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MONTHLY REPORT • ECONOMIC AND FINANCIAL MARKET OUTLOOK

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ECONOMIC & FINANCIAL ENVIRONMENT

DOSSIER: EUROPE'S MOMENT

CaixaBank Research

MONTHLY REPORT - ECONOMIC AND FINANCIAL MARKET OUTLOOK
September 2017

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An opportunity for Europe

After Germany goes to the polls on September 24, the EU will face a watershed. It will have a potentially unique window of opportunity to decide what kind of Europe should be built and which reforms are needed to underpin it.

Several converging factors have brought about this opportunity. The outcome of the French and Dutch elections, in which Europhobic populism was defeated by pro-European parties; the commitment to Europe of Germany's main presidential candidates; the UK's imminent departure from the EU, an important member that repeatedly opposed deeper integration; Trump's presidency, which makes it even more crucial for the Union to have a strong foreign policy; and the terrorist threat, which highlights the importance of effective Europe-wide coordination, at least in issues of security and intelligence.

There's also broad consensus that further European integration is needed, especially to reinforce the single currency's institutional architecture. Over the past few years a large number of undeniably far-reaching reforms has been carried out, such as banking union and the creation of the European Stability Mechanism (ESM). But we can, and must, make further progress down this road and it is better to make a start now than to wait until circumstances force urgent action.

In the first place, banking union has helped to reduce the risk of contagion between sovereigns and banks, but this union is far from complete. There is a need for a single, Europe-wide deposit guarantee scheme with indebtness capacity or access to a lender of last resort. And the legislative frameworks of the different countries need to be more standardised, such as in insolvency law, to foster economies of scale and encourage the creation of pan-European banks. There are also doubts regarding the effectiveness of the current bank resolution framework in the case of a hypothetical systemic crisis, especially when there is no strong central fiscal authority.

In fact, monetary and also banking union would surely be most strongly reinforced by creating a European fiscal authority. This is something Germany and France agree about. They both believe the euro area should have an Economics and Finance Ministry but differ widely as to the powers it should be granted. President Macron prefers a strong joint budget that could finance large investment projects and act as a means of macroeconomic stabilisation should perturbations affect different countries in different ways. Merkel, however, wants a ministry devoted to coordinating the fiscal policies and structural reforms of member states, with funds to reward the implementation of desired policies. Both these focuses require sovereignty to be relinquished. European institutions will therefore need greater political legitimacy.

In all likelihood, the most ambitious leap, namely political union, is still a long way off but some steps will certainly have to be taken down this road. Just how far we can go remains to be seen. Without doubt, the words of José Ortega y Gasset, written before the Second World War, are still highly relevant today: «The real situation of Europe would, then, appear to be this: its long and splendid past has brought it to a new stage of existence where everything has grown; but, at the same time, the institutions surviving from that past are dwarfed and have become an obstacle to expansion. Europe has been built up in the form of small nations. In a way, the idea and the sentiment of nationality have been her most characteristic invention. And now she finds herself obliged to exceed herself. This is the outline of the enormous drama to be staged in the coming years. Will she be able to shake off these survivals, or will she remain forever their prisoner?».

Enric Fernández
Chief Economist
31 August 2017

CHRONOLOGY

AUGUST 2017

16 Work begins on renegotiating the North American Free Trade Agreement (NAFTA).

JUNE 2017

8 The Conservative Party wins the elections in the UK but loses its absolute majority in parliament.
14 The US Federal Reserve raises the benchmark interest rate by 25 bp to 1%-1.25%.
18 In France, President Macron's party, La République En Marche (LRM), secures an absolute majority in the National Assembly.

MAY 2017

7 Emmanuel Macron is elected President of France.
24 Moody's downgrades China's sovereign credit rating by one notch, from Aa3 to A1.
25 OPEC agrees to extend its oil production cuts until March 2018.

APRIL 2017

16 Turkey ratifies its proposed constitutional reform in a referendum.
19 The British parliament votes in favour of an early general election on 8 June.

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.

AGENDA

SEPTEMBER 2017

4 Registration with Social Security and registered unemployment (August).
7 Governing Council of the European Central Bank.
8 Industrial production index (July).
Loans, deposits and NPL ratio (June).
State budget execution (July).
15 Quarterly labour cost survey (Q2).
20 Fed Open Market Committee.
21 European Council.
22 International trade (July).
26 Loans, deposits and NPL ratio (July).
28 State budget execution (August).
CPI flash estimate (September).
Economic sentiment index of the euro area (September).
29 Balance of payments (July and Q2).
Net international investment position (Q2).

OCTOBER 2017

2 Household savings rate (Q2).
3 Registration with Social Security and registered unemployment (September).
6 Industrial production index (August).
16 Financial accounts (Q2).
18 Loans, deposits and NPL ratio (August and Q2).
20 International trade (August).
26 Governing Council of the ECB.
Labour force survey (Q3).
27 US GDP (Q3).
30 Economic sentiment index of the euro area (October).
CPI flash estimate (October).
GDP flash estimate (Q3).
31 Balance of payments (August).
State budget execution (September).
GDP of the euro area (Q3).

Europe, one step forward

A peaceful summer in macroeconomic and financial terms. The indicators published throughout July and August continued to indicate that global economic activity is expanding at a good pace and reinforced the scenario of world growth speeding up: the global economy is set to grow by 3.5% in 2017, considerably faster than in 2016 (3.1%). However, significant global sources of risk still hover over this strong macroeconomic and low volatility environment. Specifically, geopolitical tensions are one source of concern, especially after the heightening of diplomatic tensions between the US and North Korea during the summer. Moreover, as the US economy entered a more mature phase of the business cycle, investors are becoming more sensitive to the release of economic activity indicators coming in lower than expected. One example of this is the recent weakness in both the US dollar and US Treasury yields, which have failed to recover despite the Fed's clear intention to continue its monetary policy normalisation and the good US GDP growth figure for Q2 (2.2%). Lastly, despite the fact that China's economy continues to expand at a good rate, doubts regarding its financial system persist. Consequently, although the prospects for the world economy for the last part of the year are good, there is no room for complacency.

The euro area steps up a gear. In this generally positive international environment with nevertheless important sources of risk, growth in the euro area is finally getting firmer after years of tepid performance. In particular, euro area GDP grew by 2.2% year-on-year in Q2 2017, exceeding the 2% growth threshold for the first time since the 2011-2013 recession, and continuing with the more positive growth dynamic of the past few quarters. Moreover, this stronger growth is broad-based, both across countries and sectors, as the solid GDP growth rates in the main euro area economies for Q2 show (Germany, 2.1%, France, 1.7%, and Italy, 1.5%). Different factors have contributed to the euro area's improved performance. Besides the factors that were supporting growth in the past few quarters (accommodative financial conditions and relatively low oil prices), domestic risks have also diminished and there is greater confidence in the economic recovery. This has led CaixaBank Research to raise its growth forecasts for the euro area to 2.2% for 2017 and 2.0% for 2018. The European Central Bank (ECB) sees it the same way, and has repeatedly improved its risk assessment throughout the first six months of the year. In addition, in July, this good performance of the euro area economy led the ECB to announce that it was planning to redesign its monetary policy in autumn. All this suggests that, throughout 2018, the ECB will gradually withdraw its asset purchase programme. However, beyond these improved short-term prospects, the euro area is facing the challenge of promoting greater long-term growth and motivating its citizens with a more dynamic economy and deeper political integration. In this respect, the Brexit negotiations, which initially seemed like a blow to European integration, open up the possibility to intensify proposals aimed at strengthening the European project. In fact, this month's Dossier, «Europe's moment», examines the situation of the European political and economic construction process.

The Spanish economy grows at a robust pace. Spanish economic activity continues to post exceptional growth rates, as shown by the 3.1% rise in GDP in Q2, the 9th consecutive quarter in which growth remains above 3%. In the past few years, this good performance has been supported by domestic factors (structural reforms and competitiveness gains) and external factors (accommodative financial conditions and relatively low oil prices). Recently, Spain's growth has also been supported by the positive growth momentum of other euro area economies. Thus, the CaixaBank Research scenario expects growth to remain high over the coming quarters, although it will gradually slow down as the effect of some temporary factors that are supportive of growth (oil prices and the appreciation of the euro) wanes. Spain's strong GDP growth is also having an effect on the labour market, where the unemployment rate has fallen by a cumulative 2.8 pp over the past year. In addition, economic growth is also helping the government to meet its deficit target (3.1% in 2017). Nevertheless, far from becoming complacent, Spain should continue to implement an agenda of reforms to help it deal with less favourable conditions in the future.

