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MONTHLY REPORT • ECONOMIC AND FINANCIAL MARKET OUTLOOK

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ECONOMIC & FINANCIAL ENVIRONMENT

FINANCIAL MARKETS

*The Federal Reserve's balance sheet:
a double-edged sword?*

INTERNATIONAL ECONOMY

*A downturn in international trade and
global value chains?*

EUROPEAN UNION

*Where are interest rates headed?
The ECB and macroeconomic fundamentals*

SPANISH ECONOMY

*Technology and good quality employment:
a shifting relationship?*

DOSSIER: PENSIONS: A NECESSARY DEBATE

Pension reform: an unavoidable debate

*A longer life and more active
retirement*

How to finance pensions

*Private savings for retirement:
a complement to state pensions*

MONTHLY REPORT - ECONOMIC AND FINANCIAL MARKET OUTLOOK

April 2017

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The pension debate

Congratulations are in order. Spain is one of the countries with the longest life expectancy in the world. Our male readers aged 65 will live, on average, until they are 84; our female readers until 88. Some will live even longer if, in addition to reading this *Monthly Report*, they also have other healthy habits such as regular exercise and a balanced diet. Life expectancy is set to go on growing, and probably at an ever-faster rate: six years have been added in the last four decades but it is projected to lengthen by almost eight over the next forty years.

This great piece of news lies at the heart of any discussion about the sustainability of pension systems. The vast majority of advanced economies are now facing this challenge but Spain's medium and long-term demographic pressures are particularly high as its longer life expectancy is accompanied by one of the lowest birth rates in the world. And the additional handicap of a labour market with relatively low employment rates.

A few figures help to illustrate the pressure Spain is under: the number of people paying Social Security contributions is currently around 18 million, about 60% of the working age population, while the number of people over 65 is approaching 9 million. Put another way, there are just over 2 people paying contributions for every person of retirement age.

Demographic projections for 2050 indicate that, keeping the current employment rate, this ratio would fall to 1 or, in other words, the number of people paying contributions would equal the number of people over 67 (around 14.5 million). Even if there were full employment, this ratio would scarcely reach 1.2. The country's demographic trend therefore represents a huge challenge for a pension system such as our own, where retirement pensions must be covered by Social Security contributions.

The reforms carried out in 2011 and especially in 2013 took these pressures into account and proposed a number of rules that help to ensure the system is sustainable. In their day these reforms (in which Spain was a pioneer compared with many countries) were vital in order to regain the confidence of international investors. Among other changes, the retirement age was scaled forward, a sustainability factor was introduced (linking pensions to life expectancy) and a formula was established to determine the annual revision of pensions based on the budgetary situation of the Social Security (with a minimum increase of 0.25%).

The issue at stake is that, in all probability, these rules would achieve a sustainable system but through a substantial, albeit gradual, reduction in the generosity of pensions. For many of the years over the coming decades, the current rules would probably result in annual increases of 0.25% for pensions. For instance, the European Commission has estimated a probable reduction in the ratio between the average pension and average wage, also called the replacement rate, of around 20 points over the long term, pushing this ratio to below 40%.

Discussion today should therefore focus on the appropriateness of concentrating most of the adjustment on pension size, an option that might be difficult to defend politically. There are other options that should be explored, for instance by automatically linking the standard retirement age to life expectancy, as is the case in the Netherlands and Denmark; by increasing incentives to work for longer; by obtaining additional resources for the pension system or promoting private savings for retirement which can supplement the public pension of the future. Whichever measures are implemented, these must be framed within a broader strategy of economic policy that aims to boost the growth prospects of productivity and employment and ensure public finances are sustainable.

In any case, transparency is vital. We must have a clear idea, in advance, of the pension we are likely to receive when we retire in order to plan our savings accordingly.

Enric Fernández
Chief Economist
31 March 2017

CHRONOLOGY

MARCH 2017

- 1 The European Commission presents its White Paper on the future of Europe, proposing five possible scenarios for the EU-27 in 2025.
- 16 The Federal Reserve raises the fed funds rate by 25 bp to 0.75%-1%.
- 29 The UK triggers article 50 of the Lisbon Treaty to begin negotiations to leave the EU.

JANUARY 2017

- 23 Donald Trump signs an executive order formally withdrawing the US from the Trans-Pacific Partnership (TPP).

DECEMBER 2016

- 4 Italy holds a referendum, resulting in the rejection of the proposed constitutional reform. The Prime Minister, Matteo Renzi, resigns and is replaced by Paolo Gentiloni.
- 8 The ECB prolongs QE up to December 2017 and reduces its monthly asset purchases from 80 to 60 billion euros as from April.
- 14 The US Federal Reserve raises the fed funds rate by 25 bps to 0.50%-0.75%.
- 22 The Italian bank, Monte dei Paschi di Siena, fails in its attempt to increase its capital by 5 billion euros and the Italian government creates a 20 billion bailout fund to prop up the country's banking sector.

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.

AGENDA

APRIL 2017

- 3 Household savings rate (Q4).
- 4 Registration with Social Security and registered unemployment (March).
- 7 Industrial production index (February).
- 17 Financial accounts (Q4).
- 18 Loans, deposits and NPL ratio (February).
- 21 International trade (February).
- 27 State budget execution (March).
Labour force survey (Q1).
Governing Council European Central Bank.
Economic sentiment index of the euro area (April).
CPI flash estimate (April).
- 28 Balance of payments (February).
GDP flash estimate (Q1).
US GDP (Q1).

MAY 2017

- 3 GDP of the euro area (Q1).
Fed Open Market Committee.
- 4 Registration with Social Security and registered unemployment (April).
- 5 Industrial production index (March).
- 18 Loans, deposits and NPL ratio (March).
Japan's GDP (Q1).
- 23 International trade (March).
- 25 Quarterly national accounts (Q1).
- 30 State budget execution (April).
Economic sentiment index of the euro area (May).
CPI flash estimate (May).
- 31 Balance of payments (March).

Economic activity is speeding up but uncertainty remains high

The global economy is accelerating. According to the indicators, Q1 2017 has been positive in terms of economic activity. This is accelerating, improving the outlook for global growth for 2017 as a whole, in line with CaixaBank Research's scenario (3.4% in 2017, slightly higher than 2016's 3.1% growth rate). Various factors are supporting this trend. Monetary policy is still accommodative in the advanced countries although the US Fed has started normalization and carried out another interest rate hike at its last meeting in March. The emerging economies are also looking solid during this initial stage of the Fed's normalization and are benefitting from the moderate recovery in oil prices: In spite of the ups and downs of the past few weeks due to US shale production, oil prices in March were 37% higher than a year ago.

Uncertainty continues, much of it political. There are still sources of risk in spite of the good outlook for global economic activity. China is a case in point. Although the National People's Congress announced a 6.5% growth target for 2017, in line with its gentle shift towards more balanced production, there are significant risks due to imbalances within the economy (high debt, overcapacity in some sectors and extensive government intervention). The advanced economies are also facing various risks. In the US, the new Administration's first legislative steps have not helped to ease the uncertainty: its inability to repeal Obama's healthcare reform has led to doubts regarding its support in Congress. Also, the first draft of the budget proposal disappointed investor sentiment due to its lack of specifics and ambition.

Political uncertainty is also dominating the European scene. March saw the start of Europe's electoral calendar with parliamentary elections in the Netherlands. The victory of the incumbent Prime Minister, Mark Rutte, and a worse result than expected for the populist right-wing candidate helped to ease political risk. But all eyes are on France's presidential election at the end of April and its legislative elections early in June. March 2017 will also go down in the history books as the date when the UK formally triggered the process to exit the European Union. A two-year period of negotiations has now begun which show all the signs of being complex.

In spite of political risks, the US is still performing well and Europe's recovery is gaining traction. Sentiment and economic activity indicators for the US continued

to advance apace regardless of the uncertainty surrounding the Trump Administration. Buoyed by the economy's good performance and almost full employment, in March the Federal Reserve increased the fed funds rate by 25 bp to the interval of 0.75%-1.00%. And it still plans a further two hikes in 2017 and three in 2018 (in line with CaixaBank Research's forecasts). The performance of the euro area is also positive, with sentiment indicators at their highest since 2011, suggesting a healthier economy at the end of Q1.

Positive trends for the Spanish economy. The good economic activity indicators point to the economy continuing to outgrow expectations. This favourable trend is reflected in the GDP forecast model by CaixaBank Research, predicting 0.8% quarter-on-quarter growth in Q1 2017 (slightly higher than the 0.7% recorded in Q4 2016), with domestic demand as its driving force. This trend, together with a forecast of more moderate increases in oil prices, justifies raising the GDP growth forecasts for 2017 and 2018 by 0.2 pp, up to 2.8% and 2.4%, respectively. CaixaBank Research has therefore also improved its outlook for the labour market (over 400,000 new jobs will be created in 2017 as a whole), and also for the current account balance. 2017 has started out in a similar way to 2016, when growth was actually higher than predicted by both private analysts and the government. It should also be noted that Spain ended 2016 with a public deficit of 4.3% of GDP (4.5% including bank bail-outs), below the 4.6% agreed with Brussels. However, if fiscal policy had remained neutral, the country's economic growth would have pushed the deficit below 4%.

FORECASTS

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

International economy

	2015	2016	2017	2018	Q3 2016	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017
GDP GROWTH										
Global	3.2	3.1	3.4	3.6	3.1	3.2	3.4	3.4	3.4	3.5
Developed countries	2.1	1.6	2.0	2.0	1.7	1.8	2.0	2.0	1.9	1.9
United States	2.6	1.6	2.3	2.4	1.7	2.0	2.3	2.5	2.2	2.3
Euro area	1.9	1.7	1.7	1.7	1.8	1.7	1.6	1.7	1.7	1.7
Germany	1.5	1.8	1.6	1.6	1.7	1.8	1.5	1.5	1.8	1.7
France	1.2	1.1	1.3	1.4	1.0	1.2	0.9	1.4	1.5	1.4
Italy	0.7	1.0	0.8	0.8	1.0	1.0	0.8	0.9	0.7	0.7
Portugal	1.6	1.4	1.5	1.4	1.7	2.0	1.9	1.9	1.2	0.8
Spain	3.2	3.2	2.8	2.4	3.2	3.0	2.9	2.8	2.7	2.7
Japan	1.2	1.0	1.1	0.8	1.1	1.6	1.4	1.2	1.1	0.9
United Kingdom	2.2	1.8	1.6	1.4	2.0	1.9	2.1	1.7	1.4	1.0
Emerging countries	4.1	4.2	4.5	4.8	4.1	4.2	4.4	4.5	4.5	4.6
China	6.9	6.7	6.4	5.9	6.7	6.8	6.6	6.5	6.3	6.2
India	7.5	7.5	7.3	7.7	7.4	7.0	7.1	7.1	7.4	7.7
Indonesia	4.9	5.0	5.1	5.6	5.0	4.9	5.0	5.0	5.2	5.2
Brazil	-3.8	-3.6	0.7	2.1	-2.9	-2.5	-1.0	0.3	1.5	2.1
Mexico	2.6	2.3	1.6	2.1	2.1	2.4	1.9	1.8	1.3	1.2
Chile	2.3	1.6	1.9	2.6	1.8	0.5	1.5	1.9	2.1	2.2
Russia	-3.7	-0.6	1.3	1.6	-0.4	-0.4	1.0	1.3	1.4	1.5
Turkey	6.0	2.9	2.7	3.0	-1.3	3.5	2.5	2.7	2.8	2.9
Poland	3.9	2.9	3.3	3.1	2.3	3.1	3.4	3.4	3.4	3.1
South Africa	1.3	0.4	1.1	1.6	0.7	0.5	1.2	0.7	1.0	1.4
INFLATION										
Global	2.8	2.8	3.4	3.3	2.7	2.9	3.3	3.4	3.4	3.6
Developed countries	0.3	0.7	2.0	1.9	0.6	1.1	2.0	2.0	2.1	2.0
United States	0.1	1.3	2.6	2.4	1.1	1.8	2.7	2.5	2.7	2.5
Euro area	0.0	0.2	1.8	1.6	0.3	0.7	1.9	1.8	1.9	1.7
Germany	0.1	0.4	2.0	1.7	0.4	1.0	2.1	2.1	2.1	1.8
France	0.1	0.3	1.7	1.6	0.4	0.7	1.5	1.7	1.9	1.7
Italy	0.1	0.0	1.4	1.4	-0.1	0.2	1.4	1.5	1.5	1.3
Portugal	0.5	0.6	1.5	1.5	0.7	0.8	1.4	1.5	1.6	1.5
Spain	-0.5	-0.2	2.2	1.5	-0.2	1.0	2.8	2.3	2.3	1.7
Japan	0.8	-0.1	0.6	0.9	-0.5	0.3	0.5	0.5	1.0	0.6
United Kingdom	0.0	0.7	2.6	2.5	0.7	1.2	2.0	2.5	2.9	2.8
Emerging countries	4.7	4.4	4.5	4.4	4.3	4.1	4.3	4.5	4.4	4.9
China	1.4	2.0	2.2	2.3	1.7	2.2	1.9	2.3	1.9	2.5
India	4.9	4.9	4.9	5.2	5.2	3.7	3.8	4.0	4.7	7.3
Indonesia	6.4	3.5	4.1	4.6	3.0	3.3	4.0	4.9	3.9	3.8
Brazil	9.0	8.8	5.3	4.6	8.7	7.1	5.5	5.4	5.3	5.0
Mexico	2.7	2.8	5.0	3.5	2.8	3.2	4.8	4.9	5.0	5.1
Chile	4.3	4.0	3.2	3.3	3.8	3.3	3.0	3.1	3.2	3.3
Russia	15.5	7.1	5.0	4.9	6.8	5.7	5.1	5.0	5.0	5.0
Turkey	7.7	7.8	7.9	6.8	8.0	7.6	8.2	8.3	7.6	7.3
Poland	-0.9	-0.7	1.4	2.0	-0.8	0.2	0.7	1.5	1.5	1.8
South Africa	4.6	6.3	5.6	5.6	6.0	6.6	5.9	5.3	5.4	5.9

Forecasts

Spanish economy

	2015	2016	2017	2018	Q3 2016	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017
Macroeconomic aggregates										
Household consumption	2.8	3.2	2.7	2.0	3.0	3.0	2.8	2.7	2.7	2.5
General government consumption	2.0	0.8	0.8	0.8	0.8	0.0	0.2	1.0	0.7	1.1
Gross fixed capital formation	6.0	3.1	3.3	3.5	2.6	2.2	2.9	2.5	3.6	4.0
Capital goods	8.9	5.1	3.1	3.3	4.3	2.7	3.0	2.1	3.1	4.2
Construction	4.9	1.9	3.3	3.5	1.6	1.9	2.8	2.8	3.7	4.0
Domestic demand (contr. Δ GDP)	3.3	2.8	2.4	2.0	2.5	2.2	2.3	2.4	2.5	2.4
Exports of goods and services	4.9	4.4	4.5	4.5	2.9	4.4	5.3	2.9	5.3	4.4
Imports of goods and services	5.6	3.3	3.6	3.6	1.0	2.3	3.6	1.9	5.0	4.1
Gross domestic product	3.2	3.2	2.8	2.4	3.2	3.0	2.9	2.8	2.7	2.7
Other variables										
Employment	3.0	2.9	2.2	2.1	2.9	2.7	2.2	2.2	2.0	2.4
Unemployment rate (% labour force)	22.1	19.6	17.7	16.3	18.9	18.6	18.7	17.9	17.0	17.0
Consumer price index	-0.5	-0.2	2.2	1.5	-0.2	1.0	2.8	2.3	2.3	1.7
Unit labour costs	0.2	-0.3	0.5	1.2	-0.3	-0.1	-0.1	0.4	0.8	1.0
Current account balance (cum., % GDP) ¹	1.4	2.0	1.8	1.6	1.9	2.0	2.0	1.9	1.8	1.8
Net lending or borrowing rest of the world (cum., % GDP) ¹	2.0	2.4	2.4	2.2	2.4	2.4	2.6	2.5	2.4	2.4
Fiscal balance (cum., % GDP) ²	-5.0	-4.3	-3.4	-2.4						

Financial markets

INTEREST RATES										
Dollar										
Fed Funds	0.26	0.51	1.02	1.94	0.50	0.55	0.75	0.92	1.08	1.33
3-month Libor	0.32	0.74	1.39	2.20	0.79	0.92	1.09	1.29	1.49	1.69
12-month Libor	0.79	1.37	2.00	2.63	1.46	1.62	1.76	1.92	2.08	2.24
2-year government bonds	0.67	0.84	1.68	2.74	0.72	1.00	1.29	1.55	1.81	2.08
10-year government bonds	2.13	1.84	2.76	3.49	1.56	2.13	2.49	2.67	2.85	3.04
Euro										
ECB Refi	0.05	0.01	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
3-month Euribor	-0.02	-0.26	-0.32	-0.21	-0.30	-0.31	-0.33	-0.33	-0.31	-0.30
12-month Euribor	0.17	-0.03	-0.08	0.05	-0.05	-0.07	-0.10	-0.09	-0.07	-0.06
2-year government bonds (Germany)	-0.24	-0.58	-0.70	-0.29	-0.64	-0.71	-0.78	-0.78	-0.66	-0.58
10-year government bonds (Germany)	0.53	0.10	0.48	0.85	-0.12	0.11	0.34	0.44	0.53	0.62
EXCHANGE RATES										
\$/€	1.11	1.11	1.03	1.04	1.12	1.08	1.05	1.03	1.02	1.02
¥/€	134.33	120.30	118.25	120.47	114.26	117.96	121.07	117.01	116.96	117.98
£/€	0.73	0.82	0.89	0.88	0.85	0.87	0.86	0.89	0.90	0.90
OIL										
Brent (\$/barrel)	53.61	45.63	56.10	61.71	47.49	51.96	55.20	54.83	56.50	58.00
Brent (€/barrel)	48.30	41.28	54.29	59.13	42.55	48.25	51.79	53.11	55.39	56.86

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

Forecasts

FINANCIAL OUTLOOK · An upward path beset with uncertainty

Financial markets are still constructive on the whole.

There have been two distinct phases in the past few weeks. At the beginning of March risk aversion reared its head again, already observed during the last few days of February, pushing down the main risky assets and particularly emerging stocks. The reason for this dip was the fear of a more aggressive toughening up of US monetary policy than initially expected, due to the strength of several economic activity indicators for the country. But in the second part of the month purchases resumed in the main risky asset markets, encouraged by the more conservative and balanced tone adopted by the Federal Reserve (Fed) on announcing another fed funds hike.

Volatility remains relatively constrained in spite of the slight upswing during the last few days of March.

Such low risk aversion is, however, a reason for concern when we consider the different sources of uncertainty hovering over the global financial environment. First, there is a large amount of doubt regarding the Trump Administration's policies (fiscal stimulus, protectionist stance, etc.), as well as how much support such policies may receive. Second, Europe's numerous elections continue to grab the attention of investors who may become more nervous as the French presidential elections in May get closer. But the outcome of Europe's first important election in the Netherlands, with voters backing the incumbent government, has helped to contain political risks in the euro area. Finally, the limited run for commodities and oil prices, in particular, could also be added to the list of risks for financial markets over the coming months.

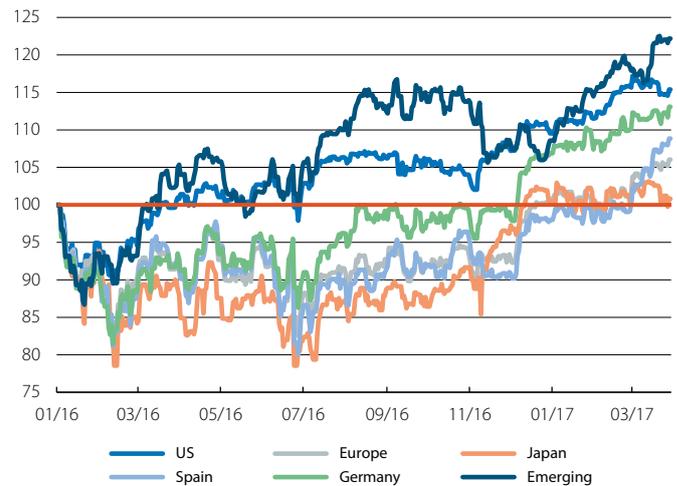
The ECB leaves its main monetary policy measures unchanged but improves its risk assessment.

