in oil prices and interest rates continued in 2016 but the drop was less than in the previous year and, consequently, also its impact on growth. On the whole these two factors, oil and interest rates, explain about 1 pp of the GDP growth in 2015 and 0.5 pps in 2016.[3] CaixaBank Research forecasts predict a moderate increase in both oil prices and interest rates in 2017, so these factors are likely to stop supporting GDP growth next year.

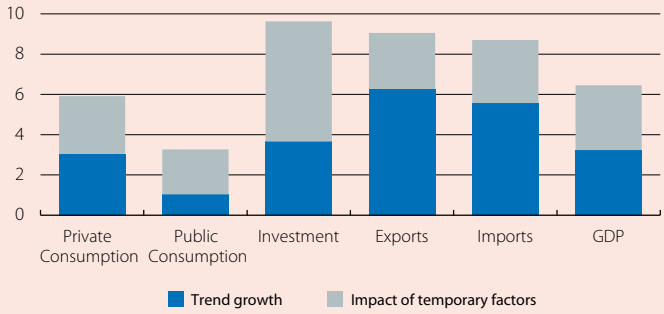
Breakdown of GDP growth

Contribution to annual change in GDP (pps)



Breakdown of GDP by demand component

Cumulative growth 2015-2016 (%)



Notes: ** Trend GDP is calculated using an autoregressive model in the GDP series assuming there are no shocks. The impact of the different factors is estimated based on the energy balance, interest payments, the depreciation in the real effective exchange rate and fiscal adjustment. To estimate the impact on demand components, a 60% marginal propensity to consume and invest is assumed, as well as an import density of 25%. The number above the bars indicates annual GDP growth.*
Source: *CaixaBank Research, based on data from the INE, ECB and the Ministry of Taxation.*

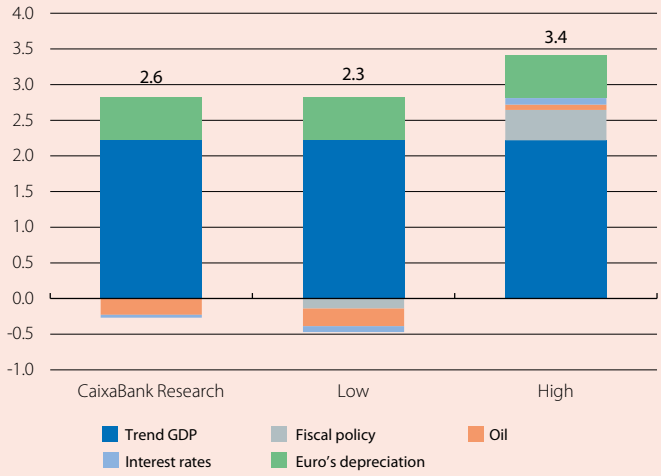
Another external element that has boosted the Spanish economy is the exchange rate. The ECB's expansionary monetary policy, together with the start of monetary normalisation in the US, resulted in the euro depreciating sharply, falling to an average of 1.11 dollars in 2015. Compared with a larger basket of currencies, it can be seen that the fall in the real effective exchange rate for Spain compared with its main trading partners started in 2014 (–2.9%) and continued in 2015 (–2.8%) and 2016 (–1.0% between January and October, the latest figure available). Given that the exchange rate's impact on the trend in exports is not immediate but its maximum effect tends to be felt after approximately one and a half years, we estimate that the effect on GDP growth in 2015 was relatively small, in the order of 0.2 pps.[4] However, the impact in 2016 is more substantial (around 0.5 pps) and will still be very significant in 2017.

Lastly, on the internal front, another factor that has provided a considerable boost to GDP growth over the last two years has been expansionary fiscal policy. In 2015 the public deficit fell by 0.8 pps to 5.0% of GDP (not including losses due to bank bail-outs). The fiscal adjustment in 2016, if the new target of 4.6% of GDP is met, will have been less, namely 0.4 pps. In both years the improvement in the macroeconomic environment would have brought about a larger reduction in the deficit had fiscal policy been neutral; in other words, the reduction in the deficit was less in relative terms because expansionary fiscal measures were