FORECASTS

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

International economy

	2015	2016	2017	2018	Q1 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018
GDP GROWTH										
Global	3.4	3.1	3.5	3.7	3.4	3.5	3.6	3.6	3.8	3.7
Developed countries	*2.1*	*1.7*	*2.1*	*2.0*	*2.0*	*2.2*	*2.2*	*2.1*	*2.2*	*2.0*
United States	2.9	1.5	2.1	2.2	2.0	2.2	2.1	2.3	2.4	2.2
Euro area	1.9	1.7	2.2	2.0	1.9	2.2	2.3	2.3	2.2	2.1
Germany	1.5	1.9	2.2	1.9	1.9	2.1	2.3	2.4	2.1	1.9
France	1.0	1.1	1.7	1.7	1.1	1.7	2.0	2.0	1.8	1.7
Italy	0.7	1.0	1.4	1.1	1.2	1.5	1.5	1.3	1.2	1.1
Portugal	1.6	1.4	2.7	2.2	2.8	2.9	2.6	2.5	2.1	2.2
Spain	3.2	3.2	3.1	2.7	3.0	3.1	3.2	3.2	3.0	2.8
Japan	1.1	1.0	1.7	1.0	1.4	2.1	1.9	1.5	1.4	0.7
United Kingdom	2.2	1.8	1.6	1.4	2.0	1.7	1.5	1.1	1.2	1.4
Emerging countries	*4.2*	*4.1*	*4.5*	*4.8*	*4.5*	*4.5*	*4.5*	*4.6*	*4.9*	*4.8*
China	6.9	6.7	6.8	6.3	6.9	6.9	6.7	6.6	6.6	6.4
India	7.5	7.9	6.3	7.3	6.1	5.7	6.5	7.0	7.0	7.2
Indonesia	4.9	5.0	5.1	5.5	5.0	5.0	5.2	5.3	5.5	5.5
Brazil	–3.8	–3.6	0.7	2.1	–0.4	0.3	1.0	2.0	2.2	2.0
Mexico	2.7	2.3	1.9	2.1	2.8	1.8	2.0	1.2	1.5	2.0
Chile	2.3	1.6	1.3	2.6	0.1	0.9	2.1	2.2	2.5	2.6
Russia	–2.8	–0.2	1.6	1.7	0.5	2.5	1.6	1.9	1.6	1.7
Turkey	6.0	2.9	3.7	3.2	5.0	4.0	3.0	2.9	3.0	3.1
Poland	3.9	2.7	4.1	3.1	4.2	4.3	4.5	3.4	3.1	2.8
South Africa	1.3	0.4	0.6	1.6	0.7	0.2	0.5	0.9	1.5	1.6
INFLATION										
Global	2.8	2.8	3.2	3.3	3.2	3.0	3.2	3.5	3.2	3.4
Developed countries	*0.3*	*0.8*	*1.6*	*1.7*	*1.9*	*1.6*	*1.5*	*1.5*	*1.5*	*1.7*
United States	0.1	1.3	1.9	2.0	2.5	1.9	1.7	1.5	1.3	2.0
Euro area	0.0	0.2	1.6	1.6	1.8	1.5	1.4	1.5	1.4	1.6
Germany	0.1	0.4	1.7	1.7	1.9	1.6	1.5	1.6	1.5	1.7
France	0.1	0.3	1.3	1.4	1.5	1.0	1.2	1.4	1.3	1.5
Italy	0.1	0.0	1.5	1.3	1.4	1.6	1.4	1.5	1.3	1.4
Portugal	0.5	0.6	1.5	1.6	1.4	1.7	1.4	1.5	1.4	1.6
Spain	–0.5	–0.2	1.8	1.5	2.7	2.0	1.5	1.0	0.6	1.3
Japan	0.8	–0.1	0.3	0.8	0.3	0.4	0.5	0.2	0.8	0.6
United Kingdom	0.0	0.7	2.6	2.4	2.1	2.7	2.6	2.8	2.5	2.5
Emerging countries	*4.7*	*4.4*	*4.4*	*4.3*	*4.2*	*4.0*	*4.4*	*4.9*	*4.5*	*4.6*
China	1.4	2.0	1.9	2.2	1.4	1.4	2.1	2.9	2.2	2.6
India	4.9	4.9	3.5	3.9	3.6	2.2	3.5	4.8	4.8	4.1
Indonesia	6.4	3.5	3.9	4.3	3.6	4.3	3.9	3.9	3.8	4.3
Brazil	9.0	8.8	3.8	4.3	4.9	3.6	3.2	3.5	4.5	4.2
Mexico	2.7	2.8	5.8	3.8	5.0	6.1	6.2	6.0	4.0	3.8
Chile	4.3	3.8	2.6	3.1	2.8	2.3	2.6	2.6	3.0	3.1
Russia	15.5	7.1	4.3	4.6	4.6	4.2	4.2	4.1	4.2	4.5
Turkey	7.7	7.8	10.4	7.9	10.2	11.5	10.4	9.5	8.4	8.2
Poland	–0.7	–0.2	1.7	2.3	1.7	1.5	1.7	2.0	2.1	2.3
South Africa	4.6	6.3	5.5	5.3	6.3	5.3	5.0	5.3	4.7	5.1

Forecasts

Spanish economy

	2015	2016	2017	2018	Q1 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018
Macroeconomic aggregates										
Household consumption	2.8	3.2	2.5	2.4	2.5	2.5	2.6	2.5	2.6	2.5
General government consumption	2.0	0.8	1.1	0.9	0.5	1.3	1.0	1.4	0.9	0.9
Gross fixed capital formation	6.0	3.1	4.2	3.5	3.9	3.4	4.6	5.0	3.8	3.8
Capital goods	8.8	5.0	5.3	3.5	5.4	4.1	5.4	6.5	3.6	4.0
Construction	4.9	1.9	3.5	3.6	2.9	3.0	3.9	4.1	4.0	3.6
Domestic demand (contr. Δ GDP)	3.3	2.8	2.5	2.3	2.3	2.4	2.6	2.6	2.4	2.4
Exports of goods and services	4.9	4.4	6.3	4.4	7.3	4.5	7.1	6.1	4.2	4.6
Imports of goods and services	5.6	3.3	4.8	3.3	5.7	2.8	5.9	4.9	2.6	3.8
Gross domestic product	**3.2**	**3.2**	**3.1**	**2.7**	**3.0**	**3.1**	**3.2**	**3.2**	**3.0**	**2.8**
Other variables										
Employment	3.0	2.9	2.7	2.3	2.5	2.8	2.5	3.1	2.7	2.5
Unemployment rate (% labour force)	22.1	19.6	17.2	15.5	18.8	17.2	16.3	16.3	16.7	15.5
Consumer price index	–0.5	–0.2	1.8	1.5	2.7	2.0	1.5	1.0	0.6	1.3
Unit labour costs	0.2	–0.4	–0.1	1.0	0.0	–0.4	–0.2	0.3	0.3	1.2
Current account balance (cum., % GDP)[1]	1.4	1.9	2.0	1.8	1.9	1.7	1.8	2.0	1.9	1.9
Net lending or borrowing rest of the world (cum., % GDP)[1]	2.0	2.1	2.2	2.0	2.1	1.9	2.0	2.2	2.1	2.1
Fiscal balance (cum., % GDP)[2]	–5.1	–4.3	–3.1	–2.4						

Financial markets

INTEREST RATES										
Dollar										
Fed Funds	0.26	0.51	1.11	1.94	0.79	1.05	1.25	1.33	1.58	1.83
3-month Libor	0.32	0.74	1.29	1.99	1.07	1.20	1.34	1.54	1.73	1.20
12-month Libor	0.79	1.37	1.82	2.43	1.75	1.75	1.76	2.02	2.21	1.75
2-year government bonds	0.67	0.84	1.41	2.52	1.23	1.28	1.39	1.75	2.09	1.28
10-year government bonds	2.13	1.84	2.42	3.31	2.44	2.26	2.30	2.69	2.99	2.26
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	–0.26	–0.33	–0.33	–0.32	–0.30	–0.30	–0.30
12-month Euribor	0.17	–0.03	–0.12	0.00	–0.10	–0.13	–0.14	–0.10	–0.07	–0.04
2-year government bonds (Germany)	–0.24	–0.58	–0.69	–0.29	–0.78	–0.74	–0.67	–0.57	–0.50	–0.40
10-year government bonds (Germany)	0.53	0.10	0.43	0.85	0.34	0.31	0.46	0.60	0.66	0.71
EXCHANGE RATES										
$/€	1.11	1.11	1.12	1.16	1.07	1.10	1.17	1.16	1.15	1.16
¥/€	134.33	120.30	125.70	130.54	121.05	122.21	129.65	129.91	130.13	130.41
£/€	0.73	0.82	0.87	0.85	0.86	0.86	0.89	0.89	0.87	0.85
OIL										
Brent ($/barrel)	53.64	45.04	52.65	59.21	54.68	50.92	51.01	54.00	56.83	58.50
Brent (€/barrel)	48.33	40.73	46.99	51.07	51.35	46.34	43.92	46.36	49.35	50.58

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

Forecasts

FINANCIAL OUTLOOK · The financial markets enjoy a summer of calm

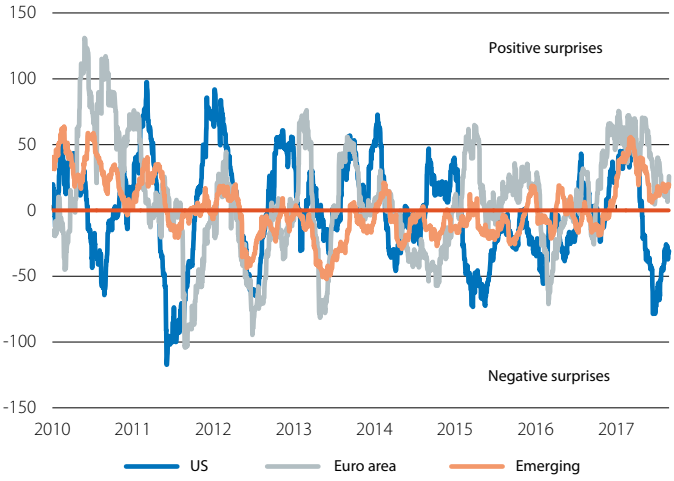
Monetary policy returns centre stage after a quiet holiday season. Global financial markets remained constructive in July and August. The world macroeconomic situation was more stable and financial volatility was low. In the advanced economies, investors are enjoying a better economic outlook owing to the euro area's increasing strength and to continuing solid growth in US economic activity. The messages issued by the US Federal Reserve (Fed) and European Central Bank (ECB) throughout July and August suggested that monetary policy would be readjusted over the coming months. The Fed will start to reduce its balance sheet via a strategy that was calmly received by investors and could begin after its September meeting. Given the improved economic scenario, in the euro area investors expect the ECB to take a less accommodative stance, gradually reducing its asset purchase programme (QE) throughout 2018. The Fed and ECB are altering their monetary policy at a time when investors have also revised upwards the macroeconomic outlook for the emerging economies.

But there are still risks, in spite of the low volatility. Volatility indicators such as the VIX (volatility in equity) and MOVE (volatility in bonds) remained very low throughout the summer except for a brief upswing in response to heightened geopolitical tension between the US and North Korea. This episode, which was resolved in August without serious consequences, reminds us that political uncertainty is still a latent risk factor. There are also doubts concerning some US macroeconomic indicators which were lower than expected. Since asset prices currently reflect such doubts, it is important for these to dissipate over the next few months to convince investors the Fed will continue its gradual normalisation of financial conditions. The high prices achieved by US equity are also a source of concern. Finally, other sources of risk are OPEC's ability to reduce the surplus oil supply and China's financial conditions.

The stock markets of the main advanced economies take a breather. The main stock markets have made significant gains since the beginning of the year, such as the S&P 500, +10.4%; Nikkei, +2.8%; FTSE 100, +4.0%; DAX, +5.0%; CAC, + 4.6% and Ibex 35, +10.1%. But they remained relatively calm during the summer months. Slightly less dynamic in June, in July the main indices were more constructive while there was relatively little trading in August. However, from the 7 to 13 of August, heightened geopolitical tension between the US and North Korea pushed up volatility, resulting in stock market losses. By region, the US stock market continues to break records while the euro area stock markets are more moderate and, in Germany specifically, the downward trend of the past few months continued.