The Governing Council of the euro area's central bank did not announce any significant alterations after its March meeting. No changes were introduced to the ECB's monetary policy, whose asset purchases will continue at a monthly pace of EUR 60 billion between April and December this year, in line with the adjustments in its asset purchase programme announced in December. But the monetary authority improved its assessment of downside risks due to solid domestic demand in the euro area and a lower risk of deflation. The ECB also slightly improved its growth forecasts for the euro area: 1.8% in 2017 and 1.7% in 2018 (+0.1 pp in both cases). Regarding inflation, the institution believes the significant increases in headline inflation observed over the past few months are due to temporary factors (e.g. the upswing in oil prices) and stressed once again the need for a self-sustained recovery in core inflation for it to consider altering its accommodative stance.

The Fed announces another hike in the fed funds rate but maintains its gradual plan for increases.

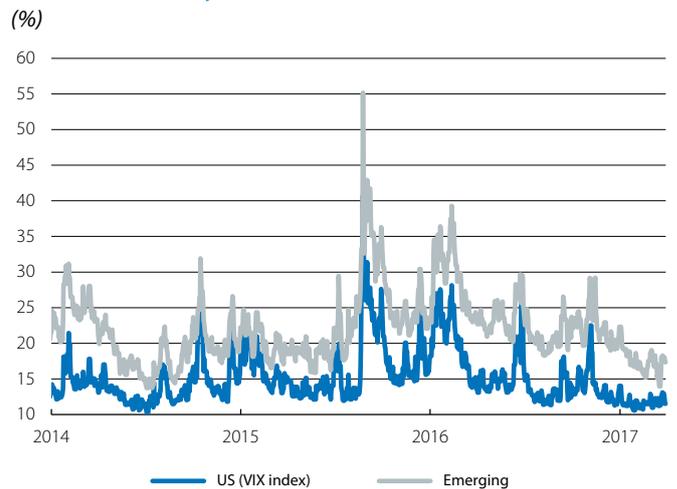
Main international stock markets

Index (100 = January 2016)



Source: CaixaBank Research, based on data from Bloomberg.

US and emerging countries: implied stock market volatility



Source: CaixaBank Research, based on data from Bloomberg.

Inflation expectations*: US and euro area



Note: * Inflation swap forward 5YSY.

Source: CaixaBank Research, based on data from Bloomberg.

anticipated, the Fed raised the fed funds rate for the second time in three months up to the interval of 0.75%-1.00%. But the US monetary authority adopted a dovish tone and kept its interest rate scenario unchanged, with two more hikes this year and three more in 2018. These means the Fed does not believe inflationary risks are on the up. Yellen noted the central bank's willingness to tolerate inflation temporarily overshooting its target (2%). Over the coming months the growing question will be when the Fed will start to reduce its balance sheet. We expect the monetary institution to announce it will cease reinvestments from its bond portfolio towards the end of this year. But good communication will be vital to avoid market disruption, like in the taper tantrum of May 2013.

Political uncertainty agitates sovereign bond markets, both in the US and Europe. Yields on US Treasury bonds fluctuated up and down. Short-term interest rates picked up, for instance US2Y yields rose to above 1.3%, supported by the Fed's interest rate hike, while long-term yields fluctuated within the interval predominant since the beginning of the year (2.4%-2.6% for US10Y). This pattern was caused by doubts concerning the Trump Administration's tax and budgetary policies, plus recent messages by the Fed that it will not alter its stance. In the euro area, the electoral calendar continues to affect sovereign yields, although recent events have improved investor sentiment to some extent. Particularly the victory in the Netherlands of the centre-right candidate on 15 March, concluding the first of several sources of risk in Europe's political agenda this year. The confirmation of J. Macron as a candidate in France's presidential elections also helped to reduce concerns of M. Le Pen, the right-wing candidate, potentially winning the election. Nevertheless, political uncertainty will continue and disruptive events cannot be ruled out entirely.

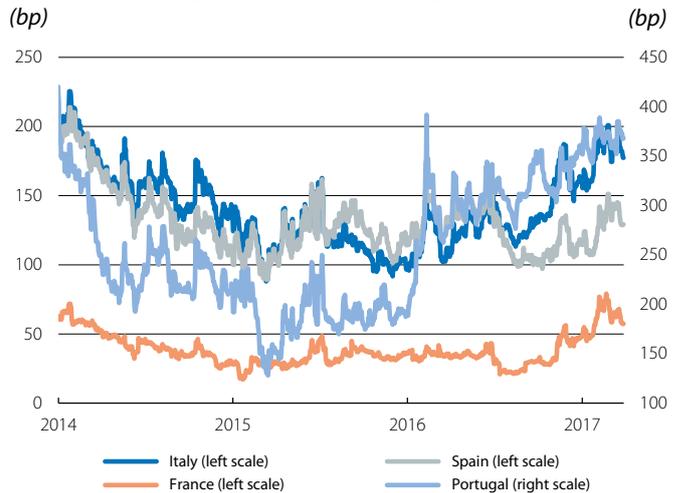
The euro-dollar exchange rate increases slightly on the forex market. After falling at the end of February, down towards the zone of USD 1.05, the euro appreciated at the beginning of March, ending the month at USD 1.08. The main reason for this rise was the Fed's less hawkish stance than expected and the ECB's more balanced message. During the last few days of March, the euro reached its highest level against the dollar this year so far, with the failure of Trump's health legislation fuelling doubts regarding the capacity of the new Administration to carry out reforms. But we have not revised our forecasts as we believe this is temporary and the diverging monetary policy dynamics have yet to be completely reflected by the markets. This is a highly uncertain scenario, however, especially when the Trump Administration's actual fiscal stimulus is still doubtful. The main emerging currencies recovered their constructive tone observed over the past few months after a dip at the beginning of March (due to fears of more restrictive policies in the US). The J.P. Morgan global index for emerging currencies regained its level prior to Trump's victory. The strong recovery observed just after the

Yields on 10-year public debt



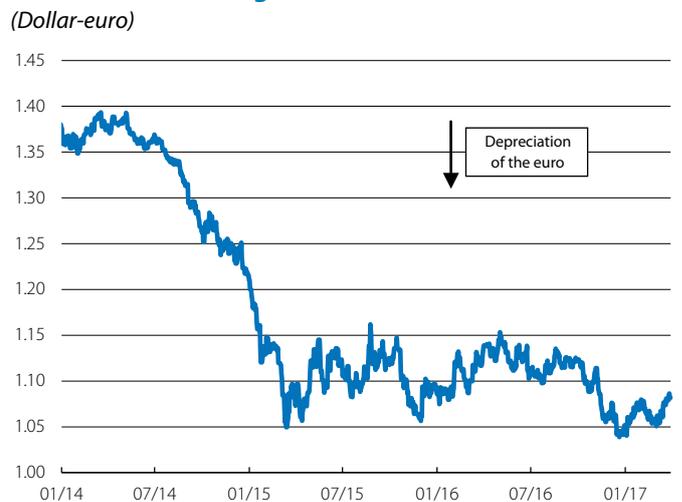
Source: CaixaBank Research, based on data from Bloomberg.

Euro area: risk premia on 10-year public debt



Source: CaixaBank Research, based on data from Bloomberg.

Dollar-euro exchange rate



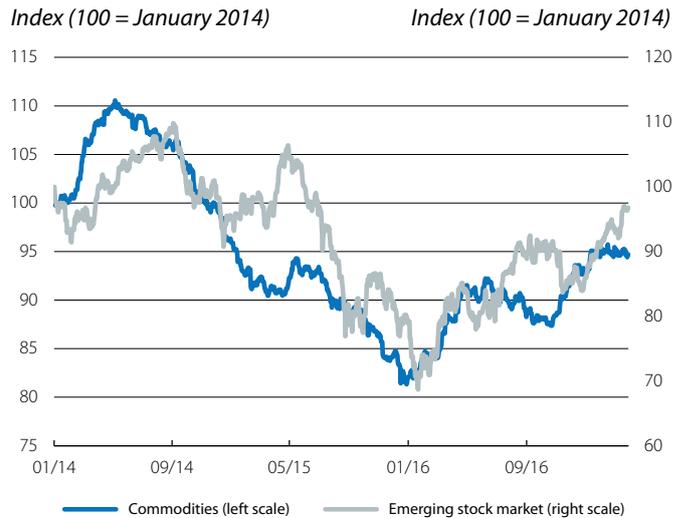
Source: CaixaBank Research, based on data from Bloomberg.

Fed's meeting is a positive sign as it suggests the emerging financial markets are able to withstand a gradual rise in the fed funds rate.

Gains continue in the emerging stock markets. Neither uncertainty about Trump's policies nor the repeated weakness of commodities prevented most emerging stock markets from ending March on a positive note. However, emerging equity was more sensitive to changes in the monetary policy stance of the US. It suffered significant losses at the beginning of the month fuelled by expectations of a more hawkish Fed, then strong gains afterwards due to the institution's more dovish message. Developed stock markets were still constructive in tone although more moderate than in the past few months. The Spanish stock exchange performed particularly well with the Ibex 35 going above 10,000 points, thanks especially to bank stock.

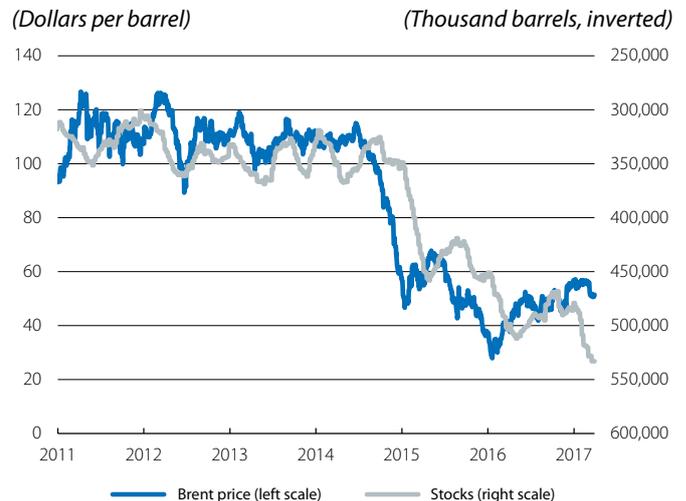
Oil prices: back down again and a change in the outlook. After a relatively stable start to the year and strong gains following the OPEC agreement, the price of crude oil has faltered again. In March the Brent barrel price posted considerable falls, back down to just over USD 50 and clearly below the USD 55 barrier exceeded when OPEC agreed to cut its production. Oil will remain volatile over the medium term but several factors suggest its upward trend will be weaker than initially projected. First, US shale production has rallied more strongly than first expected. This suggests notable productivity gains in the sector, now profitable at prices below USD 60. Second, there has been a considerable increase in US oil stocks, reaching an all-time high at the beginning of March. Given this situation, we have downgraded the gradual increase predicted in the Brent price, which should reach USD 58.5 by the end of 2017 (previously USD 62.6) and USD 64 by the end of 2018 (previously USD 69).

Emerging stock market and commodities



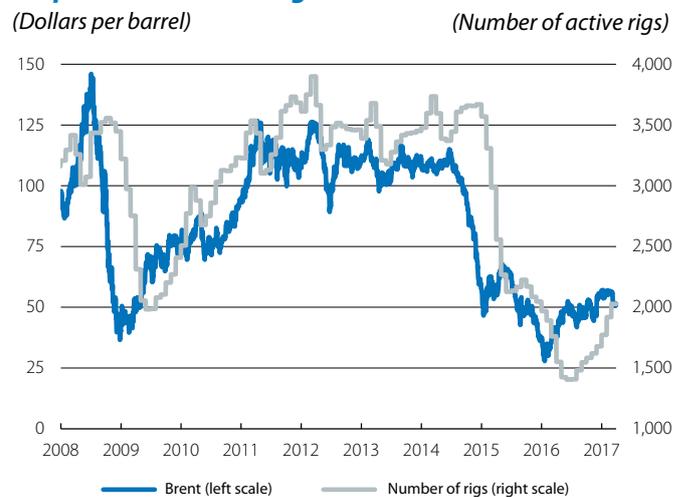
Source: CaixaBank Research, based on data from Bloomberg.

Price and stocks of crude oil in the US *



Note: * Excluding strategic reserves.
Source: CaixaBank Research, based on data from Bloomberg.

Oil prices and active rigs



Source: CaixaBank Research, based on data from Bloomberg.

FOCUS · The Federal Reserve's balance sheet: a double-edged sword?

To date, the Federal Reserve (Fed) has normalized monetary conditions by adjusting the federal funds rate. The financial community has therefore tended to focus on interest rates when it comes to the Fed's monetary policy. The Fed's second major monetary tool, its balance sheet, has remained on the sidelines. But this could be about to change.

So far the signals provided by the Fed have been few and far-between. In its Policy Normalization Principles and Plans published in September 2014, the monetary authority stated that it would shrink its balance sheet by ceasing or phasing out reinvestments. Since December 2015, however, FOMC communications have indicated this would not be carried out «until normalization of the level of the federal funds rate is well under way». Although this statement is rather ambiguous, market consensus places the threshold at around 1.50%. According to fed funds futures, this would be reached by Q1 2018, and by Q4 2017 according to CaixaBank Research. The Fed is therefore likely to announce it is stopping reinvestments towards the end of this year.

Less certain, if that is possible, is the form this reduction will take and the ultimate size of the balance sheet. The projection carried out by the New York Fed, one of the few official references available, highlights two key aspects: the gradual nature of this normalization, which would end in 2022, and the size of the balance sheet at that time, around USD 2.3 trillion.

Although this issue is still far from certain, there is good reason to believe that the Fed will start to normalize its balance sheet. First, the fact that credit has been flowing normally for several years now. This means the Fed no longer needs to intervene so directly by buying up debt securities. Second, the improvement in macroeconomic conditions and in particular higher inflation make gradual monetary normalization necessary and, in part, this entails higher long-term interest rates. On the other hand, one of the Fed's aims with QE was to reduce these once the federal funds rate reached zero lower bound. In short, full monetary normalization requires an environment in which market forces once again play a key role in fixing interest rates and it is vital for the Fed to reduce its presence in debt markets.

However, managing the balance sheet also involves risks, not so much due to operational complications but to communication problems. In effect, forward guidance regarding the balance sheet, be it expansionary or contractive, can trigger sharp fluctuations and destabilize some asset markets. Specifically, bond market agents

could have a mistaken or biased view of changes in the central bank's interest rate policy if communication is not sufficiently clear and concise. The events of spring 2013 provide a clear example of how this pass-through mechanism works for unconventional monetary policy, also known as the signalling effect.¹ The pre-announcement of tapering by the Fed Chairman at that time, B. S. Bernanke, triggered sharp increases in long-term US interest rates and greatly disrupted emerging markets. On this occasion, the Fed will be very careful to avoid any repetition of such events. It will therefore have to specify precisely the key aspects of how it will cease reinvestments from the time this is announced. Namely, the scope (some or all bonds), the pace or timings (all in one go or phased) and, ideally, the size of the balance sheet the Fed intends to achieve.

US: projections of the Fed's asset portfolio *
(USD Trillion)



Note: * Projections by the New York Fed. The projection assumes that (total or partial) reinvestment will continue until 2018.

Source: CaixaBank Research, based on data from the Federal Reserve of New York.

1. For an instructive explanation of the different pass-through mechanisms for unconventional monetary policy, see Bernanke, B. S. (2012), «Monetary Policy since the Onset of the Crisis».

FOCUS · The yield curve, growth expectations and probability of recession

There has been less clarity on the direction of US economic policy since Donald Trump was elected. The expansionary fiscal policy and less regulation in some industries that have been promised by the new President have fuelled a more optimistic view of growth prospects. But several factors suggest more caution should be taken, at the very least. These include an unemployment rate close to its all-time low with presumably little room to fall further, increased protectionism and the delicate normalization process to be carried out by the Fed over the coming quarters.

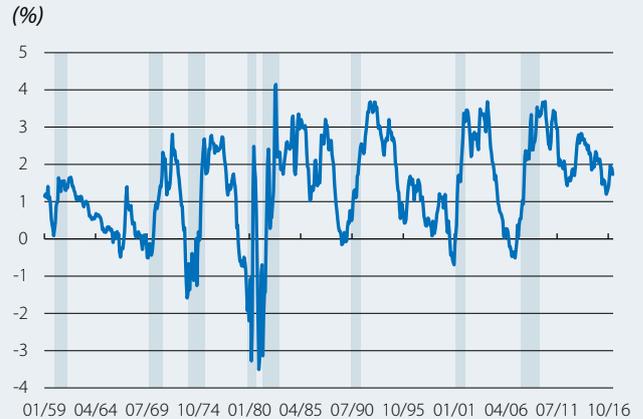
One indicator often used to gauge the cyclical position of the US economy is the one produced by the Federal Reserve Bank of New York based on the yield curve for Treasury bonds. Short-term interest rates are affected by the monetary policy implemented by the Federal Reserve. But long-term interest rates mostly reflect expectations of future trends in the short-term rates. When investors expect growth and inflation to speed up, the spread between long and short-term interest rates tends to be wide. When the spread between long and short-term yields is narrow or even negative, the opposite tends to happen.

Using the spread between the interest rates on the ten-year Treasury note and the three-month Treasury bill, the New York Fed has estimated the probability of a recession in the US in the next 12 months. As shown by the charts below, the eight recessions in the US since 1960 have coincided with a narrowing of the spread between long and short-term interest rates, a pattern captured by the Fed's model. But it is also true that, on occasion, the yield curve has flattened out and finally no recession occurred, as in 1967 and 1999, although in this last case a recession finally arrived in 2001.

Applied to the current situation, the predictions offered by the yield curve and the New York Fed's model are relatively optimistic. The spread between interest rates is currently around 1.70 pp, 0.3 pp higher than its historical average. It is therefore not surprising that the New York Fed's model predicts a relatively low probability of a recession, namely 5.2%.

But a close eye should be kept on the New York Fed's model over the coming quarters. FOMC members expect monetary normalization to continue, planning to increase the federal funds rate by 1.25 pp up to December 2018. The short end of the yield curve is therefore likely to increase. Given this scenario, the response of long-term interest rates will provide valuable information on the conditions underlying the US economy.

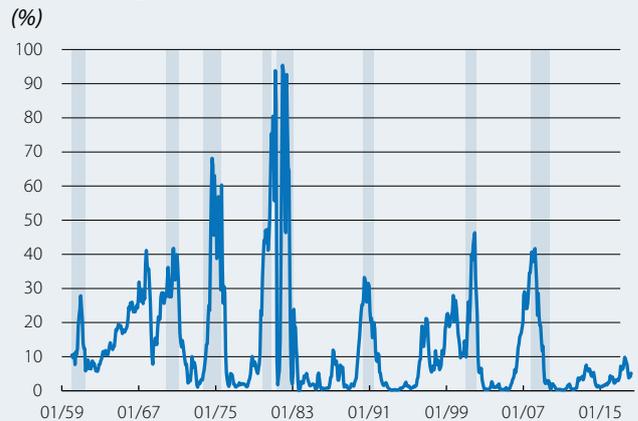
US: Treasury Spread: 10 yr bond rate-3 month bill rate



Note: The shaded areas denote recessions.

Source: CaixaBank Research, based on data from the Federal Reserve Bank of New York.

US: probability of US recession predicted by Treasury spread



Note: The shaded areas denote recessions.

Source: CaixaBank Research, based on data from the Federal Reserve Bank of New York.