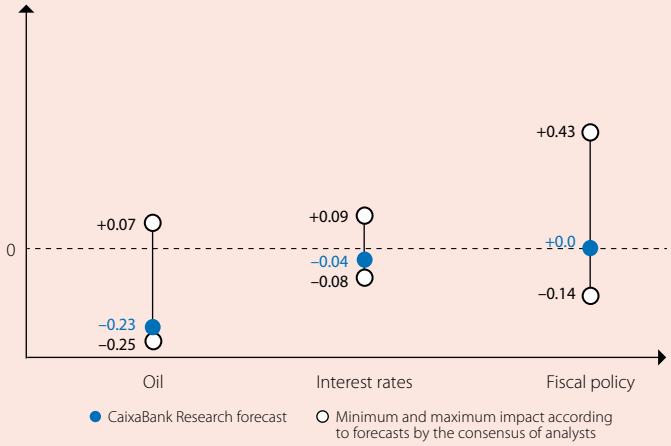
1. The average figures for November 2016 are 46.9 dollars per barrel, 1.08 dollars per euro and Spain's 10-year bond with a yield of 1.5%.
2. Trend GDP is calculated based on an estimated autoregressive model for the period 1995-2013. This estimates the growth in GDP that would have occurred without any shocks.
3. The impact of oil prices on GDP is estimated based on annual savings in the energy heading of the balance of payments. The impact of interest rates is estimated based on the savings in interest payments by households and non-financial firms based on data from non-financial accounts.
4. The impact of the real effective exchange rate on GDP is estimated based on the historical elasticity of exports and the exchange rate.

GDP growth scenarios in 2017

Contribution to the annual change in GDP (pps)



Range of each factor's contribution to the annual change in GDP (pps)



	Oil (dollars per barrel)	Yield on Spanish 10-year bonds	Fiscal deficit
CaixaBank Research	57.6	1.8	−3.4
High	41.0	1.0	−4.0
Low	60.5	2.2	−3.1

Notes: *The number above the bars indicates annual GDP growth. The High and Low scenarios have been produced based on the minimum and maximum forecasts of the consensus of analysts for each of the factors.*
Source: *CaixaBank Research, based on data from the INE, Funcas and Consensus Forecast.*

taken, such as cutting income tax. Specifically, we estimate that this fiscal impulse contributed 0.5 and 0.6 pps to GDP growth in each of the two years in question. With a view to 2017, if the deficit falls at a slightly higher rate than in the last two years and comes close to the target agreed with Brussels, fiscal policy would be almost neutral.

The impact of the aforementioned shocks has not affected the different GDP components equally but it has certainly been widespread. As can be seen in the second graph, investment is the component benefitting the most from the different temporary support factors although private consumption and public consumption have also been helped by these factors. Regarding the foreign sector, the euro's depreciation has boosted growth in exports by 3 pps, accounting for almost one third of the cumulative increase in the period 2015-2016.

In summary, a detailed analysis of the main temporary support factors suggests that these lie behind approximately half the exceptional growth observed in the Spanish economy in the two-year period of 2015-2016. Without any doubt these elements helped to regain confidence in the economy's growth capacity and thereby to consolidate its good momentum. Without them, growth would have been smaller and the confidence effect, which is more difficult to quantify, would also have been weaker.

As has already been mentioned, CaixaBank Research forecasts for 2017 suggest these tailwinds will stop blowing and that some may even become headwinds. In such a scenario, the Spanish economy's growth rate will slow down to a still notable 2.6%. However, the uncertainty surrounding this forecast is high as it depends on variables such as oil prices, interest rates and the exchange rate, whose trends are very unclear given the current international context. To illustrate this uncertainty, all we need to do is to look at the huge difference between the most optimistic and the most pessimistic forecasts provided by various analysts. For example, the forecast for the average oil price next year ranges from 41 to 60 dollars while the yield on Spain's 10-year bond ranges from 1.0% to 2.2%. In spite of this broad range of forecasts, the estimated impact on GDP growth is relatively modest (between −0.2 and +0.1 pps). It is also important to note that, in both cases, CaixaBank Research forecasts are on the more conservative side, which means that the risks would be upwards (see the third and fourth graph). Lastly, we must also point out that the opinions regarding the course that will be taken by Spain's public deficit in 2017 diverge substantially: this figure ranged from −3.1% to −4.0% of GDP in November's Funcas think tank. In this case the direct impact on GDP growth is considerable, illustrating the importance of credible measures being developed.

In summary, although the bulk of the evidence available suggests that growth will still be strong in 2017, uncertainty will also remain high, particularly due to the complex international situation. Given this environment, in which the economy's tailwinds may stop supporting the country's growth, it is vital to continue promoting an ambitious agenda of structural reforms that guarantees sustained and balanced growth in the medium term.

Judit Montoriol Garriga
Macroeconomics Unit, Strategic Planning and Research Department, CaixaBank

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

"la Caixa" BANKING FOUNDATION COMMUNITY PROJECTS: BUDGET 2016

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

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