Index of economic surprises

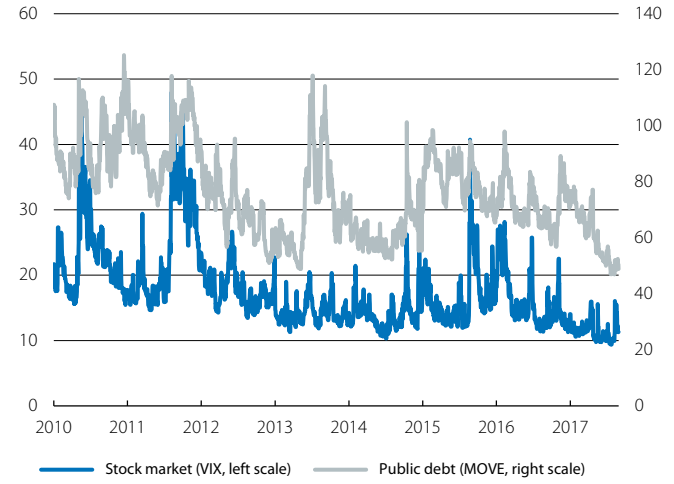
Level



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

Implied volatility in financial markets

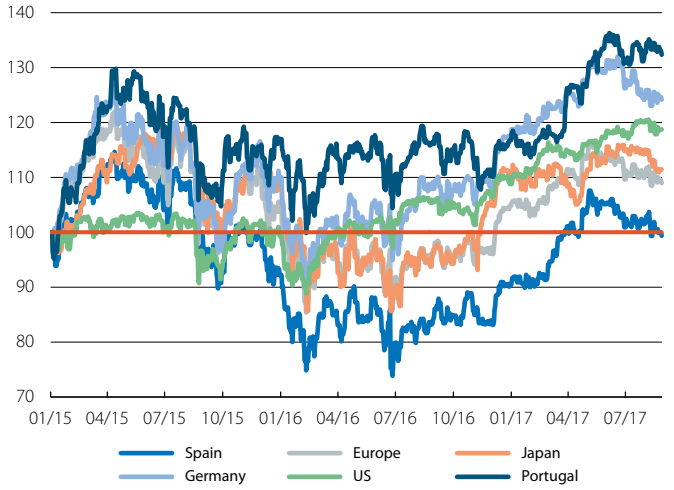
Index *Index*



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

Main advanced stock markets

Index (100 = January 2015)



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

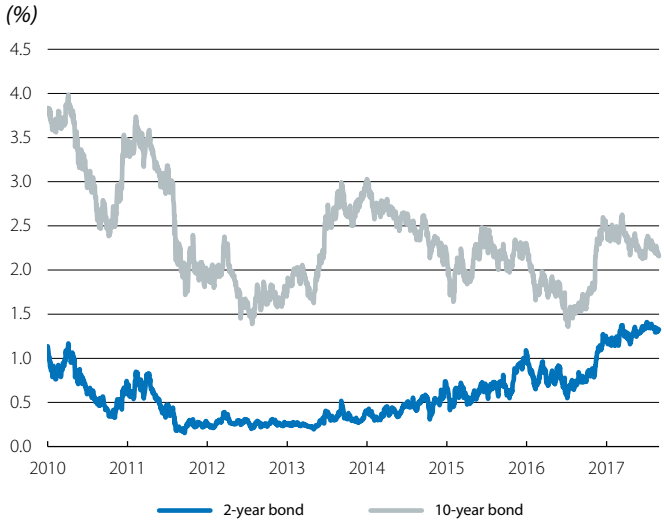
The Fed is ready to normalise its balance sheet. The messages given out by the Fed throughout the summer stressed its confidence in the outlook for the US economy and its intention to continue normalising monetary policy. At its July meeting, the Federal Open Market Committee (FOMC) maintained the fed funds interval at 1.00%-1.25%, as expected after two hikes during the first half of the year. The Fed also noted its intention to start reducing the size of its balance sheet «relatively soon». The consensus of analysts, in line with the CaixaBank Research scenario, expects the announcement to become official at the next meeting in September. The minutes of the last meeting, as well as statements by FOMC members throughout July and August, show that, in spite of some disappointing figures, the FOMC has maintained a scenario of firm growth in economic activity and a steady rise in inflation up to the 2% target. Its members therefore suggested, once again, that the fed funds rate should continue to be raised gradually over the coming quarters. Nevertheless, these messages from the Fed were contrasted, in July and August, by the downward trend in US sovereign debt premia, especially in bonds with longer maturities.

The ECB is getting ready to redesign monetary policy with greater confidence in the euro area's outlook. As expected, at its July meeting the ECB did not alter the parameters of its monetary policy, noting that QE would continue until the end of the year, as planned (net purchases totalling EUR 60 billion a month). However, both at this meeting and throughout the summer, the ECB reinforced its message of a firmer outlook for economic activity in the euro area. After improving risks to the growth scenario, the ECB's latest messages also show greater confidence in a medium-term recovery in inflation, supported by growth in economic activity and the disappearance of temporary setbacks. At the press conference after July's meeting, Draghi therefore suggested the ECB would discuss the design of monetary policy over the next few quarters during the autumn, albeit stressing that they still need to be persistent, patient and prudent. A gradual withdrawal of stimuli is therefore likely, so as not to compromise the euro area's improved economic outlook. Given these announcements, sovereign debt markets for the euro area remained positive throughout the summer and sovereign risk premia were contained.

The euro area's improved economic strength boosts the euro. Throughout the summer, the euro increased the upward trend shown over the past few months, supported by upward revisions of the euro area's macroeconomic scenario. In July and August, the euro not only reached its highest value for the past two years against the dollar (at times exceeding USD 1.20) but also reached a peak since the summer of 2014 against a basket of 19 currencies from the euro area's main trading partners.

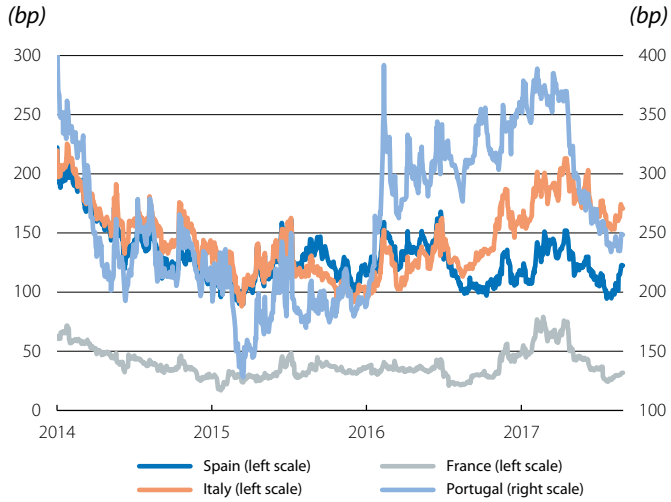
Emerging currencies remain strong. The emerging currencies appreciated slightly between July and August. Improved

US: yield on public debt



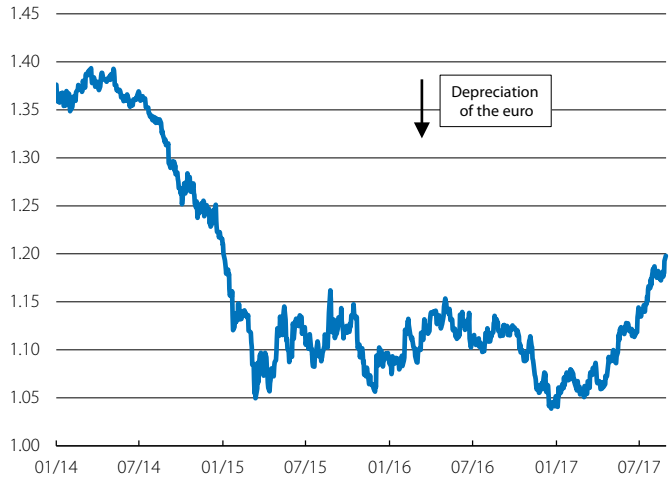
Source: *CaixaBank Research, based on data from Bloomberg.*

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.*

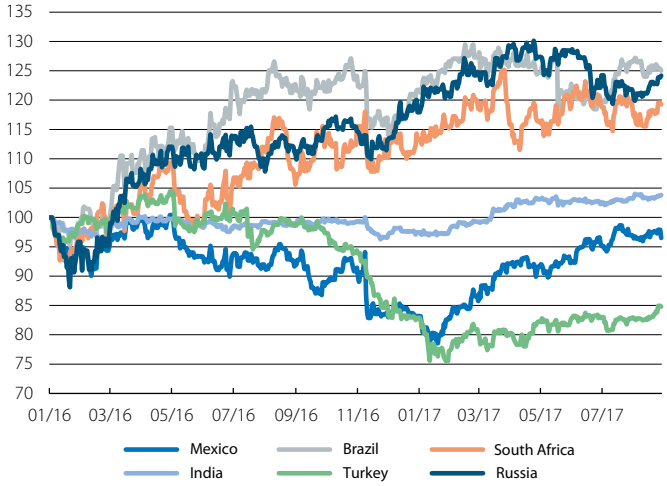
economic growth in the emerging bloc, the publication, over the past few months, of lower US indicators than expected and continuing uncertainty regarding the new US administration's agenda are helping to weaken the dollar and strengthen the currencies of the main emerging economies against the US currency. In fact, apart from the Turkish lira, they have all completely corrected the depreciation resulting from Trump's victory in the US presidential elections at the end of 2016. The Brazilian real was particularly strong over the summer, appreciating 4.4% against the dollar between July and August, boosted by positive growth in Brazilian GDP in Q2 2017 for the second consecutive quarter, meaning that the country has technically exited its recession.

Strong gains in emerging stock markets. The MSCI global index for emerging stocks was up 7.6% for July and August as a whole. The biggest gains were in Latin America and, specifically, Brazil (Ibovespa +12.6%), whose stock market was starting from a low level after the country's recent recession. The Russian stock market also made notable gains (+9.5%), another economy that has exited recession in the past few months. It was also helped by the recovery in oil prices over the summer.

Oil prices pick up and stabilise above USD 50 per barrel. Oil began the summer below USD 50, with no clear direction and looking weak because of doubts regarding OPEC's ability to cut production. However, after OPEC's last meeting at the end of July, the Brent barrel picked up and rose to around USD 52, remaining more or less at this level throughout August. The latest OPEC meeting did not change the situation regarding Libya or Nigeria, cartel members which do not come under the agreed cuts even though their production has grown considerably over the past few months. However, Saudi Arabia announced its intention to considerably reduce its exports. This announcement, together with smaller crude oil stocks in the US, helped the price of oil to recover in August and go above USD 50.

Emerging currencies against the dollar

Index (100 = January 2016)



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

Emerging stock markets by geography

Index (100 = January 2014)

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

Brent oil price

(USD per barrel)

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

FOCUS · What is the new equilibrium interest rate?

The Fed chair and the ECB president, J. Yellen and M. Draghi, have claimed that low interest rates are not only due to cyclical factors but also due to structural changes. Now that these central banks are moving towards a less accommodative monetary policy stance, we should look at these structural elements and how they might influence the normalisation process.

To do so, we have to introduce the concept of the equilibrium or natural rate of interest: the rate which, at the end of the 19th century, Knut Wicksell defined as the one «at which the demand for loan capital and the supply of savings exactly agree». Above the natural rate of interest, there is not enough investment demand, which pushes down activity and prices. Below the natural rate, investment demand overheats activity, which results in inflationary pressures. In other words, it is the rate at which an economy's growth achieves its potential and inflation is stable.

Therefore, the degree of stimuli or tightened monetary conditions imposed by a central bank depend on how far its benchmark interest rate is from the natural rate of interest. This concept is important because any changes that affect savings and investment, whether cyclical or structural, affect the equilibrium rate and, therefore, the interest rate that should be set by the central bank in order to achieve its targets.