KEY INDICATORS

Interest rates (%)

	31-Mar	28-Feb	Monthly change (bp)	Year-to-date (bp)	Year-on-year change (bp)
Euro area					
ECB Refi	0.00	0.00	0	0.0	0.0
3-month Euribor	-0.33	-0.33	0	-1.0	-8.7
1-year Euribor	-0.11	-0.11	0	-2.8	-10.4
1-year government bonds (Germany)	-0.72	-0.88	16	8.1	-24.9
2-year government bonds (Germany)	-0.74	-0.90	16	2.6	-24.1
10-year government bonds (Germany)	0.33	0.21	12	12.2	19.3
10-year government bonds (Spain)	1.67	1.66	1	28.6	22.9
10-year spread (bps) ¹	134	145	-11	16.3	3.6
US					
Fed funds	1.00	0.75	25	25.0	50.0
3-month Libor	1.15	1.06	9	15.2	51.9
12-month Libor	1.80	1.76	4	11.4	56.1
1-year government bonds	1.02	0.82	20	20.9	44.0
2-year government bonds	1.25	1.26	-1	6.2	46.6
10-year government bonds	2.39	2.39	0	-5.4	58.7

Spreads corporate bonds (bps)

	31-Mar	28-Feb	Monthly change (bp)	Year-to-date (bp)	Year-on-year change (bp)
Itraxx Corporate	74	73	1	1.7	-2.0
Itraxx Financials Senior	89	92	-3	-4.7	-6.2
Itraxx Subordinated Financials	193	211	-19	-28.7	-17.1

Exchange rates

	31-Mar	28-Feb	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
\$/€	1.065	1.058	0.7	1.3	-5.7
¥/€	118.670	119.270	-0.5	-3.5	-6.7
£/€	0.849	0.854	-0.7	-0.6	8.1
¥/\$	111.390	112.770	-1.2	-4.8	-1.2

Commodities

	31-Mar	28-Feb	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
CRB Commodity Index	431.0	432.6	-0.4	1.9	7.2
Brent (\$/barrel)	52.8	55.6	-5.0	-7.0	35.0
Gold (\$/ounce)	1,249.4	1,248.3	0.1	8.4	0.6

Equity

	31-Mar	28-Feb	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
S&P 500 (USA)	2,362.7	2,363.6	0.0	5.5	15.0
Eurostoxx 50 (euro area)	3,500.9	3,319.6	5.5	6.4	16.5
Ibex 35 (Spain)	10,462.9	9,555.5	9.5	11.9	18.8
Nikkei 225 (Japan)	18,909.3	19,119.0	-1.1	-0.7	10.6
MSCI Emerging	958.4	936.4	2.3	11.1	17.6
Nasdaq (USA)	5,911.7	5,825.4	1.5	9.8	22.0

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

ECONOMIC OUTLOOK · Economic activity set to improve in 2017

The world economy will speed up in 2017. GDP growth will reach 3.4% in 2017, slightly higher than 2016's figure of 3.1%, due to improvements both in the advanced and the emerging economies. This growth is supported by several factors. For instance, the continued accommodative monetary conditions in the advanced countries in spite of the US Fed normalizing, which translated into another interest rate hike at its last meeting in March. Another encouraging factor is the moderate recovery in oil prices as this very gradual upswing will help oil exporters without harming importers in excess. Nonetheless, weak crude oil prices over the past few weeks, due to dynamic unconventional oil production (shale), suggest downside risks for this scenario.

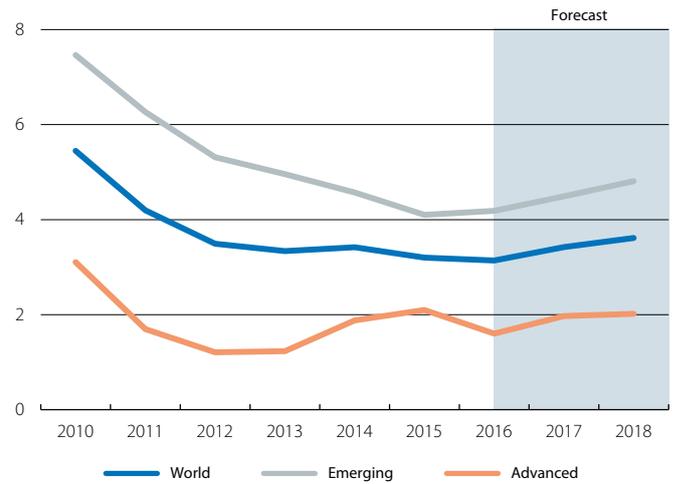
Uncertainty is still high. There are political risks on both sides of the Atlantic. In the Netherlands, the victory by the incumbent Prime Minister, Mark Rutte, against the right-wing populist candidate, Geert Wilders, helped to ease uncertainty in Europe. In the US, the Trump Administration had to withdraw its proposal to repeal part of Obamacare as it lacked support from its own party. At a more global level, the G20 failed to reach a unanimous endorsement in favour of free trade and against protectionism.

UNITED STATES

Sentiment and economic activity indicators continue to point to considerable growth, albeit the former more than the latter. In March the Conference Board Consumer Confidence index rose to 125.6 points, its highest in the past 16 years. The ISM business sentiment index for manufacturing reached 57.7 points (the highest in the past two years) while the services index stood at 57.6 points, comfortably in the expansionary zone (above the 50 point threshold). Economic activity indicators also continued post increases, substantial in general but less dynamic than the sentiment indicators. February saw growth in retail sales and personal expenditure consumption (in real terms) but less than in previous months. The industrial production index remained unchanged from the previous month.

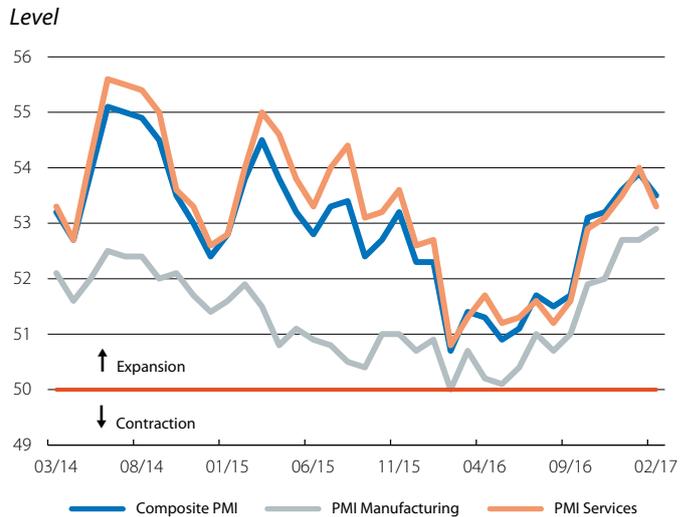
The Fed raises the federal funds rate, encouraged by upward inflation and a labour market indicating a mature economic cycle. At its March meeting the Fed decided to raise the federal funds rate by 25 bp to 0.75-1.00% given the institution's confidence in the US economy. 235,000 jobs were created in February, a substantial figure since the US economy is now close to full employment. Unemployment remained almost stable at 4.7% while wages rose by a significant 2.8% year-on-year. Inflation continued its rise to 2.7%, 0.2 pp higher than January's figure. Core inflation (without food or energy)

World GDP
Annual change (%)



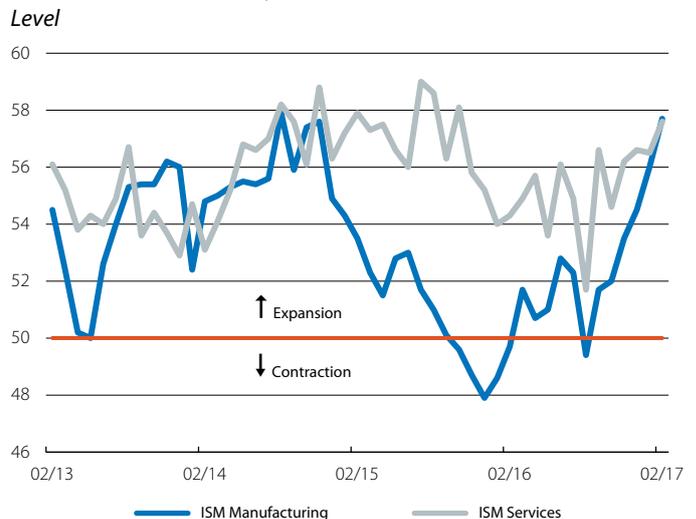
Source: CaixaBank Research, based on IMF data (WEO).

Global economic activity indicators



Source: CaixaBank Research, based on Markit data.

US: economic activity indicators



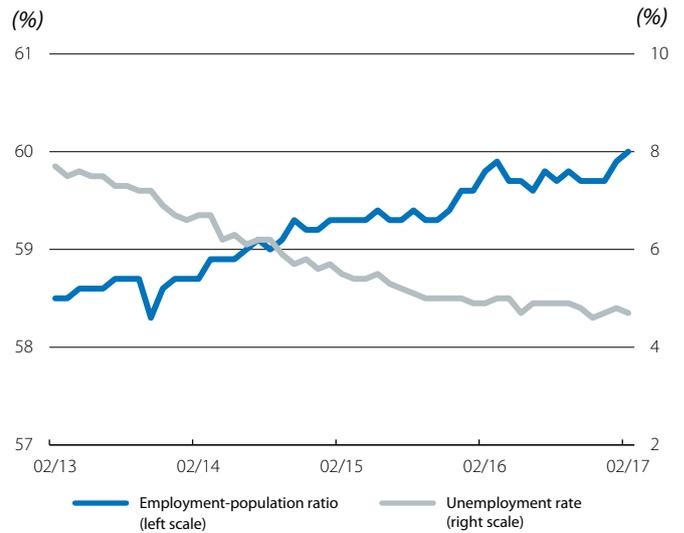
Source: CaixaBank Research, based on data from the ISM.

hovered around 2.2%, 0.1 pp lower than in January. The year-on-year change in the core price index for personal consumption expenditures, the Fed's benchmark price index, remained stable in January (at 1.7%). The continued rise in headline inflation and stabilization of core inflation around 2% certainly support another interest rate hike. But this hike does not represent any shift in the Fed's stance, which is still planning two further hikes in 2017 and three in 2018 (as already announced at the end of 2016 and in line with the CaixaBank Research scenario). A very gradual normalization, since in the last four cycles of hikes the federal funds rate was raised by close to 1.7 pp per year on average (see the Focus «A federal funds rate hike: this time is different» in MR12/2015).

Uncertain figure for Q1 2017 GDP. After six years of expansion, the US economy is enjoying significant growth rates of around 2%, supported by solid private consumption, a healthy real estate sector and more dynamic corporate investment. The CaixaBank Research scenario predicts that fiscal policy will also support economic growth in the final part of 2017 and throughout 2018. However, in the short term, Q1 GDP growth might be slightly less than expected. Although the momentum suggested by sentiment and economic activity indicators is good, the BEA (the US statistics office that produces the country's accounts data) tends to underestimate the GDP growth rate for Q1 and overestimate this figure for the other quarters due to seasonal effects. This problem is well-known but the BEA itself was not able to correct it in its annual revision of the historical series last summer. Consequently, a GDP flash estimate of between 1 and 1.5 pp below the forecast (in annualized quarter-on-quarter terms) cannot be ruled out. The forecast model used by the Federal Reserve of Atlanta, the GDPNow, which tends to anticipate these sudden slowdowns, estimates a 1.0% growth annualized quarter-on-quarter, far below the 2.8% average of Q3-Q4 2016 and the 2.1% predicted by CaixaBank Research for Q1 2017.

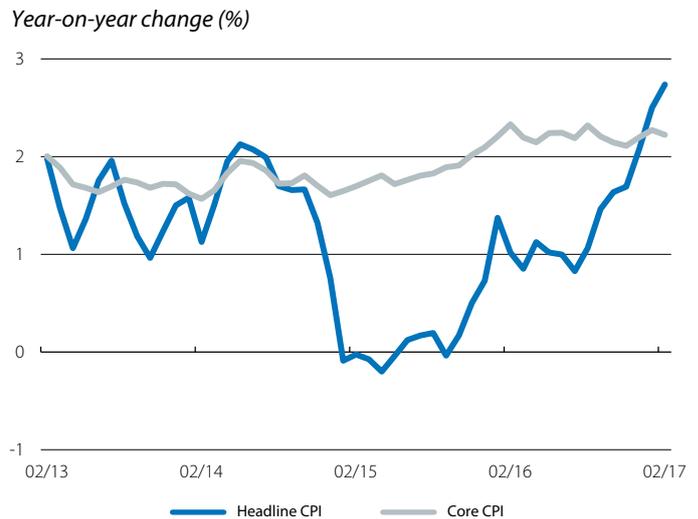
High risks still hover over the macroeconomic situation. In the medium term, uncertainty regarding the Trump Administration's policies and how much support they might receive from Congress is a risk affecting US economic prospects. This could be a downside or upside risk as the new President's agenda includes both positive and negative elements for US growth. The shift towards protectionism and mass deportation of immigrants would be on the negative side. Positive elements would be the promise of significant fiscal stimulus which, in addition to tax cuts, might also include considerably more spending on infrastructures (see the Dossier «The US: to invest or not to invest, that is the question» in MR03/2017). In any case, the first budget proposal for the 2018 tax year presented by the new Administration was not very ambitious and relatively incomplete. There are therefore downside risks concerning the fiscal support expected for the end of 2017 and throughout 2018.

US: labour market



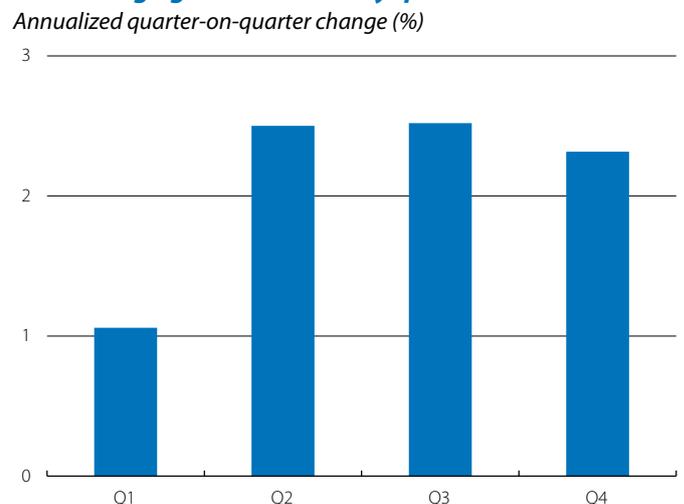
Source: CaixaBank Research, based on data from the Bureau of Labor Statistics.

US: CPI



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

US: average growth in GDP by quarter



Note: Average quarter-on-quarter growth in Q1, Q2, Q3 and Q4 for the period Q1 2010-Q4 2016. Source: CaixaBank Research, based on BEA data.

EMERGING ECONOMIES

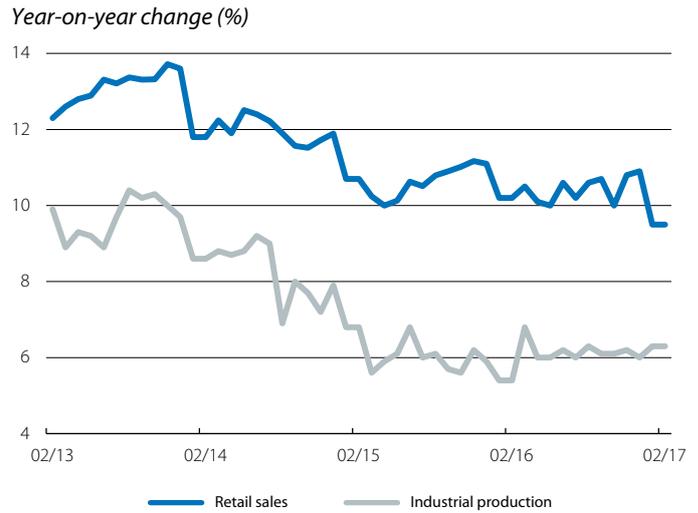
Emerging economic activity remains solid at the beginning of 2017. The aggregate activity indicator for emerging economies as a whole, produced by the IIF, rose in February from already high levels. This was supported by the widespread improvement in industrial production as well as the recovery in international manufacturing trade for these economies. Capital inflows continued after the substantial outflows triggered by Trump’s victory. According to the IIF’s daily portfolio flows tracker, during the week following the Fed’s last interest rate hike the emerging countries received the largest capital inflows since September 2013. The Fed’s insistence that its hikes will be very gradual was undoubtedly a relief for these flows.

China sets its growth target at 6.5%, confirming the scenario of a soft landing. At the National People’s Congress in March, the Chinese government announced a 6.5% growth target for 2017, slightly below the 6.7% of 2016 and in line with a «soft landing». The Asian giant is immersed in changing its production model, promoting domestic consumption and services ahead of investment and exports, specially so in manufactures. A shift that entails a slower but more balanced growth rate. Although the move from one paradigm to another is expected to be gentle, risks are still high as the environment is considerably imbalanced (high debt, overcapacity in some sectors and large degree of government intervention).

Brazil delays its exit from the recession. In Q4 2016, GDP fell by 0.9% quarter-on-quarter (–2.5% year-on-year), a larger decrease than expected. This figure confirms the difficulties faced by the country to overcome its recession, in particular due to persistently weak private consumption which has decreased in quarter-on-quarter terms for the last eight quarters. GDP fell by 3.6% in 2016 as a whole. Given Brazil’s weak economy, CaixaBank Research has lowered its GDP growth forecast for 2017 from 0.9% to 0.7%. One positive note is that inflation fell considerably due to the anti-inflationary effect of the real’s appreciation.

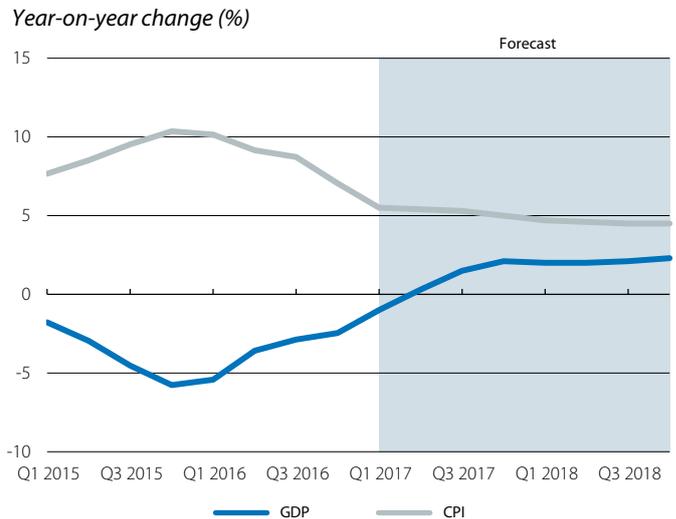
Turkey ends the year with surprisingly strong growth. In Q4 2016, GDP increased by 3.5% year-on-year, much more than expected. An acceleration in domestic demand lies behind this unexpected recovery in the Turkish economy (GDP had fallen by 1.3% year-on-year in Q3). In spite of this good finish to 2016, with 2.9% annual growth, economic activity is expected to slow down in 2017. This is due to political uncertainty (with a referendum on 16 April to validate the new Constitution that will considerably alter Turkey’s institutional framework), the country’s external vulnerabilities and also high inflation.

China: economic activity indicators



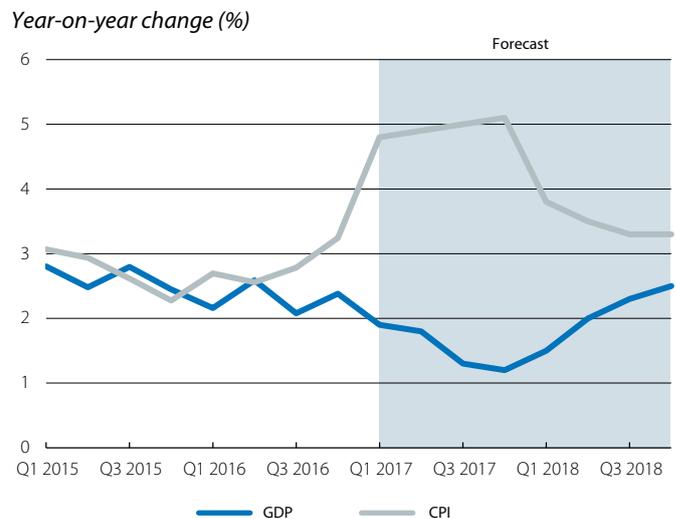
Source: CaixaBank Research, based on data from China’s national statistics office.

Brazil: GDP and CPI



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

Mexico: GDP and CPI



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

FOCUS · Quo vadis, Turkey?

Investors seem to be going off Turkey. Since the *coup d'état* attempt in July 2016, the lira has depreciated by 21% against the dollar, by far the worst performance by any emerging currency. After the failed coup, Turkey's credit rating was downgraded and, in January, it lost its investment grade given by the only agency, Fitch, which had yet to class the country's sovereign debt as a «junk». The spread between the yield on Turkish 10-year sovereign debt compared with the US (the risk premium) reached the 800-bp zone last July, where it has remained ever since.