However, the natural rate is a theoretical concept and can only be inferred indirectly. In fact, the view taken by Yellen and Draghi is based on the fact that, over the past 40 years, there has been a decline in market interest rates without any upswing in inflation or overheating of aggregate demand. They therefore conclude that, if the lower interest rates observed have not over-stimulated the economy much, they cannot be very far from the natural rate of interest, which would have also declined. According to the statistical techniques used to formalise this intuition, it is estimated that the natural rate of interest has tended to fall since the end of the 1980s, although the precise extent of this decline varies depending on the methodology used.[1]

Estimates also show that, taking global factors into account, this decline has been widespread among the main Advanced Economies. Some may have increased their tendency to save (demographics, preference for safe assets and greater inequality) while others may have reduced their propensity to invest (pessimism regarding future growth and an increase in the share of sectors that use physical capital less intensively). The range is broad but the empirical evidence available highlights, above all, the role played by demographics and a greater preference for safe assets.[2]

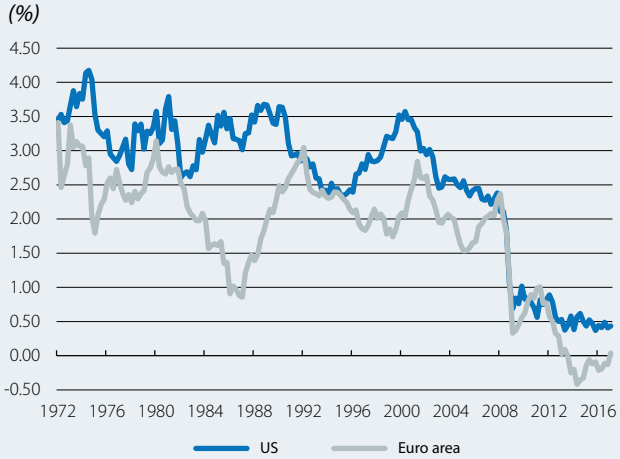
1. See Holston, K., Laubach, T. and Williams, J. C. (2016), «Measuring the Natural Rate of Interest: International Trends and Determinants», FRBSF Working Papers. The estimated downward trend is robust to alternative methodologies.

First, the ageing of the populations over the past few decades in the Advanced Economies has led to an increase in the share of working age population that save for their retirement. At the same time, increases in life expectancy encourage people to save more for a longer retirement. In the future, ageing may push the natural rate of interest back up by increasing the proportion of retired people, who reduce the volume of their savings. However, longer working lives and the expectation of a smaller retirement pension could continue to push interest rates down. In any case, such processes are slow and, for the time being, demographics will continue to push down interest rates.

Second, fluctuations in the natural rate of interest are inversely correlated with macroeconomic uncertainty.[3] In this respect, the increase in risk aversion observed after the Asian crises of the 1990s and the 2007 financial crisis is particularly relevant, which led to an increase in the demand for safe assets. Nevertheless, as the economic expansion continues, risk aversion is falling and the greater preference for safe assets of the past 20 years is declining. Other short-term factors, legacy of the recession that have been pushing down the natural rate of interest, could also disappear. For instance, high debt levels are still limiting the capacity to spend and invest, making activity less sensitive to interest rates.

To sum up, some of the factors that pushed down the natural rate of interest will disappear in the short term but others will remain, supporting a gradual monetary normalisation. In the long term, the evolution of underlying factors (demographics, productivity and inequality) will dictate the parameters of monetary policy.

Real natural rate of interest



Source: *CaixaBank Research, based on data from Holston, Laubach and Williams (2016).*

2. See Gagnon, E. *et al.* (2016), «Understanding the New Normal: The Role of Demographics», Federal Reserve Board of Washington, and Del Negro, M. *et al.* (2017), «Safety, Liquidity, and the Natural Rate of Interest», Federal Reserve Bank of New York.
3. Lansing, J. L. (2017), «R-star, Uncertainty, and Monetary Policy», FRBSF Working Papers.

FOCUS · OPEC's dilemma and an end to the contango structure in the crude oil market

One of the reasons why oil prices have remained relatively low is the sharp increase in the production capacity of unconventional oil producers and particularly shale oil in the US. This is positive on the whole but OPEC countries are losing market share and, above all, their financial situation is deteriorating, as they tend to depend heavily on oil revenues. The OPEC countries have been quick to respond but the strategy chosen to tackle the rise in shale is more complex than at first glance.

On the one hand, OPEC countries are trying to increase revenue from oil to improve their fiscal situation. One way they are doing this is by attempting to push up the price. However, a higher price per barrel helps those oil producers with larger production costs, such as shale producers, allowing them to increase their production.

In order for OPEC's strategy to help the OPEC countries as much as possible, the expected future price of oil, or forward price, is as important as the current price. This is because the various oil-producing countries have different business models. The OPEC countries and their allies enjoy very low production costs, the average life of their oil wells is relatively long and their production capacity is quite flexible. On the other hand, unconventional oil producers, and particular shale producers, have to constantly invest to maintain their level of production since the average life of their wells is relatively short. Decisions to invest are therefore closely related to the expected price in the short and medium term, as well as to financing costs. For instance, when the oil price is likely to rise, their financing costs fall and their investment capacity increases. Ultimately, these producers can hedge the sale price of the oil they produce on the futures market.

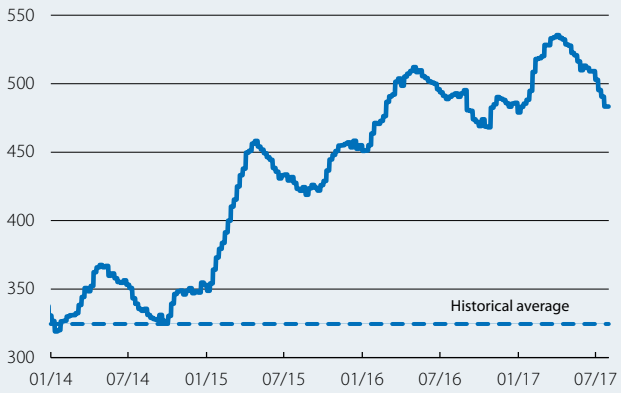
Over the past few years, the price of oil has been in contango; its spot or cash price has been lower than its forward price, benefitting shale producers. This is partly due to surplus reserves pushing down the spot price. That is why, last November, OPEC announced it was cutting its production, an agreement which, last May, was prolonged until March 2018.

The measures taken by the OPEC countries seem to be having some effect (see the first chart). In any case, although there has been a sharp decline in stocks from the peak levels, this is partly due to seasonal effects and the absolute level is still far from the historical average of 325 million barrels, a figure used as a benchmark to gauge when the market is at equilibrium. It should also be noted that, after the measures taken by OPEC, the futures market now has a price structure that is more favourable for the cartel's interests (see the second chart).

Once stock levels get back to normal, OPEC may return to higher production levels provided this is carried out gradually and, above all, without producing another glut.

*Crude oil stocks in the US **

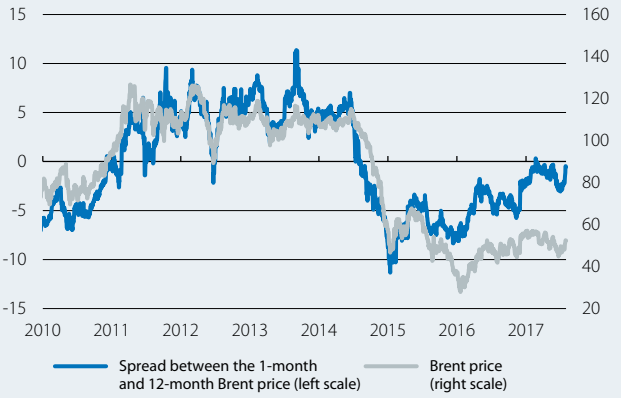
(Million barrels)



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

Crude oil prices: spot and forward spreads

(USD) *(USD-barrel)*



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

KEY INDICATORS

Interest rates (%)

	31-Aug	31-Jul	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	–3.0
1-year Euribor	–0.16	–0.15	–1	–7.8	–10.8
1-year government bonds (Germany)	–0.73	–0.67	–6	7.1	–12.8
2-year government bonds (Germany)	–0.73	–0.68	–5	3.6	–11.2
10-year government bonds (Germany)	0.36	0.54	–18	15.2	42.5
10-year government bonds (Spain)	1.56	1.50	6	17.6	54.7
10-year spread (bps) [1]	120	96	24	2.4	12.3
US					
Fed funds	1.25	1.25	0	50.0	75.0
3-month Libor	1.32	1.31	1	32.2	48.1
12-month Libor	1.71	1.73	–2	2.4	15.3
1-year government bonds	1.22	1.21	1	40.9	62.9
2-year government bonds	1.33	1.35	–2	14.2	52.5
10-year government bonds	2.12	2.29	–17	–32.4	54.0

Spreads corporate bonds (bps)

	31-Aug	31-Jul	Monthly change (bp)	Year-to-date (bp)	Year-on-year change (bp)
Itraxx Corporate	55	52	3	–16.9	–12.4
Itraxx Financials Senior	53	50	3	–40.1	–36.9
Itraxx Subordinated Financials	124	118	6	–97.8	–79.8

Exchange rates

	31-Aug	31-Jul	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
$/€	1.191	1.184	0.6	13.2	6.7
¥/€	130.980	130.570	0.3	6.5	13.5
£/€	0.921	0.896	2.8	7.9	8.5
¥/$	109.980	110.260	–0.3	–6.0	6.3

Commodities

	31-Aug	31-Jul	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
CRB Commodity Index	435.6	441.7	–1.4	3.0	8.2
Brent ($/barrel)	52.4	52.7	–0.5	–7.8	11.4
Gold ($/ounce)	1,321.4	1,269.4	4.1	14.7	0.9

Equity

	31-Aug	31-Jul	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
S&P 500 (USA)	2,471.7	2,470.3	0.1	10.4	13.9
Eurostoxx 50 (euro area)	3,421.5	3,449.4	–0.8	4.0	13.2
Ibex 35 (Spain)	10,299.5	10,502.2	–1.9	10.1	18.2
Nikkei 225 (Japan)	19,646.2	19,925.2	–1.4	3.2	16.3
MSCI Emerging	1,087.7	1,066.2	2.0	26.1	21.7
Nasdaq (USA)	6,428.7	6,348.1	1.3	19.4	23.3

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

ECONOMIC OUTLOOK · **World growth remains firm**

Global economic activity is still growing at a strong rate. The summer months have offered few surprises regarding the trend in the world growth cycle. Judging by PMI economic activity indicators, the global economic growth rate is similar to before the summer, in particular helped by the advanced economies. However, emerging indicators have weakened slightly although they are still above the 50-point threshold, implying their economic activity is still expanding. This trend, which reflects the overall situation at present, endorses the view that the world economy will grow by 3.5% in 2017. This is considerably faster than in 2016, when GDP rose by 3.1%. The risks are still generally downside, however, as the main sources of concern before the summer (geopolitical, policy and strictly economic) have not altered to any great extent.

UNITED STATES

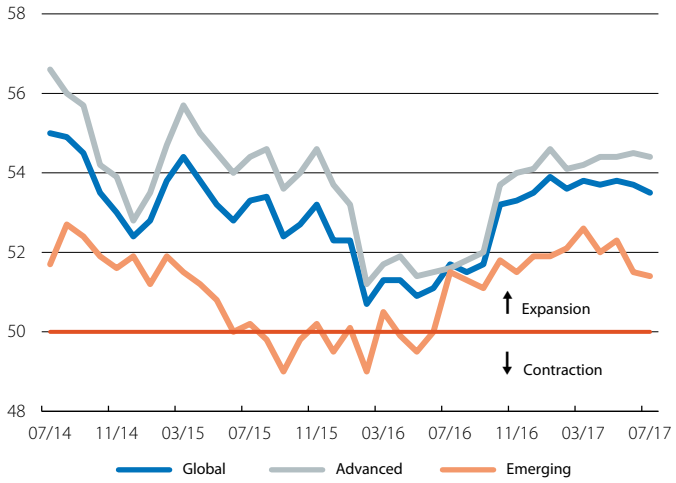
The US economy speeds up in Q2. During this period, GDP grew by 0.8% quarter-on-quarter compared with 0.3% in Q1. In year-on-year terms, GDP grew by 2.2% (2.0% in the preceding quarter) although the year-on-year change is lower than usual due to the historical series being revised, with the 2015 figure now higher than the previously published figure. By demand component, this acceleration in the growth rate was primarily due to higher growth in private consumption and a recovery in public consumption. Moreover, inventories did not make a negative contribution this quarter, unlike Q1. We can determine the immediate outlook for US economic activity using national account data from Q2. First, the composition of GDP growth alone suggests the economy may expand even faster as the advance is largely due to household consumption, a macroaggregate figure that accounts for 70% of GDP and is normally slow to change trend.

Sustained economic activity in Q3. In addition to the good composition of Q2 growth, lead economic activity indicators for Q3 also suggest that the rate of economic activity continues at a similar level to the previous quarter. In particular, consumption indicators point to household spending remaining strong. This is largely the result of a dynamic labour market. 209,000 jobs were created in July, in addition to an already considerable figure in June when 231,000 net jobs were added to the economy. Given this expansionary situation for labour, the unemployment rate fell by 0.1 pp in July to 4.3%. Meanwhile wage growth remained at 2.5% year-on-year.

Inflation is contained. The downward trend in inflation is still paradoxical, at least to some extent, considering the economic cycle is at a mature stage and economic activity is speeding up. Whereas January's CPI was 2.5% higher than a year earlier, in July the year-on-year increase was just 1.7%.

Economic activity indicators: PMI

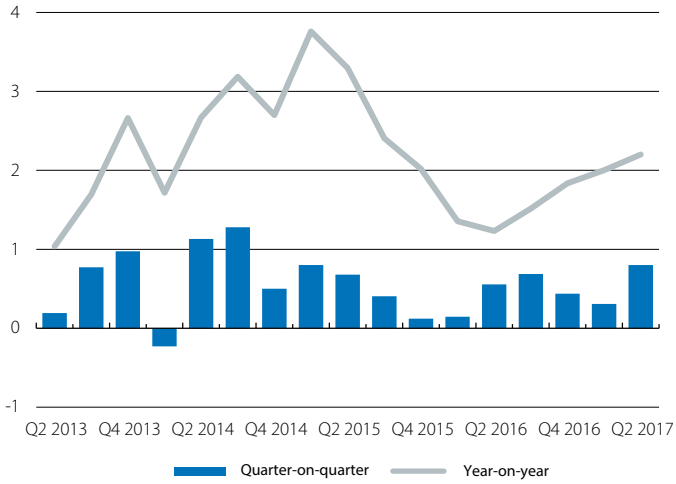
Level



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

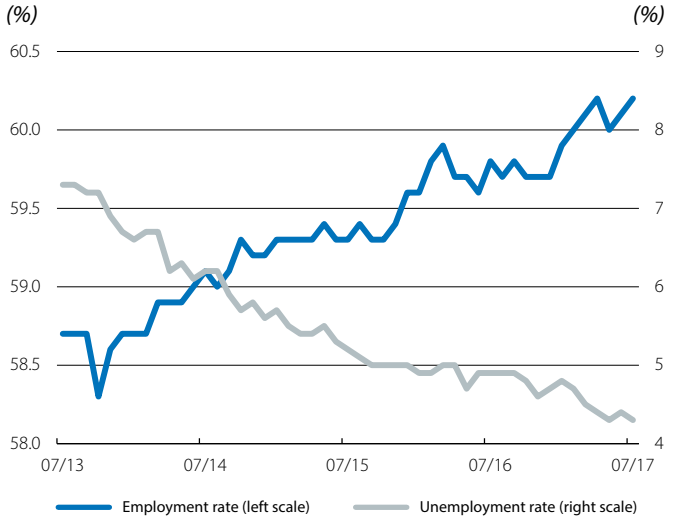
US: GDP

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



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

US: labour market



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

Since growth in the underlying core index (without food or energy) has also slowed down, from 2.3% in January to 1.7% in July, this contained trend in prices cannot be attributed to volatile factors such as oil prices. Given this situation, what monetary policy actions can be expected from the Fed? Judging from the minutes of its July meeting, the key to the Fed's assessment is the view that this reversal in inflation is temporary and that it will recover towards 2% year-on-year in the medium term. Consequently, the central bank is likely to begin the process to reduce its balance sheet over the coming months, as well as gradually raising the fed funds rate.

JAPAN

Strong growth in Japan. Japan's GDP saw dynamic growth in Q2 2017, up by 1.0% quarter-on-quarter (2.1% year-on-year), more than the 0.4% rise of the previous quarter. The country has now posted six consecutive quarters of positive growth, something it has not seen since 2006. This growth was supported by robust investment, especially public, and higher private consumption. Unlike previous quarters, exports declined in real terms. In spite of these strong figures, given the absence of any far-reaching structural reforms and the volatility inherent in Japan's GDP series, its growth rate is likely to be considerably lower over the next few quarters, although still positive. Like the US, this faster growth is occurring together with a price trend that indicates a lack of inflationary tensions (up by 0.5% year-on-year in July).

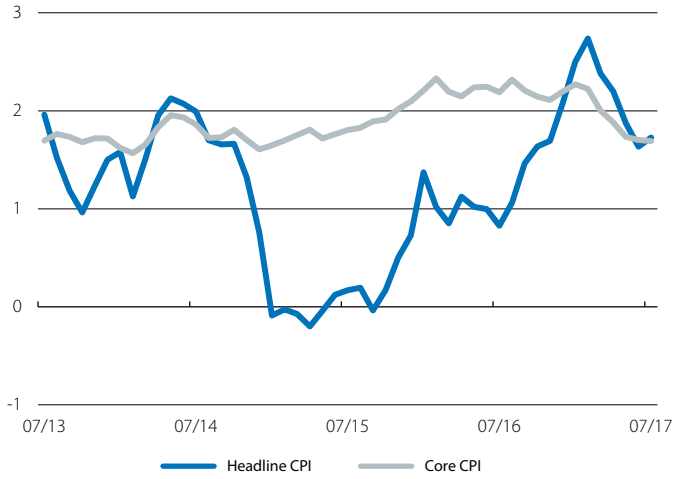
EMERGING ECONOMIES

The emerging economies are performing satisfactorily although there are still sources of uncertainty. As mentioned above, the emerging economies on the whole have recorded notable growth in their economic activity. This can be seen, for instance, in the IIF inndicator which estimates aggregate growth for the main emerging countries (IIF growth tracker). This indicator suggests the GDP growth rate for the emerging bloc was still high at the end of Q2. The latest indicators have also tended to outperform expectations, as shown by the indices of «economic surprises» which monitor the gap between actual and forecast macroeconomic figures. In response to these more constructive indicators, inflows of capital flows for the emerging economies have tended to pick up over the past few months.

Asia: in Q2, the Chinese economy remains firm while India wanes. The Chinese economy grew by 6.9% year-on-year in Q2, unchanged from its rate of growth in Q1. National account data, together with the most recently published indicators, suggest the economy is still enjoying high and stable growth. No great changes have been seen in the area of prices either. The CPI was up by 1.4% year-on-year in July, a similar figure to June (1.5%). On the other hand, in Q2 India's GDP grew by 5.7% year-on-year, less than the 6.1%

US: CPI

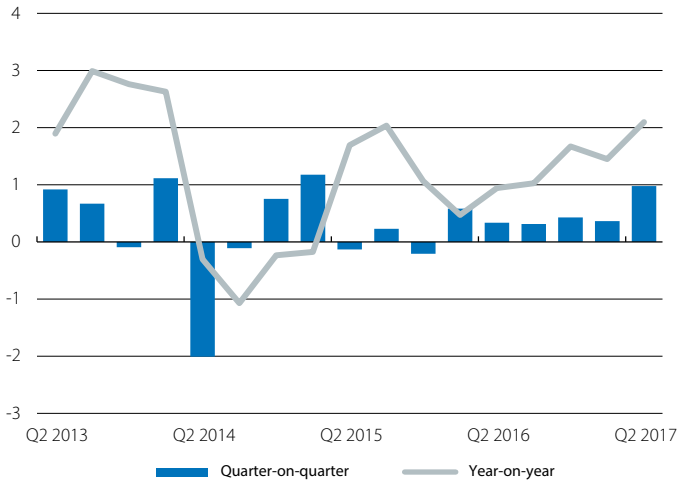
Year-on-year change (%)



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

Japan: GDP

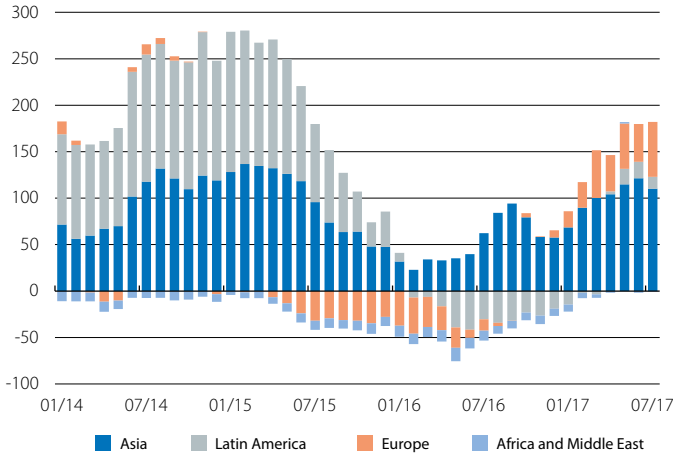
Quarter-on-quarter and year-on-year change (%)



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

*Emerging economies: portfolio capital inflows **

Cumulative over 12 months (USD billion)



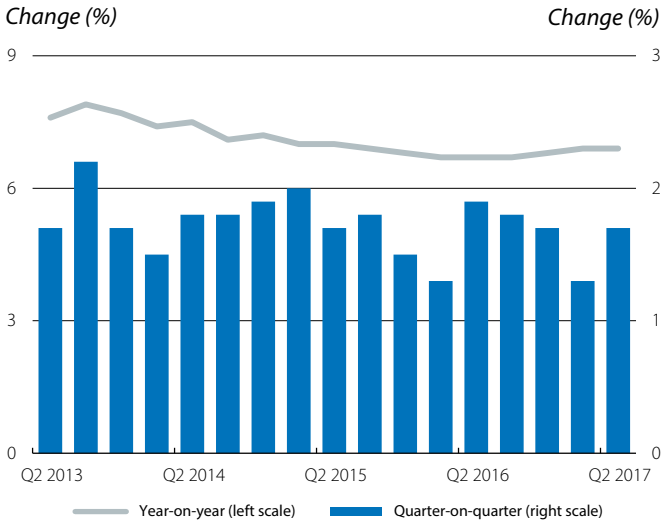
Note: ** Flows of equity and debt.*
Source: *CaixaBank Research, based on data from the IIF.*

posted the preceding quarter and below expectations. This means the Indian economy has been slowing down for the last five quarters in a row. One of the reasons behind this decline in economic growth has been the introduction of the new goods and services tax (GST), which came into force on 1 July. In spite of this weak tone, as the series of temporary shocks in the last few quarters are overcome (monetary change and GST), the country's future outlook will become slightly more promising.