The trigger for these events appears to be concerns regarding Turkey's recent political shift. The country's institutional framework had been better than many emerging countries but recent events have sowed doubts regarding future developments. The outcome of the referendum on 16 April is particularly crucial, when citizens will decide on an important change in the Constitution. If, as expected, this is ratified by voters, Turkey's institutional system will give the President sweeping powers. This raises questions as to how far the equilibrium between executive, legislative and judicial powers, quite finely balanced until now, will deteriorate.

But it is not only the political sphere that is causing concern. Turkey has enjoyed strong growth since it exited the Great Recession with average annual growth of 6.7% between 2010 and 2016. But this dynamism has been accompanied by two significant imbalances: high inflation (8.0% in 2010-2016) and a large current account deficit (-6.3% of GDP over the same period). In turn, this has resulted in a worrying increase in external debt (up by 12 pp of GDP between 2010 and 2016, to 48.5%). Over the last few years, Turkish firms (excluding banks) have taken advantage of the favourable international financial conditions and corporate bonds in foreign currencies rose to 32.3% of GDP in Q3 2016 (two thirds in dollars and the rest in euros), double the figure 10 years ago. This will become a weak point if the dollar and euro continue to appreciate against the lira, which is more than likely. And neither can we expect Turkey's central bank to defend its currency to any great extent given the limited international reserves (less than its short-term external debt).

Historically, Turkey has tended to become more dependent on external financing and build up inflationary tension as its activity rate picks up. But the situation has been aggravated over the last few years by an excessively accommodative monetary policy: Turkey has not had a positive real benchmark rate since 2009. Too much monetary stimulus for an economy that, as we have

already mentioned, grew substantially up to 2016. Nevertheless, it should be noted that its fiscal balance have, perhaps, been one of the few positive areas.

Turkey therefore has a lot of weak fronts. One aspect that will determine its macroeconomic trend is inflation, which will continue high (7.9%) due to the combined effect of the lira's strong depreciation and rising commodity prices. In response, the central bank is expected to become more belligerent than in previous years: according to Bloomberg's analyst consensus, the benchmark interest rate could reach 8.75% by the end of the year, 75 bp above its current level. But such predictions should be taken with care, given the accommodative monetary conditions of previous years. High inflation will erode spending capacity, pushing down private consumption which, together with the expected slump in investment, will prevent high growth in 2017 (2.7%, slightly less than the 2.9% in 2016). Finally, the current deficit will also remain high (5.6% of GDP). Given this situation, the IIF estimates that Turkey's external gross financial needs will reach 28% of GDP this year (22% in 2016). A tough challenge in a more restrictive international financial context than the past. As a result, Turkey will probably remain one of the «fragile emerging economies» for some time yet.

Turkey: key macroeconomic indicators

	2009-2013	2014	2015	2016 (e)	2017 (f)	2018 (f)
Growth in real GDP (%)	5.6	5.2	6.1	2.9	2.7	3.0
CPI inflation rate (%)	7.5	8.9	7.7	7.8	7.9	6.8
Current account balance (% of GDP)	-6.3	-5.5	-4.5	-4.4	-5.6	-5.6
Fiscal balance (% of GDP)	-2.0	0.1	1.3	-0.9	-1.7	-1.4
Public debt (% of GDP)	36.9	28.6	27.5	26.4	26.0	25.8

Note: (e) Estimate; (f) Forecast.

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

FOCUS · A downturn in international trade and global value chains?

We have explored the phenomenon of the slowdown in world trade over the last few years several times in this *Monthly Report*. For instance, we have analysed the poor investment trend in advanced countries, the shift in China’s economic growth pattern, the deceleration in the liberalisation of trade and rising protectionism as important factors in the downturn in world trade.¹ This Focus looks at the slowdown in the formation of global value chains (GVCs) as a significant event in the changing pattern of trade.²

Between the end of the 1980s and early 2000s, three factors led to the emergence of GVCs. First, falling transport costs, especially by air, as a consequence of technological advances in the sector. Second, extensive liberalisation which resulted, among other things, in much lower customs duties (from above 30% to below 3% for the global average). Last, advances in ICT were also key as they drastically reduced the cost of coordinating the many different production stages carried out in different countries.

This rise in GVCs provided a huge boost for trade flows, which grew much faster than GDP (see the chart). The reason is that goods and services started to cross borders several times during the production process (see the figure).

However, in the last few years the rate growth of new global chains has decelerated (some analysts are even suggesting a reversal) and the effect on the slowdown in world trade is expected to be significant. Several studies attribute between 25% and 50% of the slowdown in trade to this factor.³ China is a case in point: it is still the world’s leading exporter of manufactured goods but the share of imported inputs in its exports has gone from 60% in the mid-90s to 35%. China’s exported goods are therefore less integrated in GVCs than they used to be.

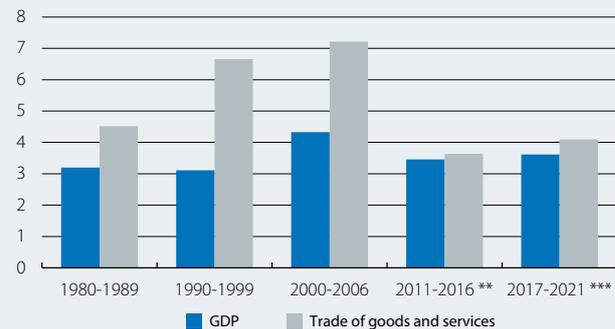
Fewer new GVCs are being created primarily for three reasons: trade costs are falling more slowly (because commercial liberalisation has eased, for instance), the formation of GVCs has now reached a mature stage, and the composition of world economic activity has changed.

Regarding the composition effect, the growing importance of services in the world’s economic activity is particularly striking. By way of example, in the BRICs services have gone from an average of 40% of GDP in 1990 to 60% today. Services are generally less tradables and those that are traded have a much less fragmented production chain than manufactured goods. Substantial growth rates in these sectors therefore entail slower growth rates in trade flows and the formation of GVCs.

In short, as the growth in GVCs has run out of steam, the recovery in international trade will be limited. Some experts therefore argue that the previous growth rates for trade flows (7%) were exceptional and the current environment is merely a return to «normal».

World GDP and international trade *

Average annual change (%)



Notes: * GDP in real terms and at purchasing power parity. Volume of trade in goods and services; the years 2007-2010 are not included due to the effect of the crisis. ** Estimate for 2016. *** Forecasts for 2017-2021.

Source: CaixaBank Research, based on IMF data (WEO, October 2016).

Exports in a global value chain



Source: CaixaBank Research.

1. See the Focuses «Slowdown in world trade and investment» and «Global trade slowdown: the role played by protectionism» in MR12/2016 and MR02/2017, respectively.
 2. Global value chain refers to the division of the production of a good or service into different production stages located in different countries.
 3. See Al-Haschimi, A., Gächter, M., Lodge, D. and Steingress, W. (2016), «The great normalisation of global trade», VoxEU, October; Constantinescu, C., Mattoo, A., Ruta, M., (2017), «Trade Developments in 2016: Policy Uncertainty Weighs on World Trade», Global Trade Watch, World Bank, Washington, D. C., IMF (2016), «Global Trade: What’s behind the Slowdown?», WEO, October, chapter 2.

KEY INDICATORS

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

UNITED STATES

	2014	2015	Q1 2016	Q2 2016	Q3 2016	Q4 2016	01/17	02/17	03/17
Activity									
Real GDP	2.4	2.6	1.6	1.3	1.7	2.0	–	...	–
Retail sales (excluding cars and petrol)	4.5	4.3	3.9	4.4	3.6	3.8	5.0	4.4	...
Consumer confidence (value)	86.9	98.0	96.0	94.8	100.7	107.8	111.6	116.1	125.6
Industrial production	2.9	0.3	–1.6	–1.1	–1.0	–0.1	0.2	0.3	...
Manufacturing activity index (ISM) (value)	55.6	51.4	50.0	51.5	51.1	53.3	56.0	57.7	...
Housing starts (thousands)	1,001	1,108	1,151	1,159	1,145	1,248	1,251	1,288	...
Case-Shiller home price index (value)	171	179	186	188	188	192	195	...	...
Unemployment rate (% lab. force)	6.2	5.3	4.9	4.9	4.9	4.7	4.8	4.7	...
Employment-population ratio (% pop. > 16 years)	59.0	59.4	59.8	59.7	59.8	59.7	59.9	60.0	...
Trade balance ¹ (% GDP)	–2.8	–2.8	–2.8	–2.7	–2.7	–2.7	–2.7	...	...
Prices									
Consumer prices	1.6	0.1	1.1	1.0	1.1	1.8	2.5	2.7	...
Core consumer prices	1.7	1.8	2.2	2.2	2.2	2.2	2.3	2.2	...

Note: 1. Cumulative figure over last 12 months.

Source: CaixaBank Research, based on data from the Department of Economic Analysis, Department of Labor, Federal Reserve, Standard & Poor's, ISM and Thomson Reuters Datastream.

JAPAN

	2014	2015	Q1 2016	Q2 2016	Q3 2016	Q4 2016	01/17	02/17
Activity								
Real GDP	0.2	1.2	0.4	0.9	1.1	1.6	–	...
Consumer confidence (value)	39.3	41.3	41.4	41.2	42.1	42.1	43.2	43.1
Industrial production	2.1	–1.2	–3.2	–1.7	0.5	2.6	1.9	...
Business activity index (Tankan) (value)	13.5	12.8	6.0	6.0	6.0	10.0	–	...
Unemployment rate (% lab. force)	3.6	3.4	3.2	3.2	3.0	3.1	3.0	...
Trade balance ¹ (% GDP)	–2.5	–0.5	–0.2	0.1	0.5	0.7	0.9	1.0
Prices								
Consumer prices	2.8	0.8	0.0	–0.3	–0.5	0.3	0.5	0.2
Core consumer prices	1.8	1.0	0.6	0.6	0.2	0.1	0.1	–0.1

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	Q1 2016	Q2 2016	Q3 2016	Q4 2016	01/17	02/17
Activity								
Real GDP	7.3	6.9	6.7	6.7	6.7	6.8	–	...
Retail sales	12.0	10.7	10.3	10.2	10.5	10.6	9.5	9.5
Industrial production	8.3	6.1	5.9	6.1	6.1	6.1	6.3	6.3
PMI manufacturing (value)	50.7	49.9	49.5	50.1	50.2	51.4	51.3	51.6
Foreign sector								
Trade balance ¹ (value)	383	608	588	576	554	513	508	470
Exports	6.0	–2.3	–14.3	–7.5	–7.0	–5.2	8.0	–1.5
Imports	0.4	–14.2	–14.1	–7.1	–4.7	2.1	16.7	38.0
Prices								
Consumer prices	2.0	1.4	2.1	2.1	1.7	2.2	2.5	0.8
Official interest rate ² (value)	5.60	4.35	4.35	4.35	4.35	4.35	4.35	4.35
Renminbi per dollar (value)	6.2	6.3	6.5	6.5	6.7	6.8	6.9	6.9

Notes: 1. Cumulative figure over last 12 months. Billion dollars. 2. End of period.

Source: CaixaBank Research, based on data from the National Bureau of Statistics of China and Thomson Reuters Datastream.

ECONOMIC OUTLOOK · The euro area's economy is gaining traction in an uncertain environment

A better outlook for growth in spite of several elections.

At a European level, March saw three important events that highlight how economic activity is improving despite high political uncertainty. First, the ECB improved its risk assessment due to a stronger recovery, slightly upgrading its growth forecasts for the euro area to 1.8% in 2017 and 1.7% in 2018. This is in line with CaixaBank Research forecasts of 1.7% both for 2017 and 2018. Second, in the political sphere, the Dutch parliamentary elections on 15 March marked the start of Europe's electoral calendar with a favourable outcome for the incumbent government. However, all eyes are on the French presidential elections at the end of April, a key source of risk for the euro area's economy. Lastly, on 29 March the UK formally triggered the procedure to leave the EU, beginning two years of negotiations. Given the considerable links between the EU and the UK, both parties have to lay the foundations for a new relationship that is as orderly as possible. But the process will be complex and uncertainty is high.

Domestic demand boosts euro area growth. The 0.4% quarter-on-quarter growth in GDP for the euro area in Q4 2016 resulted from the positive contribution of 0.5 pp made by domestic demand while external demand subtracted slightly from growth (-0.1 pp). Apart from strong private consumption, up 0.4% quarter-on-quarter, there was also considerable growth in investment, namely 0.6% quarter-on-quarter. The effect of solid domestic demand could also be seen in the 2.0% quarter-on-quarter increase in imports, explaining the foreign sector's negative contribution in spite of healthy exports (1.5%). Q4 figures show a similar growth pattern to 2016 as a whole: GDP grew by 1.7%, with domestic demand contributing 1.9 pp and external demand subtracting 0.2 pp from annual GDP growth.

Economic activity indicators point to more solid growth in Q1. In March, the composite business sentiment index (PMI) for the euro area reached its highest level since April 2011, at 56.7 points (clearly above the 50-point threshold for the expansionary zone). March's economic sentiment index (ESI) also reached a peak since 2011 at 107.9 points. Economic activity indicators accelerated across all countries. In Germany the PMI composite index rose to 57.0 points (56.1 in February) while the ESI climbed to 109.2 points. French indicators performed even better. The composite PMI reached 57.9 points (55.9 in February) and the ESI rose to 104.9 points, suggesting economic activity is speeding up slightly. Nevertheless, the upcoming French presidential elections are a considerable source of risk and the medium-term growth projections for the French economy are also rather

Euro area: ECB forecasts

Annual change (%)

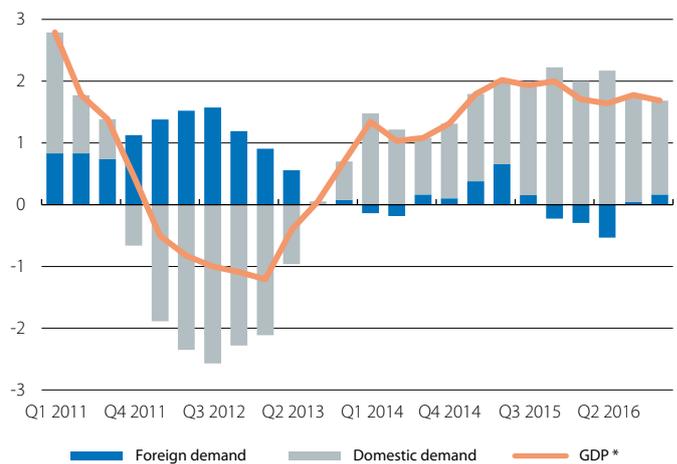
	Forecast			Change compared with December 2016 forecast (pp)		
	2017	2018	2019	2017	2018	2019
GDP	1.8	1.7	1.6	▲ 0.1	▲ 0.1	=
HICP *	1.7	1.6	1.7	▲ 0.4	▲ 0.1	=
HICP without energy or foods	1.1	1.5	1.8	=	▲ 0.1	▲ 0.1

Note: * Harmonized index of consumer prices.

Source: CaixaBank Research, based on data from the ECB (ECB Staff Macroeconomic Projections).

Euro area: GDP

Contribution to year-on-year growth (pp)

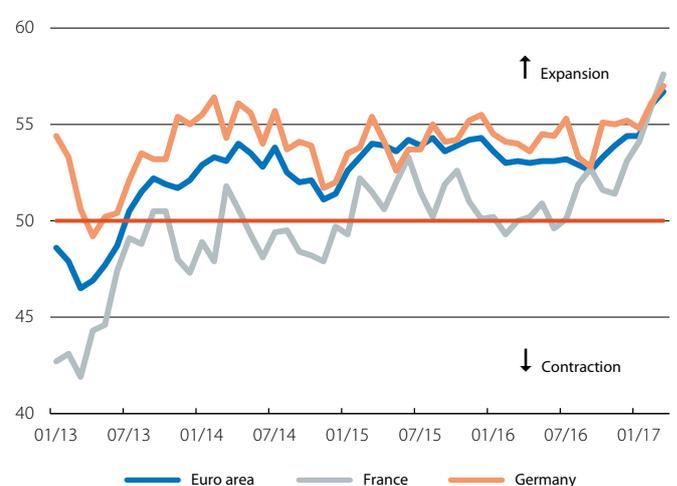


Note: * Year-on-year change (%).

Source: CaixaBank Research, based on Eurostat data.

Euro area: PMI composite activity indicator

Level



Source: CaixaBank Research, based on Markit data.

disappointing. The French president elected in May will therefore need to carry out reforms.

Consumption indicators point to strong domestic demand.

Retail sales rose by 1.0% year-on-year in January. Although this figure is slightly lower than December (1.2%), it is still above average for the past two years. The euro area's consumer confidence index stood at -5.0 points in March, maintaining the upward trend starting in Q2 2016. Household consumption will continue strong over the coming months, boosted by improvements in the labour market and accommodative financial conditions.

Economic growth translates into job creation. Employment rose by 0.3% quarter-on-quarter for the euro area as a whole in Q4 2016 (0.2% in Q3), ending the year at 153.9 million workers (the highest level since Q3 2008). This increase in employment was widespread across countries but especially in Spain and Portugal, both up by 0.4%, and also Italy with employment rising by 0.3% after the previous quarter's dip (-0.1% in Q3 2016). Growth in employment was more moderate in France and Germany (0.2% and 0.1%, respectively), although it should be noted that the German economy is close to full employment. Higher employment is gradually leading to wage rises, up by 1.6% year-on-year in Q4 in the euro area overall, slightly higher than the average growth in Q1-Q3. But there are big differences between countries, reflecting their highly disparate labour markets. Wage costs rose faster in Germany (2.9% year-on-year) and France (1.5% year-on-year) while posting weak growth in Italy after several quarters of decline.

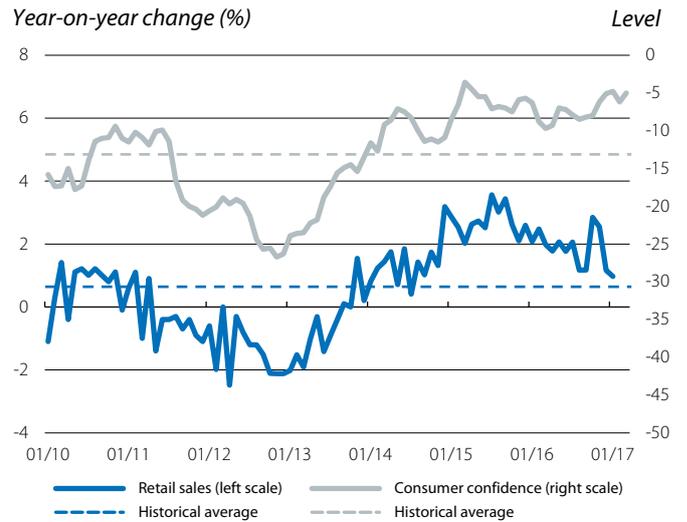
Inflation continues to normalize. Euro area headline inflation, measured by the harmonized index of consumer prices (HICP), stood at 1.5% in March. This figure is 0.5 pp below the 2.0% posted in February, due primarily to a smaller contribution by its volatile components (energy and unprocessed food). The base effect of the slump in oil prices towards the end of 2015 has also started to dwindle. This had led to large positive contributions from energy prices but oil has now stabilized at around USD 50-55 per barrel. Core inflation, indicating the medium-term inflationary trend, stood at 0.7% in March, 0.2 pp below February's figure. This slight dip was caused by a smaller contribution from service prices due to the calendar effects of Easter, which falls entirely in April this year while in 2016 it was in March. Beyond this one-off factor, we expect core inflation to recover gradually over the coming months thanks to the growth in economic activity and improved labour market conditions.

PORTUGAL

Portugal's economic growth is looking more solid as the country's macroeconomic imbalances are corrected.