Russia speeds up its growth thanks to oil. Political uncertainty is one of the aspects affecting, to a greater or lesser extent, the economic trends in some of the benchmark emerging economies. Nevertheless, each country is set apart by its own idiosyncratic aspects. Russia, for instance, is finally putting its harsh 2015-2016 crisis behind it. The economy posted 2.5% year-on-year growth in Q2 compared with 0.5% in the previous quarter. Although details on the components are not available, the recovery in oil prices is likely to be a fundamental reason for this acceleration in growth. However, and in spite of this recovery in GDP terms, the underlying sensation is still one of a fragile recovery. This is partly because the economy is still suffering from the effects of international sanctions. Given the territorial tensions on Russia's borders, this factor might become even more important in the future.

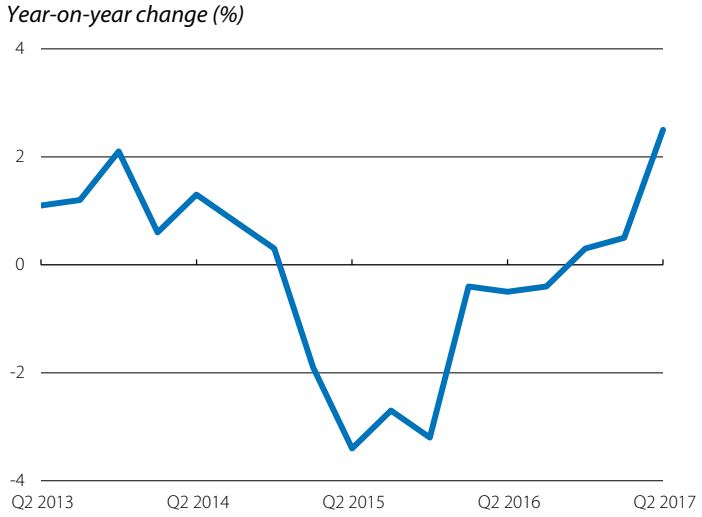
Brazil and Mexico, burdened by uncertainty. Although President Temer narrowly avoided being tried for alleged corruption, institutional uncertainty still hovers over Brazil. Indicators confirm the country is recovering its growth rate but this will probably occur at a slower pace than would be the case if such uncertainty did not exist. Mexico, however, has gone from posting 2.8% year-on-year growth in Q1 2017 to just 1.8% in Q2. The country seems to be starting to feel the effects of persistent political uncertainty, both domestic (presidential elections in 2018) and foreign (vital NAFTA negotiations beginning in August).

China: GDP



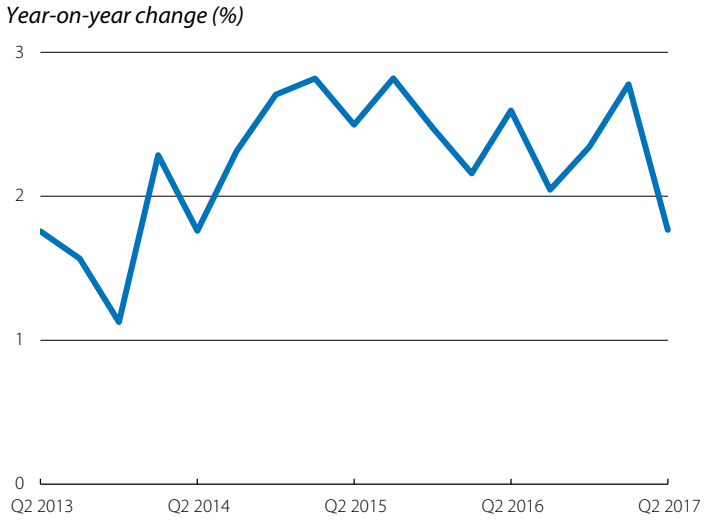
Source: *CaixaBank Research, based on data from the Chinese National Statistics Office.*

Russia: GDP



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

Mexico: GDP



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

FOCUS · Financial volatility and political uncertainty: who says there is fear?

Over the past few months, one of the major issues in macrofinance has been the coexistence of financial volatility at an all-time low and high political uncertainty. But should we be surprised by this apparent paradox? Just how closely are financial volatility and political risk related?

The most widely used indicator to measure financial volatility on the US stock market is the VIX, commonly known as the «fear index», which measures the implied volatility of S&P 500 index options. As can be seen in the first chart, the gap between the economic policy uncertainty index for the US and the VIX reached a peak in January, when Donald Trump took office. Since then it has fallen slightly. In fact, this gap is currently narrower than the level reached in two relatively recent episodes: the «fiscal cliff»[1] at the end of 2012 and the US federal government shutdown in 2013 after budget negotiations failed. This recent narrowing of the gap is mainly due to a 39% drop in the US policy uncertainty index between January and June. Nevertheless, policy uncertainty is still relatively high.

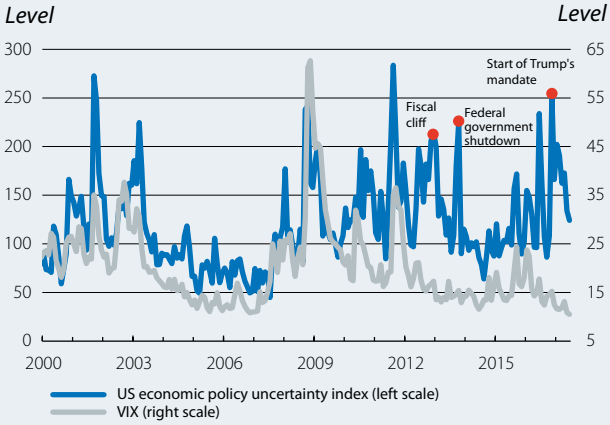
A more rigorous and sophisticated way of gauging to what extent the VIX is abnormally low given the current levels of political uncertainty is to compare the observed VIX with the VIX predicted by US and global indices of policy uncertainty. When this is carried out, we can see that, since July 2016, the VIX predicted by political factors vastly overestimates the actual volatility observed.

There are two other factors that are also presumably related to the decline in the VIX: macroeconomic and financial conditions. If we carry out the same exercise and compare the observed VIX with the VIX predicted by macrofinancial conditions,[2] we can see that the predicted VIX is closer to the VIX observed over the past few months. For instance, the predicted VIX based on political uncertainty had a prediction error of 5.9 points in June compared with an error of just 2.86 points in the prediction made based on macrofinancial conditions.

If we look closely at the trend in the observed VIX and the predicted VIX in the second chart, it seems that, between 2003 and 2007, the predicted VIX based on policy uncertainty was relatively similar to the observed VIX

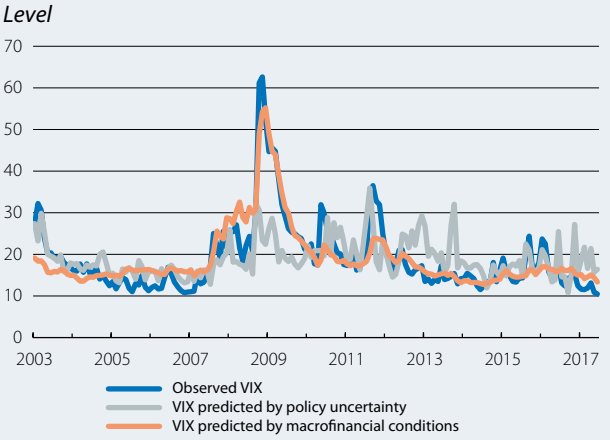
1. When automatic increases in taxes were coupled with massive spending cuts by the US government to reduce the federal deficit.
2. The macroeconomic variables included are the US business sentiment index (ISM) and a measure of global macroeconomic volatility based on the index of economic surprises for the G-10. Financial conditions were measured using the financial index elaborated by the Federal Reserve of Chicago.

VIX index and political uncertainty *



Note: ** Economic policy uncertainty index by Baker, Bloom and Davis.*
Source: *CaixaBank Research, based on data from the Federal Reserve Bank of Saint Louis and Thomson and Reuters.*

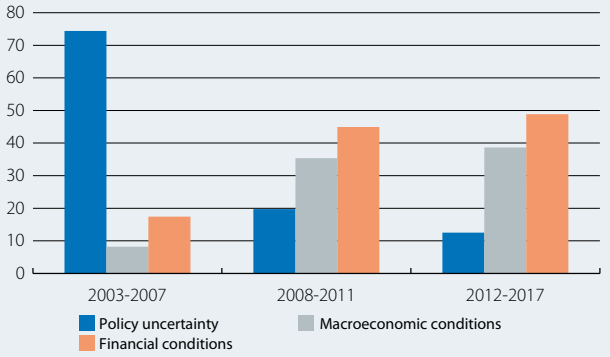
The VIX index predicted by political and macrofinancial factors



Source: *CaixaBank Research.*

Factors affecting the VIX

Contribution of each factor (% of total)



Note: *Calculated based on the lineal formula detailed in note 3. The explained variance of monthly financial volatility in the US was 76% between 2003 and 2007, 89% between 2008 and 2011, and 47% between 2012 and 2017.*
Source: *CaixaBank Research.*

while, since 2012, macrofinancial conditions have predicted a trend much more similar to that of the VIX. To check whether this is the case, we have divided the sample into three periods: from 2003 to 2007, from 2008 to 2011 and from 2012 to 2017. We have also analysed the policy, macroeconomic and financial factors that lie behind financial volatility. [3] The findings leave no room for doubt: policy factors accounted for 74% of the explained variance in the VIX between 2003 and 2007 but only 12.5% between 2012 and 2017. The relative weight of macroeconomic factors and especially of financial factors was also greater between 2008 and 2017 than between 2003 and 2007. We should also note the decline in the explained variance of the VIX over the past few years. The explanatory power of political and macrofinancial factors was 76% between 2003 and 2007, and 89% between 2008 and 2011. But this figure was just 47% between 2012 and 2017. This suggests that factors unrelated to political uncertainty, macroeconomic variables or the index for financial conditions currently lie behind a larger percentage of the VIX variation.