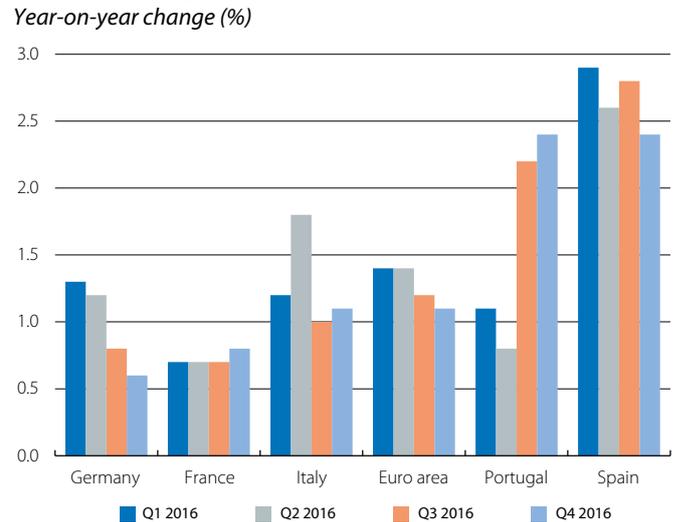
Portuguese GDP grew by 2.0% year-on-year in Q4 2016, the fastest growth rate since 2010. Private consumption performed particularly well in Q4, up by 1.1% quarter-on-

Euro area: consumption indicators



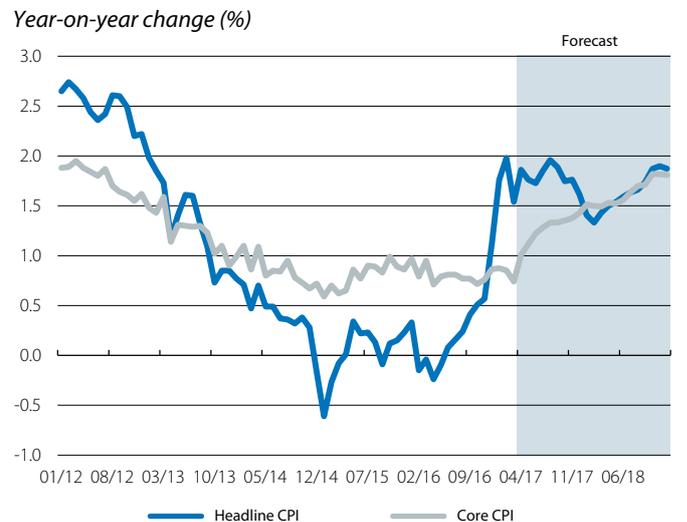
Source: CaixaBank Research, based on data from Eurostat and the European Commission.

Euro area: employment



Source: CaixaBank Research, based on Eurostat data.

Euro area: harmonized CPI



Source: CaixaBank Research, based on Eurostat data.

quarter (0.4% in Q3), while investment rose by 4.6% quarter-on-quarter (0.2% in Q3). Growth in public consumption was much more contained, however, namely 0.3% quarter-on-quarter. This strong growth in domestic demand boosted imports (up by 4.5% quarter-on-quarter), resulting in the foreign sector making a negative contribution to quarter-on-quarter GDP growth (-1.0 pp) in spite of good export figures (up 2.5% quarter-on-quarter). These data confirm that Portugal's economic growth is more balanced in the current expansionary phase beginning in 2014, with domestic demand driving growth and healthy exports. For 2016 as a whole, GDP increased by 1.4% and the growth rate is expected to be similar in 2017. CaixaBank Research's scenario predicts 1.5% growth in GDP this year.

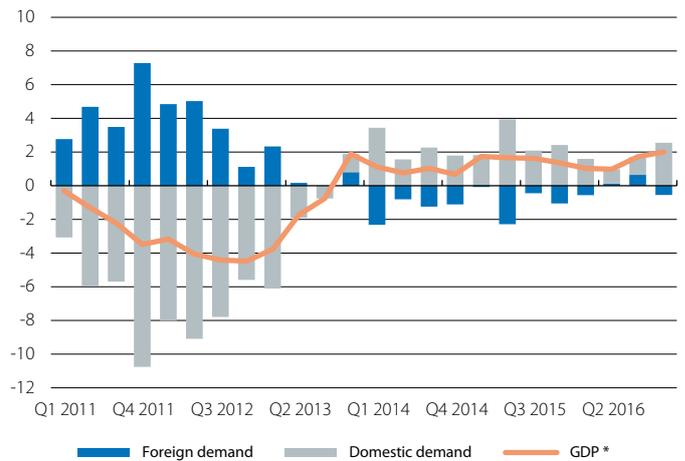
The budget deficit is falling but public debt remains high.

Portugal's fiscal balance ended 2016 at -2.1% of GDP, outperforming the stability target set by the European Commission (-2.5% of GDP). This figure is 2.3 pp better than the one posted in 2015 (-4.4%), thanks to a 0.9% increase in revenue and 3.8% decrease in expenditure. Revenue growth was due both to the economic recovery and also extraordinary measures such as the debt settlement programme (PERES), while expenditure was cut via reductions in public investment, unemployment benefits and debt interest payments. After improving its fiscal balance, the Portuguese government has asked the European Commission to leave the excessive deficit procedure. Nevertheless, given the country's public debt of 130.4% of GDP, fiscal consolidation will have to continue over the coming years.

Portugal's current account surplus continues to increase gradually, at 1.0% of GDP in January (cumulative over 12 months). Between 2000 and 2008, Portugal's foreign sector suffered from a persistent current account deficit, reaching -12.1% of GDP in 2008, resulting from a pattern of strong domestic consumption, low savings and poor export competitiveness. This negative trend has since been corrected. First via the adjustment in imports due to the impact of the economic recession. More recently, a series of structural adjustments (fiscal consolidation, private deleveraging and better export specialisation, both in products and destinations) have helped to correct this trend. The country now has a moderate current account surplus. In composition terms, there has been a sustained increase in the services balance surplus and a correction in goods balance deficit. In January, the services balance posted a surplus of 7.1% of GDP and the goods balance a deficit of 5.0% of GDP.

Portugal: GDP

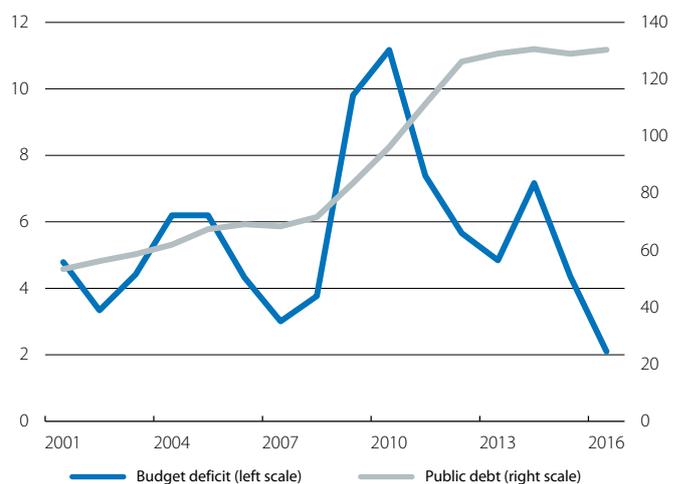
Contribution to year-on-year growth (pp)



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

Portugal: budget deficit and public debt

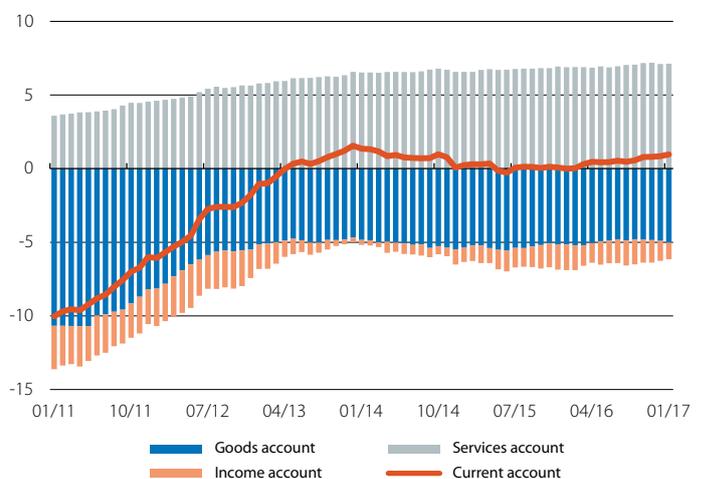
(% of GDP) (% of GDP)



Source: CaixaBank Research, based on INE data.

Portugal: current account

Cumulative over 12 months (% of GDP)



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

FOCUS · Where are interest rates headed? The ECB and macroeconomic fundamentals

Global macroeconomic fundamentals and also those of a particular country largely determine the interest rate on its sovereign debt. For instance, a state’s ability to pay depends on its current level of debt and on expectations regarding its public surplus or deficit and its future economic growth. The state of Europe’s economy also determines the benchmark interest rate set by the European Central Bank (ECB), used to influence a constellation of interest rates. Global factors are also important (such as the yields for other economies, insofar as they offer alternative investment opportunities) and investor risk appetite. Consequently all these ingredients, as well as their historical relationships, are used to estimate the yield on 10-year government bonds in line with macroeconomic fundamentals; i.e. the macro or fair-value yield.¹

As the first chart shows, macroeconomic fundamentals tend to be good indicators of the yield observed in the market. An analysis by component shows the fair-value yield’s key determining factors to be the level of public debt, global financial conditions (yield on US Treasury bonds and financial volatility) and the ECB’s benchmark interest rate. In the past few years, while the level of debt has pushed up interest rates, the major factors pushing down fair-value yields have been the highly accommodative financial conditions at a global level (mainly due to US accommodative monetary policy) and the reduction in the ECB’s benchmark interest rate. However, since mid-2014 the ECB’s use of unconventional monetary policy has pushed government bond yields down to levels significantly lower than would be warranted by such macroeconomic fundamentals, primarily in the euro area’s core countries.

It is therefore likely that the eventual withdrawal of the ECB’s unconventional monetary policy will lead observed yields to converge upwards towards fair-value yields. Less accommodative financial conditions in the US and the normalization of the ECB’s interest rates will also push up fair-value interest rates. So what will happen to the risk premia throughout this process? The second chart shows that, after the financial and sovereign debt crisis, macroeconomic fundamentals justify higher risk premia than in the 2000-2007 period (essentially due to high public debt and less dynamic economic activity). In the core countries, the risk priced in market valuations

1. This is estimated based on a panel regression between 2000 and 2014 for Germany, Austria, Belgium, Spain, France, the Netherlands, Ireland, Italy and Portugal, with the following explanatory variables: market expectations for the 3-month Euribor and growth in real GDP, debt-to-GDP ratio, an indicator for stock market volatility and the 10-year Treasury yield.

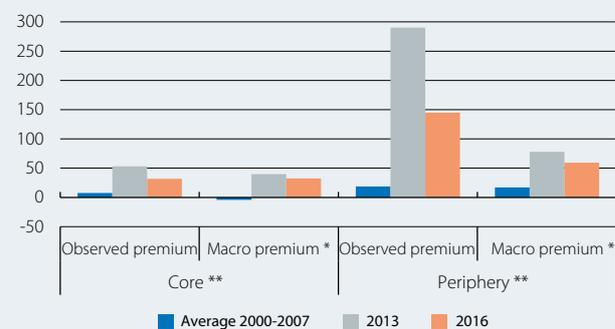
reflects these differences in fundamentals: observed premia today are in line with macroeconomic fundamentals. However, in the periphery the observed spreads are higher than the risk premia predicted by economic fundamentals. This is because investor sentiment,² which heavily penalized peripheral countries in the sovereign debt crisis, still acts as a drag on peripheral sovereign yields. Although in the Focus «ECB monetary policy and sovereign risk premia» in MR03/2017 we noted that, in the short term, the ECB’s tapering might lead to upswings in risk premia, the macroeconomic fundamentals suggest these should fall again in the medium term.

10-year European government bond yields * (%)



Notes: * Weighted average for Germany, Austria, Belgium, Spain, France, Italy, the Netherlands and Portugal. ** Yield predicted by macroeconomic fundamentals (global financial conditions, ECB’s monetary policy, public debt and expected growth). Source: CaixaBank Research, based on data from Thomson Reuters, Eurostat and Consensus Economics.

10-year sovereign debt risk premia (bp)



Notes: * Risk premium predicted by macroeconomic fundamentals (global financial conditions, ECB’s monetary policy, public debt and expected growth). ** Core: weighted average for Austria, Belgium, France, and the Netherlands. Periphery: weighted average for Spain, Italy and Portugal. Source: CaixaBank Research, based on data from Thomson Reuters, Eurostat and Consensus Economics.

2. It could also reflect a structural change in the valuation of fundamentals and their relationship with sovereign yields.

FOCUS · Euro area debt clock

Since 2015, the ECB’s quantitative easing programme (QE) and its low interest rate policy have substantially pushed down the financing costs of euro area countries. However, public debt remains high, at above 90% of GDP in the euro area, and when monetary stimuli are withdrawn and interest rates rise, public finances will start to feel the pressure.

It is therefore necessary to bring debt down to more sustainable levels. EU agreements establish that public debt should be below 60% of GDP and that countries whose debt exceeds this level must reach the target within 20 years. In order to analyse the fiscal effort required, we estimated the primary balance¹ needed to meet the EU target. This analysis is for 2020, presumably when the ECB will have started its monetary normalisation process. We used the IMF’s growth and debt forecasts for 2020 and interest rates that could be expected given each country’s macroeconomic fundamentals and the monetary policy the ECB is likely to implement (see the Focus «Where are interest rates headed? The ECB and macroeconomic fundamentals» in this *Monthly Report* for a more detailed explanation of the methodology).

On the one hand, public debt in countries such as Germany and the Netherlands is very likely to be below 60% of GDP by 2020. Therefore, they will be able to implement relatively accommodative fiscal policies.

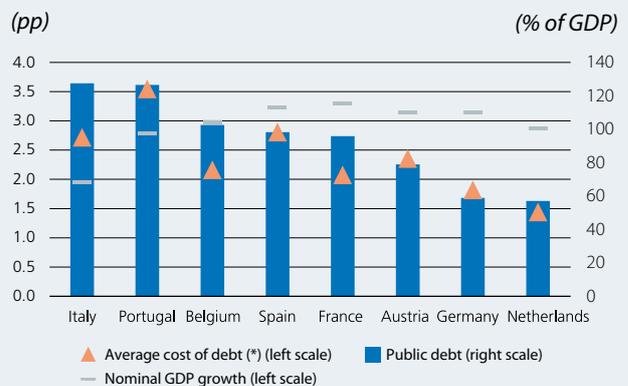
Other countries, however, will need to increase their fiscal effort significantly if they want to reduce their public debt at the pace that is required by EU fiscal rules. For example, Belgium and Spain would have to maintain a primary surplus of around 1.5% of GDP and France of 0.7%. Because these countries currently run primary deficits, an improvement of their public finances now that the macroeconomic environment is more favourable could prove beneficial.

The effort required is even greater in Italy and Portugal since they have a relatively higher level of public debt. And in the case of Italy, even more so, since its growth prospects are quite modest. The IMF also seems relatively conservative in its growth forecasts for Portugal. One of the variables that determine the trend in public debt is the difference between the interest rate and the nominal GDP growth rate, also known as the ‘snowball effect’. Intuitively, the higher the interest rate, the greater the nominal growth that is required to reduce public debt as a percentage of GDP. As the second chart shows, the snowball effect for Italy and Portugal would actually increase public debt by 2020. However, these

countries could offset the higher financing costs and continue to gradually reduce their debt ratio (albeit not at the agreed pace) provided they maintain their current primary surplus.

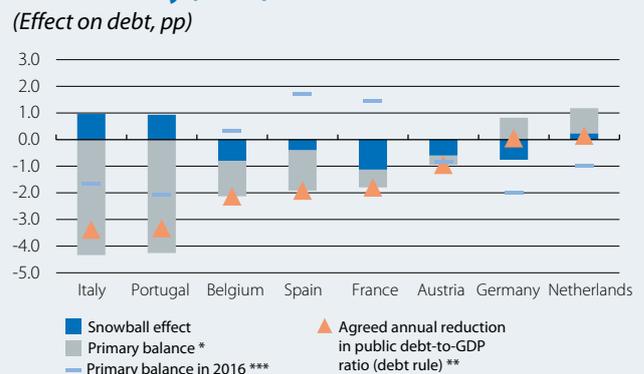
To sum up, this simple analysis shows that bringing public debt down to pre-crisis levels requires perseverance and effort. This task will become even more demanding once monetary policy starts to normalise. This highlights the importance of implementing reforms to boost potential growth in several European countries. Public debt will fall much faster if growth is actually greater than what is forecast by the main international institutions.

Growth, public debt and average cost of debt forecasts for 2020



Note: * Average expected cost of debt based on the methodology used in the Focus «Where are interest rates headed? The ECB and macroeconomic fundamentals» in this *Monthly Report*. **Source:** CaixaBank Research, based on data from the IMF.

Analysis of medium-term debt sustainability (2020)



Notes: * The primary balance is the balance that meets the debt rule given the snowball effect predicted for 2020. Negative primary balances correspond to surpluses. ** The debt rule refers to the annual rate at which public debt needs to fall to reach 60% of GDP within 20 years. *** Positive/negative primary balances correspond to deficits/surpluses. **Source:** CaixaBank Research, based on data from AMECO and the IMF.

1. Public debt before interest payments.

KEY INDICATORS

Activity and employment indicators

Values, unless otherwise specified

	2015	2016	Q1 2016	Q2 2016	Q3 2016	Q4 2016	01/17	02/17	03/17
Retail sales (year-on-year change)	2.7	1.9	2.2	1.8	1.4	2.3	1.2	...	...
Industrial production (year-on-year change)	2.1	1.4	1.4	1.0	1.1	2.3	0.6	...	...
Consumer confidence	-6.2	-7.7	-8.3	-7.8	-8.2	-6.4	-4.8	-6.2	-5.0
Economic sentiment	104.2	104.8	103.9	104.2	104.2	106.9	107.9	108.0	107.9
Manufacturing PMI	52.2	52.5	51.7	52.0	52.1	54.0	55.2	55.4	56.2
Services PMI	54.0	53.1	53.3	53.1	52.6	53.4	53.7	55.6	56.5
Labour market									
Employment (people) (year-on-year change)	1.0	1.3	1.4	1.4	1.2	1.2	-	...	-
Unemployment rate: euro area (% labour force)	10.9	10.0	10.3	10.1	9.9	9.7	9.6	...	...
Germany (% labour force)	4.6	4.2	4.3	4.2	4.1	3.9	3.8	...	...
France (% labour force)	10.4	10.0	10.2	9.9	10.1	10.0	10.0	...	...
Italy (% labour force)	11.9	11.7	11.6	11.6	11.6	11.8	11.9	...	...
Spain (% labour force)	22.1	19.6	20.5	20.1	19.3	18.7	18.2	...	...

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

Foreign sector

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

	2015	2016	Q1 2016	Q2 2016	Q3 2016	Q4 2016	01/17	02/17
Current balance: euro area	3.2	3.6	3.2	3.5	3.4	3.6	3.5	...
Germany	8.6	8.4	8.7	8.9	8.6	8.4	8.3	...
France	-0.2	-1.1	-0.8	-0.8	-1.1	-1.1	-1.4	...
Italy	1.6	2.8	1.9	2.3	2.6	2.8	2.7	...
Spain	1.4	2.0	1.4	1.7	1.8	2.0	2.0	...
Nominal effective exchange rate¹ (value)	92.3	94.7	94.1	94.8	95.1	94.8	94.3	93.8

Note: 1. Weighted by flow of foreign trade. Higher figures indicate the currency has appreciated.

Source: CaixaBank Research, based on data from the Eurostat, European Commission and national statistics institutes.

Financing and deposits of non-financial sectors

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

	2015	2016	Q1 2016	Q2 2016	Q3 2016	Q4 2016	01/17	02/17	
Private sector financing									
Credit to non-financial firms ¹	-0.4	1.8	1.2	1.7	2.1	2.2	2.3	2.0	
Credit to households ^{1,2}	0.7	1.7	1.5	1.7	1.8	1.9	2.2	2.3	
Interest rate on loans to non-financial firms ³ (%)	1.6	1.4	1.4	1.4	1.3	1.3	1.3	1.2	
Interest rate on loans to households for house purchases ⁴ (%)	2.1	1.9	2.0	1.8	1.8	1.8	1.8	1.8	
Deposits									
On demand deposits	11.1	10.0	11.2	10.1	9.5	9.3	9.3	9.2	
Other short-term deposits	-3.8	-1.9	-2.4	-1.8	-1.2	-2.0	-2.2	-2.1	
Marketable instruments	2.6	2.9	-1.0	2.3	5.7	4.7	7.3	3.5	
Interest rate on deposits up to 1 year from households (%)	0.8	0.5	0.6	0.6	0.5	0.4	0.4	0.4	

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 · No sign of a slowdown

The economy keeps growing at a good pace. The Spanish economy performed well in the first three months of the year and there is no sign of the expected slowdown – as yet. In general, economic activity indicators for January and February were more positive than for the previous quarter. Private consumption and particularly investment in capital goods were very strong and were probably the drivers of domestic demand in Q1 2017. On the supply side, strong business sentiment indicators have also been accompanied by good business figures in industry and services at the beginning of the year. The CaixaBank Research GDP forecast model estimates 0.8% quarter-on-quarter growth in Q1, slightly higher than the rate posted in Q4 2016 (0.7% quarter-on-quarter).

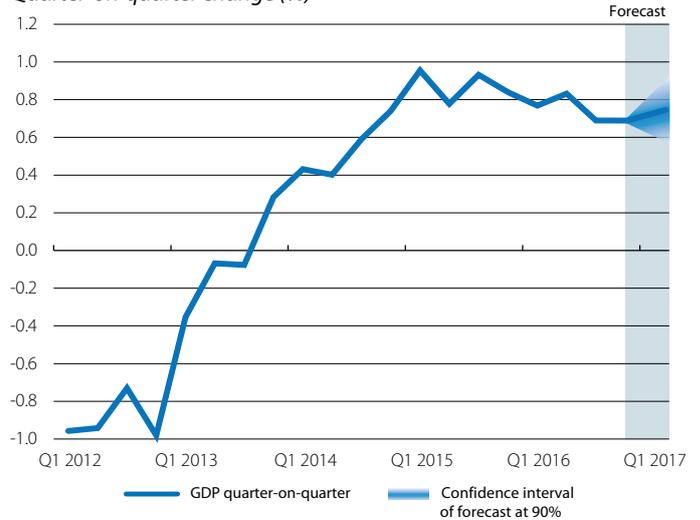
Growth prospects are improving. Such positive indicators for economic activity and confidence, together with the likelihood that oil prices will not rise as fast as previously thought, have led us to improve our GDP growth forecast by 0.2 pp, both for 2017 and 2018, up to 2.8% and 2.4%, respectively. Forecasts by other analysts, such as the Funcas think tank and Consensus Economics, as well as those of institutions such as the OECD, IMF and Bank of Spain, have all been upgraded recently. This will therefore be the third consecutive year that Spain outperforms the growth forecasts made a year before, assuming there are no shocks that interrupt the economy’s expansion. By way of example, in MR04/2016 CaixaBank Research predicted 2.1% growth for 2017, 0.7 pp lower than the current forecast. But this scenario still faces strong risks, especially due to Europe’s high political uncertainty given its full electoral calendar and the start of Brexit negotiations.

Higher GDP growth is being passed on to the labour market. In line with these good economic activity figures, data for the labour market have also been very positive. The number of registered workers affiliated to Social Security rose by 46,079 people in February, seasonally adjusted, a similar figure to two years ago. The job creation rate therefore speeded up to 3.4% year-on-year. It is also significant that this improvement was widespread across most economic sectors. Registered unemployment fell by 32,711 people, also seasonally adjusted. The rate of decline in registered unemployment therefore increased by 0.3 pp to –9.7% year-on-year. This good performance by the labour market in the first two months of the year, as well as the improved GDP growth prospects, have also led us to raise our growth forecasts for employment in 2017 to 2.2%, representing 400,000 additional jobs on average.

Wage rises are still moderate. This strong growth in employment is occurring while wage rises are still moderate,

GDP

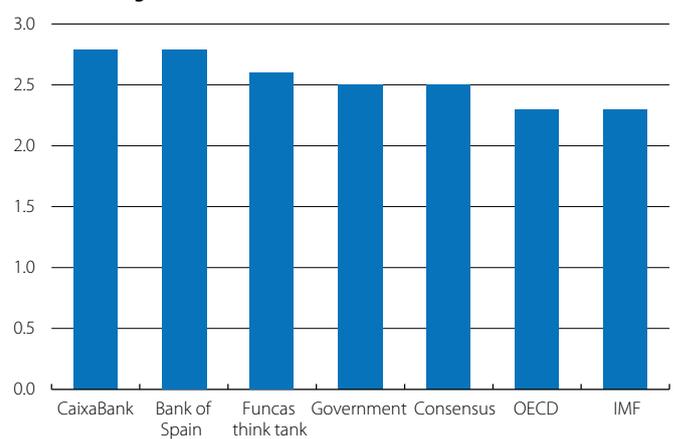
Quarter-on-quarter change (%)



Source: CaixaBank Research, based on INE data.

GDP growth forecasts in 2017

Annual change (%)

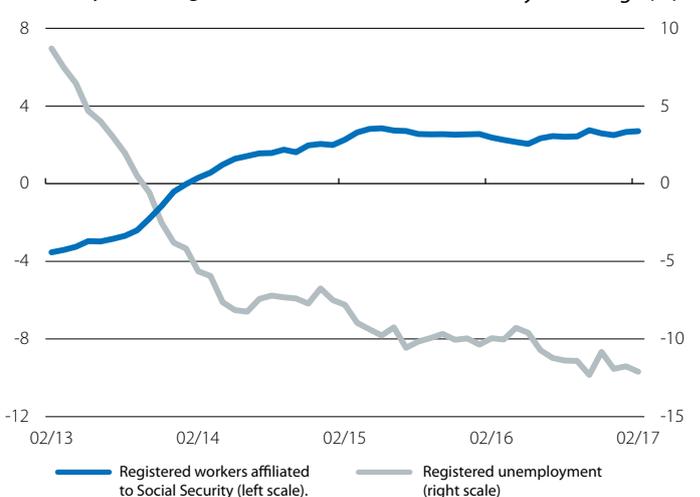


Source: CaixaBank Research, based on data from the Bank of Spain, Ministry of Finance, Consensus Economics, Funcas, OECD and IMF.

Registration with Social Security and registered unemployment

Year-on-year change (%)

Year-on-year change (%)



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

namely 1.2% on average in the collective agreements signed in February. According to the quarterly labour cost survey, wage costs actually decreased by 0.8% year-on-year in Q4 2016, falling to EUR 2,650 per worker and month. But the trend differs across sectors and particularly in the public sector, where the difference is remarkable. In this sector, the extra payment for civil servants was withdrawn in December 2012 but then gradually reinstated. With 2009 as our benchmark, labour costs in public administration and defence remained below the total for all economic sectors but this trend reversed 2015 and 2016 when 50% of the withdrawn extra payment was repaid in each of these two years.

Prices will gradually reflect the stronger economy. Inflation will gradually move towards the ECB's target of 2% as the expansion firmly takes root in Spain's economy. At present, the core CPI, which excludes energy products and fresh food, posted a slight increase of 1.0% year-on-year in February, still far from this target. In clear contrast, headline inflation dipped to 2.3% in March after reaching 3.0% in both January and February. But the upswing in inflation at the start of the year was temporary and due to price changes in electricity and fuels. Over the coming months, oil prices will continue to rise, reaching USD 58.6 per barrel by December 2017. This is lower than we had previously predicted due to the sustained growth in unconventional oil production in the US. The extra supply limits the effect of the OPEC agreement last November to cut production (see the Financial Markets section in this *Monthly Report*). We have therefore downgraded our forecast for average annual inflation to 2.2%. In short, headline inflation will fall as the effect of rising energy prices dwindles, while core inflation will move in the opposite direction, growing slightly due to dynamic private consumption.

The more moderate price increase in oil will support the current account. In 2016, the current account balance was EUR 21,786 million (2.0% of GDP), larger than the EUR 14,725 million achieved in 2015 thanks to the smaller income deficit and especially the reduction in the goods deficit. The improved energy account thanks to lower oil prices also played a crucial role: energy savings totalled EUR 6,882 million, equivalent to 0.7% of GDP. In 2017, rising oil prices will push up the energy deficit to EUR 26,500 million (2.3% of GDP). Oil prices will therefore no longer act as a support. Consequently, to achieve the planned current account surplus of 1.8% of GDP, it will be vital for exports of goods and services to continue performing as well as they have over the past few years. For the time being, January's customs figures confirm that exports of goods are still growing at a good rate (2.8% year-on-year, cumulative over 12 months). International tourist arrivals are also improving on their record figures from 2016, with 11.9% year-on-year growth in February.

The healthy economic context helped to achieve the public deficit target in 2016. Spain ended 2016 with a smaller public

Labour cost per worker

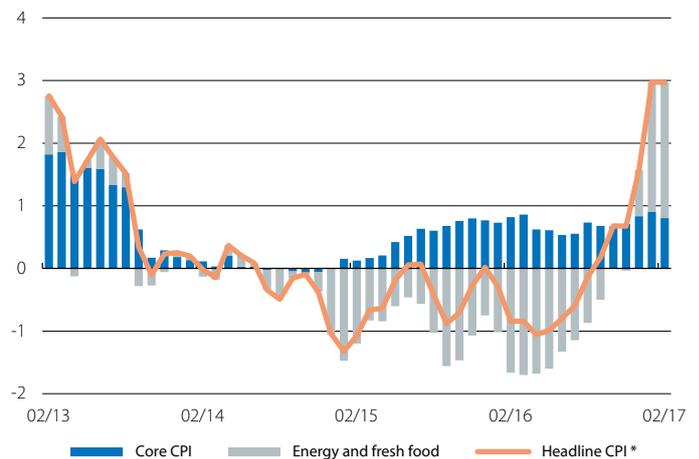
Index (100 = 2009)



Note: * Sections CNAE-9 from B to S.
Source: CaixaBank Research, based on INE data (EPA).

CPI

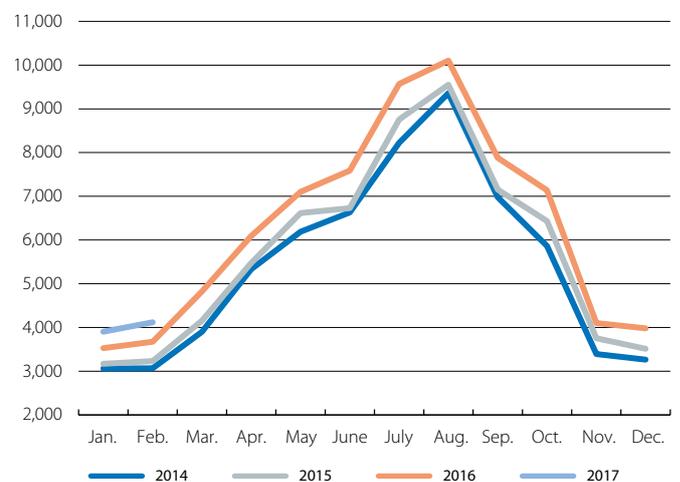
Contribution to year-on-year growth (pp)



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

Foreign visitor arrivals

(Thousands)



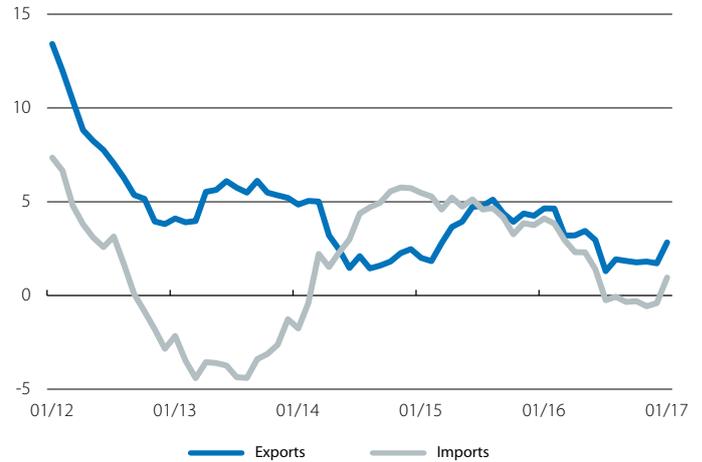
Source: CaixaBank Research, based on INE data.

deficit than the target agreed with Brussels (4.6% of GDP). The deficit was 4.3% of GDP if we exclude bank restructuring costs, which total 0.2 pp. The fact that economic growth in 2016 outperformed the forecasts used when the budgets were initially approved has undoubtedly been a huge advantage. In fact, the strong economic growth in 2016 would have reduced the public deficit by an additional 1 pp if fiscal policy had been neutral. We can therefore consider last year's fiscal policy was expansionary. With a view to 2017, the better starting point thanks to a more favourable end to 2016 means that the adjustment required this year to achieve the deficit target of 3.1% of GDP will be less than initially planned. The better economic outlook in 2017 will also help to achieve the target. State budget execution up to February places the deficit at -0.9% of GDP, 0.3 pp below the figure of February 2016.

The improved economic cycle is also boosting credit. Better economic activity and low interest rates thanks to the ECB's expansionary monetary policy are helping credit to start flowing again. In February, new loans granted to households for consumption and housing continued to increase very sharply (up by 18% and 21% year-on-year, cumulative for the year, respectively). More new loans are also being granted to SMEs (7% year-on-year). But in spite of these improvements in loans, in February the outstanding balance of resident private sector credit contracted by 3.0% year-on-year as this sector is still deleveraging. A breakdown of credit by segment for Q4 2016 shows a disparate trend depending on the reason for the loan. Developer loans speeded up their decline to 10.6% year-on-year while loans to other firms moderated their decline. This is a very positive sign that credit for productive activities is gradually recovering.

International trade of goods *

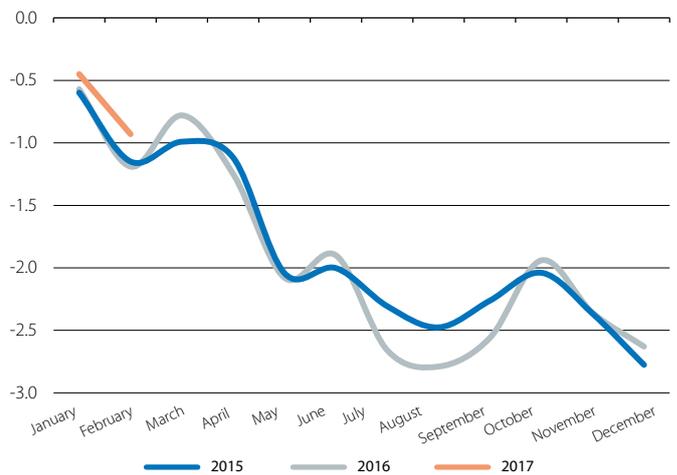
Year-on-year change, cumulative over 12 months (%)



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

Central government balance

(% of GDP)



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

Credit and NPL ratio in Q4 2016

	Balance (EUR billion)	Year-on-year change (%)	NPL ratio (%)
Households (housing)	535	-3.0	4.7
Households (consumption)	117	5.3	8.9
Production activities	605	-6.1	13.1
Construction	40	-9.2	29.1
Development	121	-10.6	25.5
Services	317	-5.7	8.0
Industry	108	-2.4	8.9
Agriculture	19	4.8	9.1
Total *	1,257	-3.8	9.1

Note: * The total balance does not include loans to NPISH or unclassified loans.
Source: CaixaBank Research, based on data from the Bank of Spain.

FOCUS · Technology and good quality employment: a shifting relationship?

Technological change brings with it a change in most jobs and potentially job quality. The emergence of a new technology essentially leads to a new way of producing things with the consequent disappearance of some tasks and the appearance of others. There is also a change in the skills and knowledge required by workers. This transformation in employment affects different workers in different ways. Technology can improve job quality if it complements the work carried out and increases worker productivity.¹ In other cases, technology can be disruptive and wipe out some professions, making effective active employment policies vital.

Spain's labour market has certainly felt the impact of technological transformation. This article analyses the relationship between how technology-intensive each industry is and the quality of its employment. To explore this issue, we have divided industries into three groups according to their technological intensity. Data provided by EU KLEMS allow us to measure the stock of IT capital in each industry, defined as the total capital in computing and communication equipment, software, databases and R&D. Based on data from the LFS for Q4 2016, we have analysed the contract type (temporary or permanent) in the labour relation as this is a good proxy for job quality.² The findings are conclusive in favour of technology: the temporary employment rate is 37% in less technology-intensive sectors, much higher than the rate of 23% found in highly technology-intensive sectors. The difference is particularly large for workers with primary qualifications (32 pp difference in the temporary nature of their employment), while it is less relevant for higher qualified workers (see the first chart).³

Innovation has accelerated over the past few years and it is therefore useful to focus on those employees who have been employed by a company for less time, since more established workers may have permanent contracts for reasons not related to the adoption of such technology. The second chart shows that workers who have been with the firm for a maximum of six months have very high temporary employment rates (87% on average). But it is revealing that the temporary employment rate falls

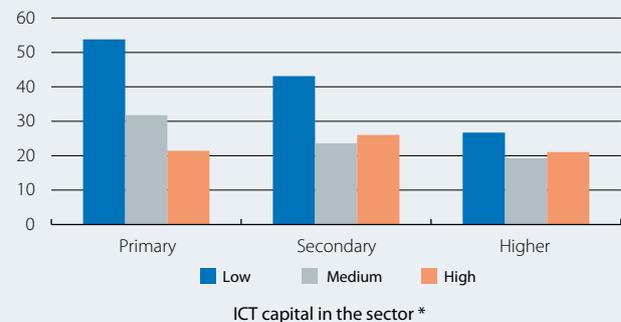
1. Generally, higher worker productivity is associated with higher wages and better labour conditions.
2. Job quality is a multifaceted concept and refers to other aspects of the labour relationship in addition to contract type. However, the temporary nature of employment is a good indication of quality as it is closely correlated with other variables such as involuntary part-time employment and overqualified workers.
3. These descriptive findings have been confirmed in a probit regression model for the probability of workers having a temporary contract which includes control variables for worker characteristics.

as the industry's technology intensity increases. This correlation is even stronger for employees who have worked for the company between 6 and 12 months, with an 11 pp difference in the temporary employment rate (see the second chart).⁴

In summary, the findings endorse the hypothesis that more ICT-intensive industries are generally associated with more stable labour relations and that the lower qualified workers are the ones who benefit the most in these sectors.

Temporary employment rate by ICT capital in the sector and workers' qualifications (Q4 2016)

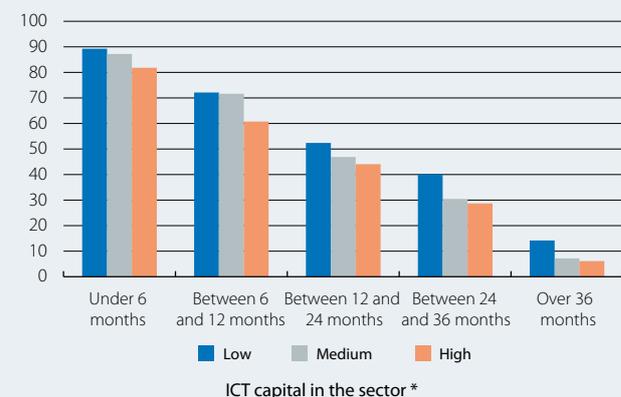
(% of all employment)



Note: * ICT capital includes computing and communication equipment, software, databases and R&D, measured as a percentage of the gross value added for the sector. Data from 2014. Source: CaixaBank Research, based on data from the INE and EU KLEMS.

Temporary employment rate by ICT capital in the sector and number of months workers have been with the company (Q4 2016)

(% of all employment)



Note: * ICT capital includes computing and communication equipment, software, databases and R&D, measured as a percentage of the gross value added for the sector. Data from 2014. Source: CaixaBank Research, based on data from the INE and EU KLEMS.

4. This difference in the temporary employment rate increases to 17 pp if we restrict our comparison to workers with primary qualifications who have been with the company for 6 to 12 months. Once again, the findings presented are coherent with those of a probit model which includes controls such as the educational attainment and age of the worker.

FOCUS · Structural unemployment in Spain

The Spanish economy's strong growth in over the past two years has acted as a boost for job creation. In the period 2015-2016, the number of employees rose by 939,000 people. But unemployment is still very high (18.6% in Q4 2016) and it is not obvious which part of this has become structural.