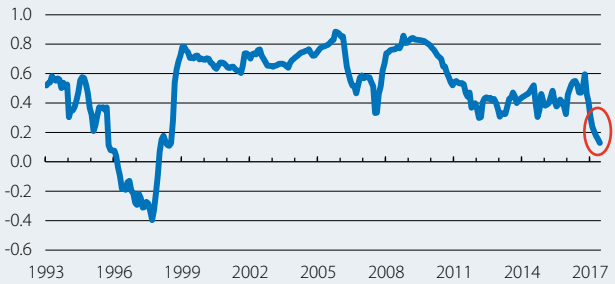
These findings may look surprising at first sight but they become plausible when other elements are also taken into account. On the one hand, political uncertainty may have lost some of its influence on financial volatility because, as shown by the Chicago University economists Pastor and Veronesi, [4] political news are now less reliable and policy signals have become noisier. The difficulty in interpreting political information accurately might have led investors to react less to political events even when there is greater uncertainty.

On the other hand, financial variables may have gained relative weight over political factors in the period 2008-2017 compared with 2003-2007 due to unconventional monetary policies (for instance, the first US quantitative easing programme, QE1, began at the end of 2008). The Fed's massive bond buying programmes have increased liquidity in the financial system, pushing up the price of some financial assets as well as reducing fears of sharp slumps in these prices, thereby decreasing volatility. [5]

Macrofinancial elements also seem to be related to the decrease in the explained variance of the VIX between 2012 and 2017. In particular, the recent increase in passive management funds [6] could have been a relevant factor. These funds track a specific index and therefore reduce the capital bought and sold on a daily basis on the financial markets. One consequence could be that financial volatility has become less sensitive to certain macroeconomic and financial fluctuations.

Correlation between the VIX and policy uncertainty in the US

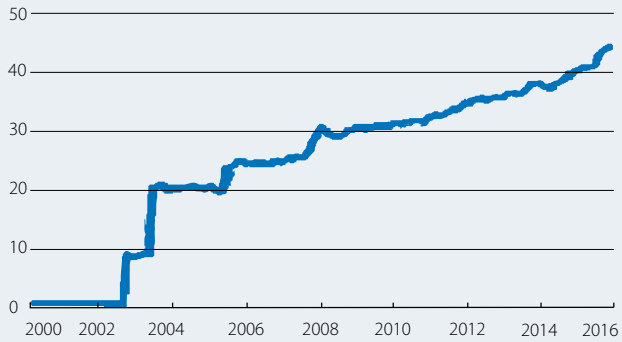
(Correlation index)



Note: *The correlation between two variables takes values between –1 and +1 and measures their degree of lineal relation. A correlation of 1 corresponds to a perfect positive lineal relation while a correlation of 0 corresponds to a zero lineal relation. In this exercise, the moving correlation has been calculated over the past three years between the VIX and the economic policy uncertainty index for the US.*
Source: *CaixaBank Research.*

Share of investment in passive management funds out of all investment funds in the US

(%)



Source: *CaixaBank Research, based on data from EPFR Global.*

3. The formula for the lineal regression is as follows: $VIX_t = \beta * EPU_t + \gamma * CM_t * + \alpha * IFC_t + \varepsilon_t$. Where EPU_t is the vector of economic policy uncertainty indices by Baker, Bloom and Davis for the US and the world, CM_t is the vector of macroeconomic variables detailed in note 2, and IFC_t is the index for financial conditions. Lastly, ε_t is a random error term.
4. See Pastor, L. and Veronesi, P. (2017), «Explaining the puzzle of high policy uncertainty and low market volatility», VOX Column.
5. For more details, see Mallick, S., Mohanty, M. S. and Zampolli, F. (2017), «Market volatility, monetary policy and the term premium», BIS Working Papers.
6. The passive management of investment portfolios is an investing strategy, for bonds or equity, that replicattes the evolution of a specific index. In the US they account for almost half of the capital managed by investment funds and 14% of the stock market value.

KEY INDICATORS

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

UNITED STATES

	2015	2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017	07/17	08/17
Activity								
Real GDP	2.9	1.5	1.5	1.8	2.0	2.2	–	...
Retail sales (excluding cars and petrol)	4.3	3.8	3.4	3.4	4.0	2.9	4.0	...
Consumer confidence *(value)*	98.0	99.8	100.7	107.8	117.5	118.1	120.0	122.9
Industrial production	–0.7	–1.2	–1.2	–0.1	0.6	2.1	2.2	...
Manufacturing activity index (ISM) *(value)*	51.4	51.5	51.1	53.3	57.0	55.8	56.3	...
Housing starts *(thousands)*	1,107	1,177	1,150	1,248	1,238	1,165	1,155	...
Case-Shiller home price index *(value)*	179	189	189	192	197	198	...	...
Unemployment rate *(% lab. force)*	5.3	4.9	4.9	4.7	4.7	4.4	4.3	...
Employment-population ratio *(% pop. > 16 years)*	59.4	59.7	59.8	59.7	60.0	60.1	60.2	...
Trade balance [1] *(% GDP)*	–2.8	–2.7	–2.7	–2.7	–2.8	–2.8	...	...
Prices								
Consumer prices	0.1	1.3	1.1	1.8	2.5	1.9	1.7	...
Core consumer prices	1.8	2.2	2.2	2.2	2.2	1.8	1.7	...

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

	2015	2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017	07/17
Activity							
Real GDP	1.1	1.0	1.0	1.7	1.4	2.1	–
Consumer confidence *(value)*	41.3	41.7	42.1	42.2	43.4	43.4	43.8
Industrial production	–1.2	–0.2	1.0	2.8	3.9	5.8	...
Business activity index (Tankan) *(value)*	12.8	7.0	6.0	10.0	12.0	17.0	–
Unemployment rate *(% lab. force)*	3.4	3.1	3.0	3.1	2.9	2.9	2.8
Trade balance [1] *(% GDP)*	–0.5	0.7	0.5	0.7	0.7	0.6	0.8
Prices							
Consumer prices	0.8	–0.1	–0.5	0.3	0.3	0.4	0.5
Core consumer prices	1.4	0.6	0.4	0.2	0.1	0.0	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

	2015	2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017	07/17
Activity							
Real GDP	6.9	6.7	6.7	6.8	6.9	6.9	–
Retail sales	10.7	10.4	10.5	10.6	10.0	10.8	10.4
Industrial production	6.1	6.0	6.1	6.1	6.8	6.9	6.4
PMI manufacturing *(value)*	49.9	50.3	50.2	51.4	51.6	51.4	51.4
Foreign sector							
Trade balance [1] *(value)*	608	512	554	512	467	458	456
Exports	–2.3	–8.4	–7.0	–5.3	7.8	9.1	7.2
Imports	–14.2	–5.7	–4.7	2.1	23.9	14.3	11.3
Prices							
Consumer prices	1.4	2.0	1.7	2.2	1.4	1.4	1.4
Official interest rate [2] *(value)*	4.35	4.35	4.35	4.35	4.35	4.35	4.35
Renminbi per dollar *(value)*	6.3	6.6	6.7	6.8	6.9	6.9	6.8

Notes: *1. Cumulative figure over last 12 months. Billion dollars. 2. End of period.*
Source: *CaixaBank Research, based on data from the National Bureau of Statistics of China and Thomson Reuters Datastream.*

ECONOMIC OUTLOOK · **Growth momentum in the euro area**

Economic growth is gaining traction in the euro area. After several years of weak recovery in the euro area, economic growth is finally picking up in most member states. It is also becoming more self-sustainable after a noticeable decline in domestic risks and improved confidence. One sign of this is the IMF raising its forecasts in July for the euro area's main economies. CaixaBank Research has also improved its growth forecasts for euro area economic activity, up to 2.2% in 2017 and 2.0% in 2018. This upward revision is on the back of several quarters of growth figures above the average of the past few years. However, although domestic risks have diminished, particularly on the political front, there are still significant sources of global uncertainty (both political and geopolitical). Longer-term growth in the euro area might also be hindered by other factors, such as its ageing population and high debt, both public and private. In the political sphere, how the Brexit negotiations will develop over the coming months will be vital. Especially important is the discussion of the Brexit bill, the amount the UK might have to pay the EU for pre-existing financial obligations. Discussions may also intensify regarding the EU's necessary reformulation to further its economic integration, an issue we analyse in detail in this month's Dossier, «Europe's moment».

Q2 data confirm the euro area's growth rate has improved. Euro area GDP rose by 2.2% year-on-year (0.6% quarter-on-quarter) in Q2 2017. GDP growth speeded up in the main euro area countries: in Germany, to 2.1% year-on-year; France, to 1.7% year-on-year, and Italy, to 1.5%. Domestic demand is particularly strong in all three economies although less so in Italy, still vulnerable to banking and political risks. Outside the euro area, in Eastern Europe, Poland led the field with 4.4% growth year-on-year. A slight slowdown in the UK's economy was also confirmed. The negative impact of Brexit on economic activity is starting to be felt, with growth at 1.7%.

Economic activity indicators point to the euro area economy continuing to perform well in Q3. The composite business sentiment index (PMI) for the euro area as a whole stood at 55.8 points in August, remaining as strong as it was in the first half of the year (averaging 56.1 points). The economic sentiment index (ESI) also increased to 111.9 points in August, its highest level for the past 10 years. The euro area's industrial production data were weaker than the previous month, however, down by 0.6% month-on-month. Nevertheless, indicators broadly point to the euro area economy continuing to grow at a good rate in Q3.