Formally, structural unemployment (SU) is the unemployment rate compatible with an inflation rate close to the central bank's target and it is therefore also known as the non-accelerating inflation rate of unemployment (NAIRU) or non-accelerating wage rate of unemployment (NAWRU). SU cannot be observed directly but is estimated based on the relationship between unemployment and inflation throughout the economic cycle, also known as the Phillips curve. In the short-term, unemployment below its structural level pushes up prices and wages, and vice versa. SU is difficult to estimate because it can vary over time depending on changes in institutional and economic factors. For instance, more flexible labour regulations can reduce SU while a permanent shock in a specific industry, such as construction, can increase it.

The first chart shows the trend in Spain's unemployment rate together with the latest NAWRU estimate by the European Commission, in February 2017. As can be seen, the unemployment rate rises more quickly than structural unemployment during periods of crisis, suggesting that unemployment essentially increases due to cyclical factors. But part of this increase may also be structural, especially when accompanied by higher long-term unemployment as this can depreciate the human capital. According to the European Commission, NAWRU is currently 17.2% and, without reforms, will fall slightly to 16.8% next year. This figure is actually higher than the unemployment forecast for 2018 (16.0%), suggesting that wage pressure may increase over the coming quarters.

This estimate should be used with care, however. First, the current conditions of Spain's economy, and particularly its labour market, suggest the Commission may be overestimating NAWRU. No significant pressure can be seen on prices or wages, for instance core inflation is still close to 1% and February's wage agreements contain a moderate rise of 1.2%. Secondly, estimates of structural unemployment are also renowned for being unreliable, especially when specific regulatory measures are applied in the labour market, as it is difficult to estimate their impact on SU in real time. Evidence of this unreliability can be seen in how NAWRU estimates have altered year after year. As shown by the second chart, even the Commission's estimates have been successively

downgraded as new data become available. The OECD, using a slightly different methodology, provides a 15.7% SU estimate for 2016,¹ considerably lower than the European Commission's figure.

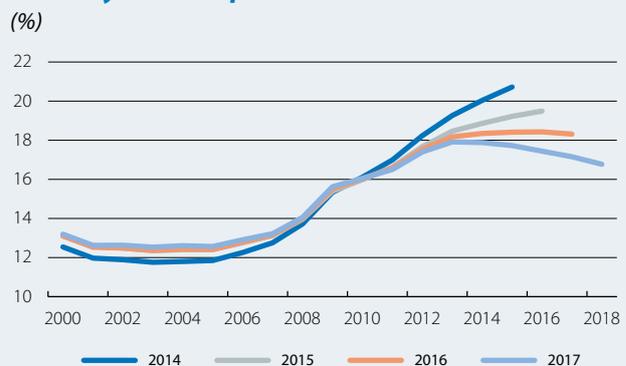
Irrespective of the methodology used, international comparisons indicate that Spain's structural unemployment is the highest among European countries, even exceeding Greece (16.0%) and Portugal (10.3%) in 2016. This underlines the need to continue exploring measures that can help to reduce Spain's SU further. Measures which would certainly improve the situation are active employment policies as well as skills education and worker training. They could also count on widespread political backing.

Unemployment and structural unemployment rates according to the European Commission



Source: CaixaBank Research, based on data from the European Commission (February 2017).

Trend in structural unemployment estimates made by the European Commission *



Note: * NAWRU estimates made by the European Commission in spring each year.
Source: CaixaBank Research, based on data from the European Commission.

1. OECD, 2016, Economic Outlook No. 100, November.

FOCUS · Spanish inflation and rising oil prices: different this time?

Inflation has livened up over the last few months in Spain. In August 2016, when inflation was still negative (-0.1%), it began a strong upward trend that brought it to 3.0% by February 2017. This entire upswing is due to the rise in oil and electricity prices. But two key issues hover over the next few months. How this upswing will affect the price of the rest of goods as, to date, it has been limited to the energy components of the CPI. And whether the impact on Spain's inflation will be greater than on the euro area as a whole, since this could erode the gains made in competitiveness over the past few years.

Higher oil prices affect inflation through three different channels. First, they have a direct impact on fuel prices. Spain is affected more than the euro area as a whole since fuels account for 7.7% of the Spanish CPI compared with 4.2% in the euro area. Fixed taxes are also lower in Spain, so fuel prices fluctuate more in line with oil prices. Second, higher oil prices have an indirect effect on other components as they increase those production costs intrinsically linked to oil, such as transport. Third, there are also second-round effects which result from changes in the inflation expectations of economic agents and which, for instance, could influence wage negotiations.

One way to measure these three effects, both for Spain and the euro area, is by breaking down the CPI into 94 components. The correlation is then calculated between each component and the price of oil,¹ classifying components into two groups depending on whether this correlation is significant or not. A general price index is then constructed using only those components not correlated with the price of oil. The difference between observed inflation and this general index indicates the influence of oil prices on the price of the rest of the goods.

The first finding from this analysis is that, over the last 15 years, there is a larger share of components correlated with oil in the Spanish CPI than in the euro area's CPI. Specifically, in Spain the correlated components (excluded from the general index) have a joint share of 59.1%. This is far above the euro area figure where the excluded components account for 36.7%. The biggest differences between Spain and the euro area occur in restaurants and accommodation services, with a combined share of 13.8% in the Spanish CPI. In both cases the correlation with oil prices is high in Spain but almost zero in the euro area.

This greater share of oil-correlated components in the Spanish case means that Spain's inflation increases more

sharply than in the euro area whenever crude oil becomes more expensive. When oil prices rocketed between 2007 and 2008, the effect of this increase on Spanish inflation was 4.1 pp (difference between observed inflation and the general index in August 2008) while in the euro area this was 2.3 pp in November.

We have already witnessed the direct effects and perhaps some indirect effects of rising oil prices this January and February. Should we expect the same from the second-round effects as in the past? There are reasons to believe that the structural reforms implemented over the past few years and the resulting de-indexation of inflation (labour costs, pensions and government taxes) might prevent the story from repeating itself.

Influence of oil prices on inflation *

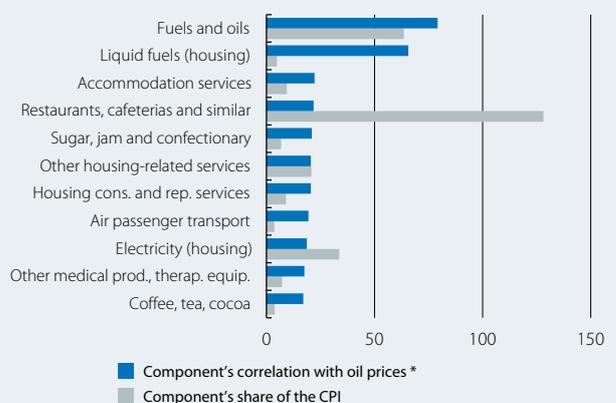


Note: * Difference between observed inflation and the inflation of a general index excluding components with a greater correlation with oil prices

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

Components of the Spanish CPI most strongly correlated with oil prices

Share in the CPI (%) and correlation (%)



Note: * The correlation is calculated for the current year-on-year change and with delays of one to four months, the chart showing the maximum correlation (the correlation has values between -100 and 100, where 100 implies perfect synchronisation).

Source: CaixaBank Research, based on INE data.

1. Specifically, for each component i the following model is estimated: $\pi^{comp_i} = \alpha + \beta_j \pi^{comp_{i-1}} + \mu_j \pi^{oil_{t-j}}$, where $j = 0, 1, 2$ or 3 and π indicates the year-on-year change in the price index.

KEY INDICATORS

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

Activity indicators

	2015	2016	Q1 2016	Q2 2016	Q3 2016	Q4 2016	01/17	02/17	03/17
Industry									
Electricity consumption	1.7	0.1	-0.8	0.8	0.3	-0.1	5.0	1.2	...
Industrial production index	3.3	1.9	2.6	1.4	1.9	1.8	2.5	...	...
Indicator of confidence in industry (value)	-0.3	-2.3	-1.9	-2.8	-3.8	-0.6	0.1	1.7	-0.9
Manufacturing PMI (value)	53.6	53.2	54.3	52.5	51.4	54.4	55.6	54.8	...
Construction									
Building permits (cumulative over 12 months)	20.0	43.7	45.2	48.1	44.8	36.9	27.5	...	...
House sales (cumulative over 12 months)	10.9	12.9	10.7	14.1	13.3	13.6	15.5	...	...
House prices	1.1	1.9	2.4	2.0	1.6	1.5	-	...	-
Services									
Foreign tourists (cumulative over 12 months)	5.6	8.2	5.9	7.5	9.3	10.1	10.3	10.2	...
Services PMI (value)	57.3	55.0	54.7	55.5	54.9	54.9	54.2	57.7	...
Consumption									
Retail sales	3.0	3.6	3.8	3.8	3.8	3.0	-1.1	0.4	...
Car registrations	21.3	11.4	8.0	17.8	11.0	8.9	10.6	0.1	...
Consumer confidence index (value)	0.3	-3.8	-2.5	-3.2	-6.1	-3.2	-2.5	-3.8	-2.2

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

Employment indicators

	2015	2016	Q1 2016	Q2 2016	Q3 2016	Q4 2016	01/17	02/17
Registered as employed with Social Security¹								
Employment by industry sector								
Manufacturing	2.2	2.8	2.8	2.7	2.7	2.8	3.0	2.9
Construction	4.7	2.6	2.6	2.1	2.7	3.3	4.7	5.0
Services	3.5	3.2	3.1	3.0	3.3	3.5	3.4	3.4
Employment by professional status		3.5						
Employees	3.5	3.5	3.4	3.1	3.5	3.8	3.9	3.9
Self-employed and others	1.9	1.0	1.2	1.0	0.9	0.9	0.9	0.9
TOTAL	3.2	3.0	3.0	2.7	3.0	3.3	3.3	3.4
Employment²	3.0	2.7	3.3	2.4	2.7	2.3	-	...
Hiring contracts registered³								
Permanent	12.3	14.2	8.3	17.4	17.9	13.3	19.5	8.4
Temporary	11.2	7.2	6.2	9.1	7.1	6.6	16.7	5.1
TOTAL	11.3	7.8	6.4	9.8	7.9	7.1	16.9	5.4
Unemployment claimant count³								
Under 25	-11.0	-12.6	-10.9	-12.0	-14.4	-13.2	-12.3	-14.0
All aged 25 and over	-7.2	-8.2	-7.8	-7.5	-8.6	-9.0	-9.2	-9.3
TOTAL	-7.5	-8.6	-8.1	-7.9	-9.1	-9.4	-9.4	-9.7

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

	2015	2016	Q1 2016	Q2 2016	Q3 2016	Q4 2016	01/17	02/17	03/17
General	-0.5	-0.2	-0.7	-0.9	-0.2	1.0	3.0	3.0	2.3
Core	0.6	0.8	1.0	0.7	0.8	0.9	1.1	1.0	...
Unprocessed foods	1.8	2.3	2.1	2.7	3.5	1.0	2.7	5.4	...
Energy products	-9.0	-8.4	-13.1	-13.6	-8.6	1.6	17.5	16.8	...

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

	2015	2016	Q1 2016	Q2 2016	Q3 2016	Q4 2016	01/17
Trade of goods							
Exports (year-on-year change)	4.3	1.7	0.2	4.3	-1.1	3.2	17.4
Imports (year-on-year change)	3.7	-0.4	-0.7	-0.3	-3.7	3.0	19.0
Current balance	14.7	21.8	15.4	18.9	20.7	21.8	22.6
Goods and services	26.2	32.9	26.1	29.3	31.2	32.9	32.8
Primary and secondary income	-11.5	-11.1	-10.6	-10.3	-10.6	-11.1	-10.2
Net lending (+) / borrowing (-) capacity	21.7	23.6	22.2	25.4	26.2	23.6	25.1

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

Public sector

Percentage GDP, cumulative in the year, unless otherwise specified

	2015	2016	Q1 2016	Q2 2016	Q3 2016	Q4 2016	01/17
Net lending (+) / borrowing (-) capacity¹	-5.1	-4.5	-0.7	-3.0	-2.8	-4.5	-
Central government	-2.6	-2.7	-0.8	-1.9	-2.6	-2.7	-0.5
Autonomous regions	-1.7	-0.8	-0.1	-0.6	-0.1	-0.8	-0.1
Local government	0.5	0.6	0.1	0.1	0.5	0.6	-
Social Security	-1.2	-1.6	0.2	-0.6	-0.6	-1.6	0.1
Public debt (% GDP)	99.8	99.4	101.1	101.0	100.3	99.4	-

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

	2015	2016	Q1 2016	Q2 2016	Q3 2016	Q4 2016	01/17	Balance 01/17 ¹
Financing of non-financial sectors²								
Private sector	-3.9	-2.6	-3.2	-2.9	-2.1	-2.1	-1.7	1,634.9
Non-financial firms	-4.0	-2.8	-3.4	-3.2	-2.2	-2.2	-1.7	914.2
Households ³	-3.6	-2.3	-3.0	-2.5	-2.0	-1.9	-1.7	720.7
General government ⁴	4.0	3.9	3.5	4.2	4.6	3.1	3.9	1,098.6
TOTAL	-1.0	-0.1	-0.6	-0.2	0.5	-0.1	0.5	2,733.5
Liabilities of financial institutions due to firms and households								
Total deposits	-1.0	-0.3	-0.4	-0.3	-0.3	-0.1	-1.0	1,152.3
On demand deposits	18.5	16.6	16.2	16.0	16.4	17.8	17.3	444.6
Savings deposits	12.9	12.4	13.4	12.1	11.5	12.5	13.9	279.6
Term deposits	-15.3	-17.2	-15.4	-16.4	-17.4	-19.7	-23.0	406.8
Deposits in foreign currency	5.6	-1.1	-4.0	1.6	-1.9	0.1	-1.5	21.3
Rest of liabilities ⁵	-13.0	-15.7	-16.7	-16.3	-11.3	-18.6	-18.9	84.0
TOTAL	-2.2	-1.6	-1.9	-1.7	-1.2	-1.6	-2.4	1,236.3
NPL ratio (%)⁶	10.1	9.1	10.0	9.4	9.2	9.1	9.2	-
Coverage ratio (%)⁶	58.9	58.9	59.0	58.7	59.3	58.9	58.9	-

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.

PENSIONS: A NECESSARY DEBATE

Pension reform: an unavoidable debate

The latest reform of the Spanish pension system was in 2011. This was the system's fifth reform in the country's democratic period and probably one of the most ambitious. The legislation provided for the pension system to be revised after five years so, in November 2016, a parliamentary committee was set up for this very purpose. As pointed out by its chair, Celia Villalobos, «today's pensions are guaranteed; the reform we want to carry out is to ensure the pensions of the future». We should therefore look at the factors affecting the pension system in the long term. Having established this frame of reference, we can then explore the big decisions that need to be taken for its reform.

One crucial aspect frequently brought up in public discussions is how demographics will affect the pension system. Europe is facing the combination of a longer life expectancy and progressive ageing of its population, the latter due to no small extent to the decline in the birth rate over the past decades, which is set to continue. But these trends are particularly strong in Spain. According to the INE, Spain's birth rate in 2015 was 9 births for every thousand inhabitants. But this will fall to 6.6 per thousand by 2030 and to 5.6 per thousand by 2060. It is true that the decline in the birth rate intensified due to a cyclical contraction in Spain's economy (with two recessions in 2008-2009 and 2011-2013). But the underlying trend predicted by the INE is one of fewer births even once the economy begins to grow again. Regarding life expectancy, by 2060 the average lifespan is expected to be eight years longer than at present. This means that, while 16% of Spain's population is currently over 67, as from the 2040s this figure will be 30%.

The pension system is also feeling the pressure from the trend in labour income. According to available empirical evidence, the labour income share has fallen globally over the past few decades and Spain is no exception. In 1999 this share accounted for 62% of total income while, in 2016, it was 56%.¹ As with the birth rate, this trend is due to both structural and cyclical factors. Structural factors include technological advances and globalisation, two phenomena that tend to increase the return on the capital factor compared with the labour factor. But these underlying trends have also become stronger during the aforementioned recessionary cycle, since the labour factor bore the brunt of the adjustment.

Nevertheless, it is all too easy to become simplistic when talking about pensions. For example, one of the recent proposals most widely covered by the media is the need to tax robots, potentially as a source of funding for pensions. First there is the difficulty in defining the «taxable base», so to speak (what is a robot, ultimately? An algorithm plus a machine or merely an algorithm?). But it also seems counterproductive to interfere in the accumulation of capital goods as this would directly hinder innovation and end up blocking a vital source of future prosperity (and therefore future pension funding).

Given such demographic pressures and labour market changes, one key issue is the likely trend in state pension expenditure related to GDP.² And this largely depends on the demographic trend itself: as a society becomes older, the number of pensioners in relation to the working age population increases (in other words the dependency ratio or demographic factor). If the other parameters remain constant, pension expenditure will therefore be higher. A second factor is the ratio between the pension received and the funds financing it; i.e. between the average pension and the average wage (known as the replacement rate). The larger a pension in relation to wages, the higher the pension expenditure. A third factor is related to the labour market. If the employment rate (the ratio of employed people to the working age population) falls, then pension expenditure (as a percentage of GDP) increases. Although this may seem paradoxical, we should remember that, the smaller the proportion of the working age population that is actually employed, the smaller the GDP and, consequently, the larger the spending on pensions as a percentage of that GDP.

So how much leeway do we actually have to adjust the pension system? Demographics strongly influence the dependency ratio, the labour market, its employment rate and the labour income share. Consequently, in an extreme scenario, the choice is between higher spending on pensions which will result in a higher replacement rate or lower spending on pensions in exchange for a

1. For a more detailed view of this issue, see the Dossier «Labour income share in perspective» published in MR02/2014, and the article «On the distribution of corporate income» in the Dossier published in MR02/2017.

2. The breakdown is as follows: Pension expenditure/GDP = (number of pensions/working age population) x (average pension/average wage) x (working age population/number of workers) x (total wages/GDP).

Pension expenditure in different scenarios

	Pension expenditure (% of GDP)	Dependency ratio * (%)	Replacement rate ** (%)	Employment rate (%)	Total wages *** (% of GDP)
Current situation	10.7	31.0	43.9	55.8	43.9
2050 simulations					
Current replacement rate					
Unfavourable employment and lower dependency ratio	22.6	64.3	43.9	60.0	48.0
Very favourable employment and lower dependency ratio	19.4	64.3	43.9	70.0	48.0
Unfavourable employment and lower dependency ratio	18.4	52.3	43.9	60.0	48.0
Very favourable employment and lower dependency ratio	15.8	52.3	43.9	70.0	48.0
Pension expenditure fixed at 12% of GDP					
Unfavourable employment	12.0	64.3	23.3	60.0	48.0
Very favourable employment	12.0	64.3	27.2	70.0	48.0

Notes: * Ratio between the number of pensions and the working age population. ** Ratio between the average pension and the average wage. *** Share of wages in GDP.

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

lower replacement rate. And this is precisely the question the Bank of Spain has attempted to answer in a recent exercise.³ Although the institution has produced numerous scenarios (see the enclosed table for a selection), we merely need to look at the most illustrative of these: if pension expenditure as a percentage of GDP increases slightly (12% of GDP in 2050, higher than the current 10.7%), the replacement rate will fluctuate between 23.3% and 27.2% (currently 43.9%) depending on the employment rate achieved. If the current replacement rate remains the same, in 2050 pension expenditure as a percentage of GDP will be between 15.8% and 22.6%.

Society is therefore faced with a very tough choice. And the pension system certainly seems to be heading in this direction. But it is not inevitable. There are two types of measure: for the first there is, in principle, general consensus but the second are more open to discussion. And to provide alternatives that do not suppose any undesirably extreme future scenarios, pension reform will probably have to be based on both types.

The first measures are indirect; i.e. they can have a positive effect on different parameters related to the system's sustainability. Two actions are particularly key. First, to reduce the shadow economy and thereby improve public revenues. A second action which is widely accepted is a whole package of structural measures aimed at improving growth potential. This would particularly be achieved by creating a more efficient labour market and human capital more in line with future demand. Ultimately, these two aspects should result in a higher employment rate (one of the factors which, as we have seen, are directly linked to pension expenditure).

But there is another package of more direct measures that act on the parameters of the pension system. These are issues which, in one way or another, have been covered by the reforms carried out by the advanced countries since 2007. They include decisions to help delay the effective retirement age and to automatically adjust pensions in order to improve the system's financial sustainability. Although all these issues are relevant, and will probably be discussed, in our opinion there are others that also need to be considered. Three areas in particular should also be explored and we devote the next articles in the Dossier to these: the need for a more flexible concept of working life after retirement, the discussion of sources of funding for the system and the essential use of private, long-term savings schemes.

As Woody Allen said, we are all concerned about the future because that is where we are going to spend the rest of our lives. And, as is almost always the case, he has hit the nail on the head. The pension debate certainly concerns how we wish to live, work, produce and consume in a future which, although it may seem distant, is nevertheless just around the corner in historical and generational terms. As in this article, those that follow explore those aspects of this future which will affect pensions. We trust that, one way or the other, they help to place an unavoidable discussion on the right track.

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3. Hernández de Cos, P. et al. (2017), «El sistema público de pensiones en España: situación actual, retos y alternativas de reforma», Documentos Ocasionales, no. 1701, Bank of Spain.

A longer life and a more active retirement

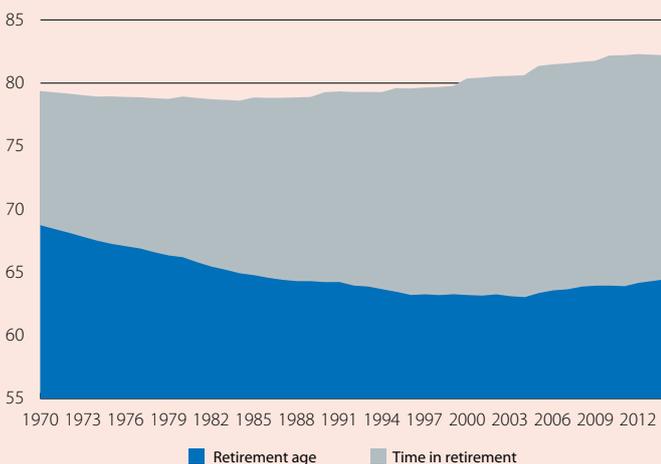
Do you ever feel there's just not enough time in one day to do everything you want? Don't worry. Although you may not believe it, our life expectancy is increasing by about four hours every day.¹ This increase in longevity has been, and will continue to be, so enormous that it warrants closer inspection, especially in the context of pensions and how our working lives are organised.

Life expectancy has increased considerably since the first state pension system was introduced in Spain in 1919, called the Retiro Obrero Obligatorio. At that time, life expectancy at birth was 42 for women and 40 for men and hardly a third of each generation reached 65, the age set for retirement. In 2015 Spain's life expectancy was 85 for women and 80 for men. And more than 90% of each generation lives longer than 65 years.

Moreover, life expectancy is likely to continue increasing substantially over the coming years. Just how much life expectancy will increase is not certain as this depends, for instance, on future medical advances. But recent studies suggest that, in the advanced countries, it might exceed 90 for women in 2030, a figure that would have been unimaginable just a few years ago.² For Spain in particular, in 2030 women are expected to live 87.4 years on average and men 82.3 years. Most of this longer life expectancy will be due to people over 65 dying later in life.

Average retirement age and years in retirement in the OECD

(Years)



Source: CaixaBank Research, based on OECD, (2015), «Pensions at a Glance».

longer. In OECD countries, men have gone from being retired for 11 years on average in 1970 to 18 years in 2013 (see the first chart). Only some countries, such as Denmark, have implemented retirement systems where the retirement age increases automatically with the life expectancy.

This increased longevity, in many cases accompanied by good health, has extended the range of activities older people can carry out. One of these is being able to work in good health for longer. This is already happening to some extent as the labour participation of older people has increased and is likely to go on doing so (see the Focus «Labour markets in the euro area after the crisis: a reality check» in MR11/2016). But the improvement in health allows for an even greater increase. For instance, Wise and his co-authors have estimated that, if workers aged between 55 and 69 in 2010 worked the same as those with the same state of health in 1995, they could work around 1.7 years longer on average in the 12 advanced countries studied.⁵

But longer lives will also include a more «healthy years». According to the OECD, around half the life expectancy after 65 will be enjoyed in good health.³ But this longer and better quality life in general does not preclude significant differences at an individual level. Factors such as different habits and exposure to health hazards will still affect our life expectancy. One example of such disparities is the life expectancy of individuals with different levels of educational attainment. For instance, men aged 65 with a higher level of education have 3.5 years more life expectancy than men with an educational attainment below the compulsory secondary level.⁴

These substantial changes in longevity have not been accompanied by equivalent changes in the retirement age. The average retirement age actually fell between 1970 and the mid-2000s, partly due to many people taking early retirement, and this trend has only started to reverse in the past ten years. Consequently, people are now retired for

1. According to Eurostat, the daily increase in life expectancy at birth in Spain between 2015 and 2030 is 4.2 hours for men and 3.4 hours for women.

2. Kontis *et al.* (2017), «Future life expectancy in 35 industrialised countries: projections with a Bayesian model ensemble», The Lancet.

3. OECD (2015), «Health at a glance».

4. Murtin, F. *et al.* (2017), «Inequalities in longevity by education in OECD countries: Insights from new OECD estimates», OECD Statistics Working Papers.

5. Wise, D., Coile, C. and Milligan, K. (2016), «Social Security and Retirement Programs around the World: the Capacity to Work at Older Ages», NBER Working Papers no. 21939.

Another factor that makes it easier to work for longer is technological change, as this reduces the difficulty and physical effort required by many jobs. Technological innovations help to curtail the physical limitations that might have otherwise ended a working life. And new technologies such as robotization increase worker productivity. Older workers who benefit from this (in general those with a higher educational attainment) can increase their productivity and lengthen their working lives.

But technological and demographic changes, among other factors, do not have the same impact on all the older population that is still able to work. One sign of this greater heterogeneity is the change in the employment rate by educational attainment of the older population between 2000 and 2015 (see the second chart). The probability that some workers continue working beyond a certain age differs depending on their educational attainment and their job, and these differences have increased. While a university lecturer can continue giving classes beyond a certain age and their greater experience may be beneficial, it is less feasible to prolong working lives in other, more physical professions. However, the pension system's design is almost binary in nature, going from full-time work to full-time retirement for all workers. Such was the situation in the past, when retirement was more because of physical limitations than any decision by the individual.

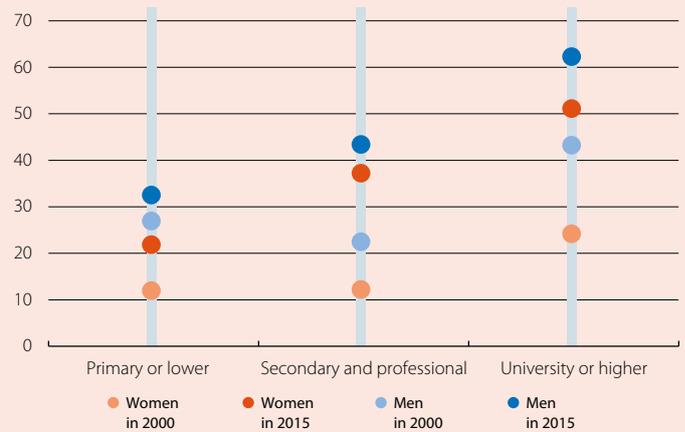
A more flexible division between working life and retirement would therefore be useful for those people who would like to do both. For instance, pension systems could allow retired people to work without penalising them financially. Empirical evidence shows that a lot of people carry on working beyond retirement age when there is a financial incentive to do so.⁶

But barriers to employment must also be reduced to increase the share of the older population in employment. We need to recognise that older people can still make a contribution to society as workers and provide them with the flexibility they need to continue working. Lastly, it is also important to improve the employability of older workers. In this respect, it will be crucial to encourage continued learning among workers, in particular given the pace of technological change.

A longer lifespan entails important challenges for the advanced countries such as how to finance their pension systems (see the article «How to finance pensions» in this Dossier) and long-term savings (see the article «Private savings for retirement: a complement to state pensions» in this Dossier). But, as we have seen, it also increases their response capacity. The generation born tomorrow will live four hours longer. Our challenge as a society is to ensure they can live those hours better.

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Employment rate of people aged 60-64 by educational attainment
(% of the working age population)



Source: CaixaBank Research, based on Eurostat data.

6. Gruber, J. and Wise, D. (2004), «Social Security and Retirement Programs around the World: Micro Estimation», University of Chicago Press.

How to finance pensions

The substantial increase in life expectancy and therefore the share of the population of retirement age represents a challenge for the state pension system. This article analyses how the Social Security system is financed and explores how the revenue system used to support Spain's pension system could be improved.

The Spanish Social Security system is currently financed mostly via contributions, accounting for 85% of all the system's income. The rest comes from the state budget and is used to meet the cost of non-contributory pensions,¹ so it has zero effect on the Social Security income statement.

Funding pensions via Social Security contributions is widespread across European countries and a key feature of contributory pension systems. In Spain, contributions represent 11.4% of GDP, a slightly lower level than in France (16.9%), Italy (13.1%) or Germany (14%). Nevertheless, the governments of these countries spend slightly more on pensions than Spain, as well as a higher tax burden in general.

Given the contributory nature of Spain's pension system and the firm commitment of the Toledo Pact to keep it that way, what additional income can be found to curtail the decline in the pension replacement rate?²

First, revenue from Social Security contributions could be increased. This could be achieved in different ways: increasing the number of people who contribute to the system, increasing the effective contribution paid per worker or a combination of both.

The number of contributors to the system can be increased by focusing efforts on creating more growth and employment and by encouraging people to work. In 2016, the unemployment rate stood at 19.6%, much higher than the EU-28 average (8.5%). An unemployment rate close to the EU-28 average would therefore help to bring Social Security's current deficit down and almost balance the budget. But in the medium term, if the decline in the replacement rate is to be minimised, we must employ measures that go beyond improving the labour market. Especially as the projected ageing of the population will increase the number of pensioners in relation to the number of workers, as explained in the article «Pension reform: an unavoidable debate» in this Dossier.³

It is therefore useful to explore the other mechanism to boost revenue, namely by increasing the contribution per worker. This can be done in several ways: by raising the tax rate, eliminating wage-based ceilings for contributions or limiting the use of tax breaks and exemptions for specific groups with employability problems. But all these measures are controversial to some extent. The main drawback, and this applies to all of them, is that an increase in revenue via Social Security contributions pushes up labour costs, making Spanish companies less competitive and potentially harming employment.

Given the limited scope to act on Social Security contributions and its associated problems, to what extent can part of pensions be funded via taxes? Insofar as certain pensions currently financed via Social Security contributions act more like a safety net, it would not be unreasonable to include them within non-contributory pensions, funded via taxes. The contributory pension could then be limited to retirement pensions, which currently account for 71% of all contributory pension expenditure, and the money for the rest of the pensions (essentially for widows, widowers and orphans) would come from the central government budget. This would cut Social Security's current burden of expenditure by approximately EUR 20 billion.

1. People in a specific situation of need and who lack sufficient resources to survive are entitled to non-contributory pensions for disability and retirement. These are not related to Social Security contributions.

2. The replacement rate is defined as the percentage of income received in retirement in relation to the prior income when working.

3. See also the Dossier «The demographic challenge» in MR10/2015.

Tax system in Europe

(% of GDP)

	Tax revenue	Of which: Social Security contributions
Austria	43.5	14.8
Belgium	44.8	14.3
Finland	44.0	12.7
France	45.5	16.9
Germany	36.9	14.0
Greece	36.8	10.7
Italy	43.3	13.1
Norway	38.1	10.4
Portugal	34.5	9.0
Spain	33.8	11.4
Sweden	43.3	9.8

Note: Data from 2015.

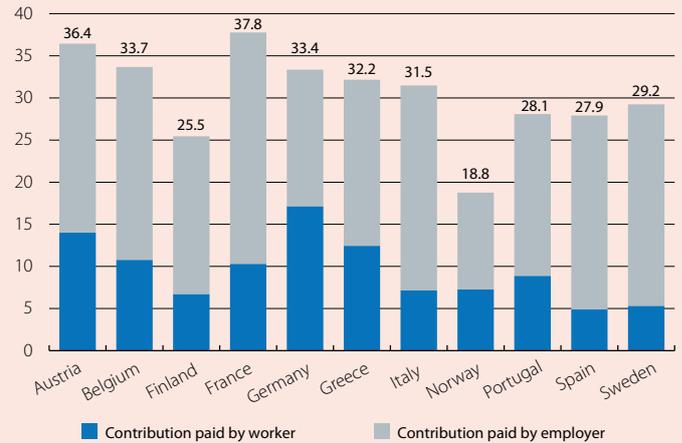
Source: CaixaBank Research, based on OECD data.

But we must realise that merely taking the money from one budget or another will not resolve the underlying problem. To finance pensions, fiscal pressure will have to be increased or other expenditure reduced in the central government budget.

There are several different ways this can be achieved. For instance, via tax reform that widens taxable bases by eliminating tax breaks and exemptions. Revenue could also be increased by making a greater effort to minimise the black economy, estimated in Spain at around 18.5% of GDP,⁴ much larger than in Germany (13.3%), France (10.8%) or the UK (9.6%). Reducing Spain’s black economy to Germany’s level would augment state coffers by EUR 17-20 billion, a similar figure to the current Social Security deficit.

In short, although there is no magic wand to improve the funding of pensions, there is considerable scope for action. It is vital to evaluate the different options in order to choose the best path.

Social Security contributions
(% of labour costs)



Note: Data from 2015.
Source: CaixaBank Research, based on OECD data.

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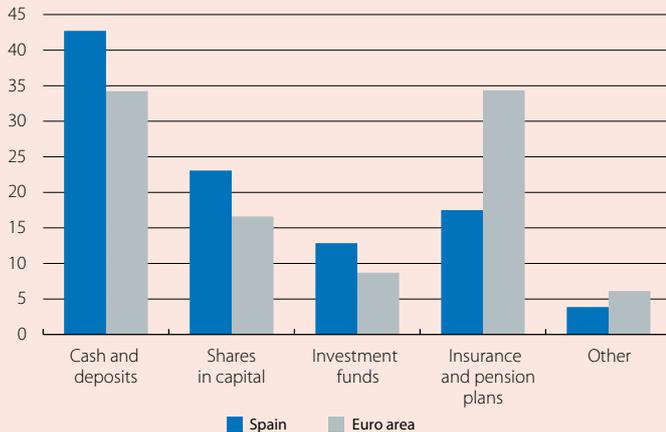
4. Data from 2014. See Schneider, F., Raczkowski, K. and Mróz, B. (2015), «Shadow economy and tax evasion in the EU», Journal of Money Laundering Control.

Private savings for retirement: a complement to state pensions

Reform of state pension systems is one of the issues that are currently stirring up most debate in developed countries. One of the methods frequently proposed to reduce pressure on state pension systems is by complementing retirement funding via private savings. In fact, private pension plans already play an important role in channelling retirement savings in many countries.

Structure of household financial savings

(% of financial assets)



Note: Data from Q3 2016.

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

But private savings are still quite negligible in Spain compared with its peers. The financial accounts for Q3 2016 indicate that pension and insurance plans, specific instruments to save for retirement, accounted for 18% of all household financial assets compared with 34% for the euro area as a whole. The proportion of investment funds and shares, however, was 10 pp higher in Spain (36% vs. 26%). In any case the still preferred way to save money, both in Spain and the euro area, is via deposits (see the chart).

Housing and property in general also makes up a large proportion of Spanish household assets. The proportion of households that own their main residence is 83% in Spain, notably higher than the 61% observed in the euro area and almost double Germany's 44%. If we add other property owned, such as second homes, then the proportion of Spanish households that own property rises to 87%.¹

One possibly surprising fact is that the percentage of Spanish households with a pension or insurance plan remained almost unchanged between 2005 and 2014. In fact, it declined slightly from 29% to 26%. This is certainly due to the economic crisis (for instance, there is a notable reduction in the percentage of households with pension plans where the reference person is self-employed). Given the economic recovery and low interest rates since 2014, it is very likely that this trend has now reversed.

As in other countries, the propensity to take out a pension plan tends to increase with age. In Spain, 31% of households where the reference person is 35–44 years old have a pension or insurance plan, while this percentage rises to almost 40% from 45 up to 65. In general, people tend to start late and save little, limiting the complementary contribution that can be made by private savings for retirement. Delaying the start of saving for retirement actually has a significant cost, as it fails to take advantage of the multiplier effect of compound interest. This can be illustrated by a simple example. Contributions of EUR 3,000 per year (increasing 2% each year, approximately in line with inflation) for 40 years with an average annual return of 5% (achievable if part of the savings portfolio is invested in equity) would provide a retirement capital of EUR 507,355. On the other hand, if the decision was taken to make larger contributions but starting later, the outcome would clearly be inferior: contributions equivalent to EUR 6,000 per year as of today (also increasing by 2% each year), starting within 20 years and for 20 years, would become EUR 364,270.

It is particularly important to plan early for retirement in the current low interest rate environment. A longer timeframe means that a larger proportion of savings can be invested in assets that offer a better long-term combination of expected yield and risk, such as equity.

The area of economics that studies how people act, known as behavioural economics,² identifies three conducts that influence the decisions made by individuals and can explain this lack of discipline in saving. First, we tend to delay decisions with no short-term benefit but which are nevertheless difficult or unpleasant to take. This behaviour is known as procrastination. It has also been shown that, in many cases, we underestimate the importance of good planning for the future, known as myopia or a short-sighted attitude. Finally, academic literature has demonstrated that a lot of decisions are taken through inertia and that we often find it difficult to change our pattern of behaviour. Procrastination, myopia and inertia are three human traits that, applied to long-term savings, help us to understand why, in many cases, we take too long to start saving for our retirement and why we save too little once we do start.

1. European Central Bank (2016), «Eurosysteem Household Finance and Consumption Survey».

2. See Benartzi, S. and Thaler, R. H. (2013), «Behavioral Economics and the Retirement Savings Crisis», Science Magazine, Vol. 339.

Most countries offer tax breaks to encourage people to take out private pension plans, such as discounting contributions from the income tax base (up to a limit), thereby delaying the payment of tax on this portion of income and its interest until it is paid out in retirement. But some countries have gone further and have opted to implement a mandatory or quasi mandatory private pension system that imposes a minimum obligatory contribution. A more flexible alternative that helps to improve discipline in saving but without forcing people is automatic enrolment. In such systems, companies must sign up workers with a pension fund when they join. Employees then have the chance to modify their level of contribution and even leave the fund. These automatic plans were implemented, for instance, in the US, UK, Italy and New Zealand with an overall positive impact on the household savings rate. Another advantage of automatic enrolment is that, as a reform, it is politically more attractive to impose than making contributions compulsory.

Another increasingly important tool to encourage people to plan properly for their retirement are financial education programmes. In the past few years, the major international institutions such as the IMF, OECD and G-20 have all stressed their importance, as well as warning about the low level of financial awareness among large segments of the population in the advanced countries. One such programme is the Financial Education Plan (Plan de Educación Financiera) set up in Spain in 2008 under the leadership of the National Securities Market Commission (CNMV) and the Bank of Spain to enhance the population's financial literacy levels, providing the basic knowledge and tools required so that people can manage their finances in a responsible and informed way.

In short, given the pressure that state pension systems are under, private plans are likely to become much more important as a complementary source of income in retirement. Measures such as tax breaks, automatic enrolment in company pension plans and financial education can all help to raise awareness of people's need to plan properly for retirement in line with their own priorities and needs.

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CAIXABANK GROUP: KEY FIGURES

As of December 31, 2016

	MILLION €
Customer funds	303,895
Loans and advances to customers, gross	204,857
Profit attributable to Group	1,047
Market capitalisation	18,768
Customers (million)	13.8
CaixaBank Group employees	32,403
Branches in Spain	5,027
Self-service terminals	9,479

"la Caixa" BANKING FOUNDATION COMMUNITY PROJECTS: BUDGET 2017

	MILLION €
Social	304.2
Excellence in research and training	79.6
Raising awareness of culture and knowledge	126.2
TOTAL BUDGET	510

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