Consumption is still a key support for euro area growth. One sign is the positive trend in retail sales, growing by 3.1%

European Union: IMF forecasts

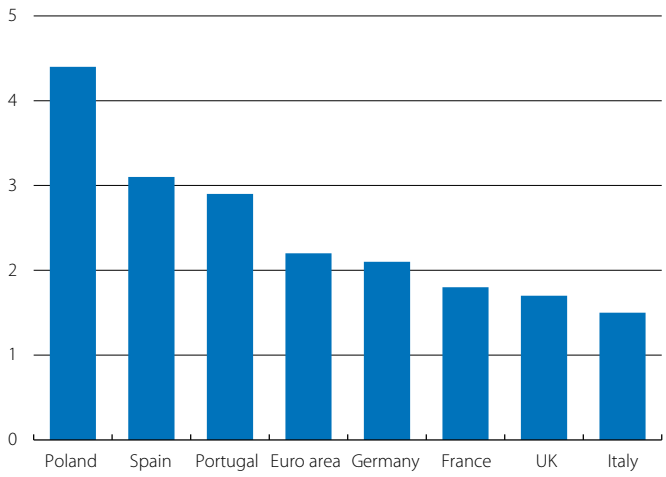
Year-on-year change (%)

	GDP forecast			Change compared with the April 2017 forecast	
	2016	2017	2018	2017	2018
Euro area	1.8	1.9	1.7	▲ 0.2	▲ 0.1
Germany	1.8	1.8	1.6	▲ 0.2	▲ 0.1
France	1.2	1.5	1.7	▲ 0.1	▲ 0.1
Italy	0.9	1.3	1.0	▲ 0.5	▲ 0.2
Spain	3.2	3.1	2.4	▲ 0.5	▲ 0.3
UK	1.8	1.7	1.5	▼ 0.3	= 0.0

Source: *CaixaBank Research, based on data from the IMF (WEO, July 2017).*

European Union: GDP in Q2 2017

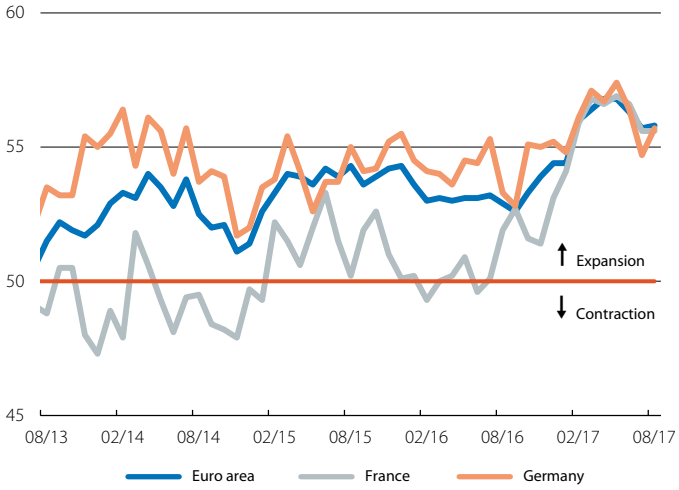
Year-on-year change (%)



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

Euro area: composite PMI economic activity indicator

Level



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

year-on-year in June, 0.7 pp more than the previous month's figure. The consumer confidence index for the euro area as a whole also reached –1.5 points in June, its highest figure since May 2007. We expect this good performance by private consumption to continue over the coming months, helped by low interest rates and ongoing labour market improvements.

The labour market is buoyed by strong economic growth. Euro area unemployment stood at 9.1% in July, 2 pp below the level of two years ago. This improvement is broadbased across countries, albeit to differing degrees and starting from very different levels. Germany, France and Italy have reduced their unemployment rates by almost 1 pp in the past two years. Over the same period, Spain and Portugal have reduced theirs by more than 5 pp and 3 pp, respectively, with a markedly strong recovery in the labour market. Portugal has performed particularly well, its unemployment rate falling to 9.1% in July, the same level as the euro area as a whole.

Inflation continues to normalise very gradually. In August, euro area headline inflation, measured by the harmonised index of consumer prices (HICP), stood at 1.5%, 0.2 pp higher than the previous month due to a larger contribution from the energy component and services. Core inflation, which excludes headline inflation's volatile components (energy and unprocessed food), remained unchanged at 1.3%. Core inflation, which is more indicative of medium term inflationary tensions, is likely to recover gradually over the coming months owing to the growth in economic activity and the improved labour market.

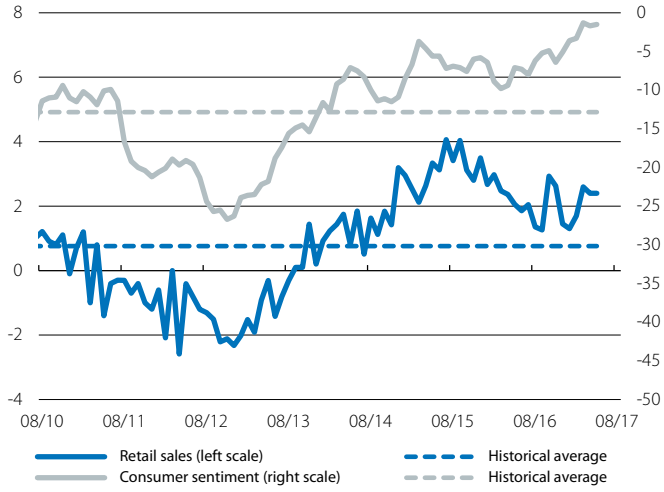
PORTUGAL'S ECONOMIC RECOVERY CONTINUES

Portugal's GDP grew by 2.9% year-on-year in Q2, its highest growth rate in the past 15 years and far higher than the rate posted since the start of its economic recovery (+1.3% on average between Q4 2013 and Q4 2016). Although quarter-on-quarter growth slowed down to 0.3%, this has occurred after several exceptionally good quarters. Domestic demand's contribution to year-on-year GDP growth in Q2 was 2.9 pp, supported by higher consumption (up by 2.1% year-on-year) and a strong upturn in investment (10.3% year-on-year). However, public consumption declined by 0.9% year-on-year. External demand contributed just 0.1 pp to year-on-year GDP growth owing to a smaller rise in both exports (8.2% year-on-year) and imports (7.5% year-on-year). Over the coming months, growth will continue to be supported by domestic demand which is looking much more solid, partly on the back of the gradual recovery in the labour market and improved business confidence. External demand should also make a positive contribution to growth since exports will be boosted by a more favourable external environment, especially in the euro area.

Economic activity will continue to perform well in Q3. The Bank of Portugal's coincident indicator for economic activity,

Euro area: consumption indicators

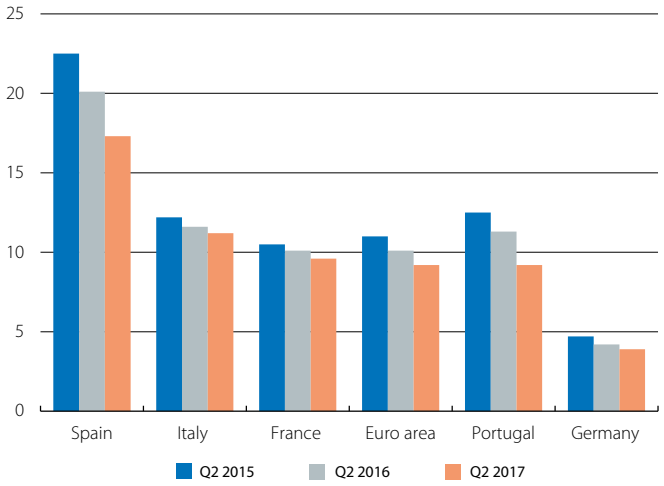
Year-on-year change (%) *Level*



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

Unemployment rate

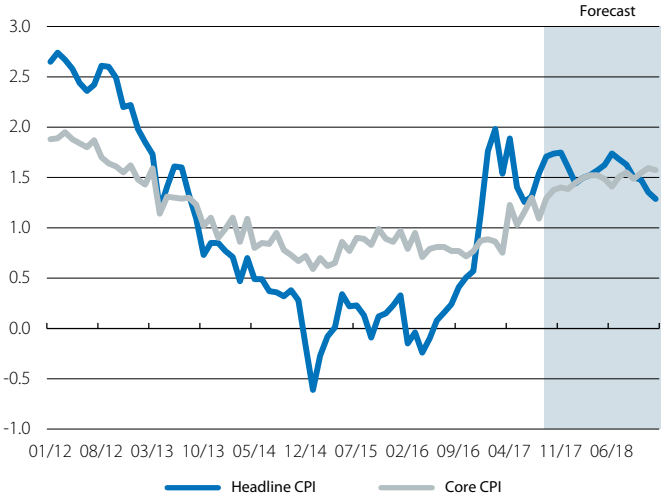
(%)



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

Euro area: Harmonised CPI

Year-on-year change (%)



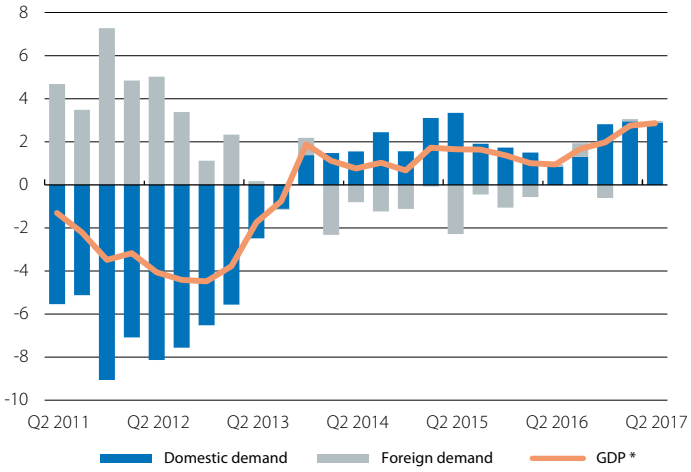
Source: *CaixaBank Research, based on data from Eurostat.*

which summarises the trend in Portugal's high frequency indicators, shows a clear upward trend from Q4 2016 and rose by 3.6% year-on-year in July. This marked improvement suggests economic activity will remain strong over the second half of the year. The Bank of Portugal's coincident indicator for private consumption also rose by 2.6% year-on-year in July, with retail sales (excluding automobiles) posting a 3.8% increase year-on-year. Both indicators point to the positive performance observed by private consumption in the past few quarters continuing in Q3.

Tourism, a key factor in Portugal's improved foreign sector. The effect of the current boom in global tourism can especially be seen in Portugal. Foreign tourists made more than 40 million overnight stays in hotel establishments in July (cumulative over 12 months), up by 11.1% year-on-year compared with the previous year and a record number of stays. Most visitors come from the UK (22.9% in 2016), followed by Germany (13.9%), France (10.6%) and Spain (10.3%). The tourism sector is therefore gaining share in Portugal's economy: in 2016 it accounted for 6.9% of GDP (up 0.5 pp compared with the previous year). It is also playing a vital role in improving the services account (tourism revenue rose by 21% from January to July 2017 compared with the same period the previous year).

Portugal: GDP

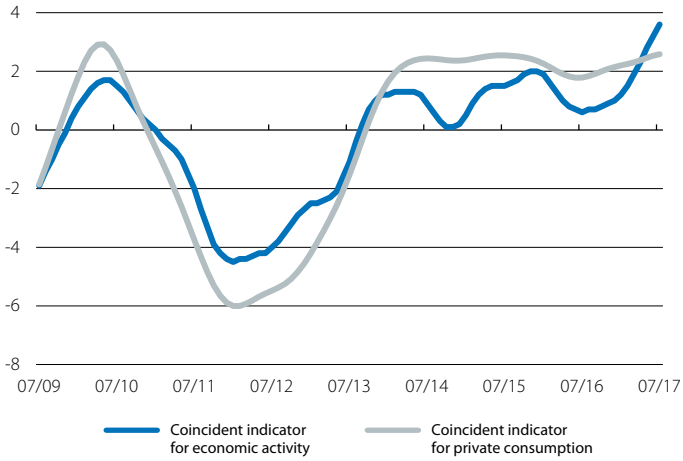
Contribution to year-on-year growth (pp)



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

Portugal: coincident indicators for economic activity and private consumption

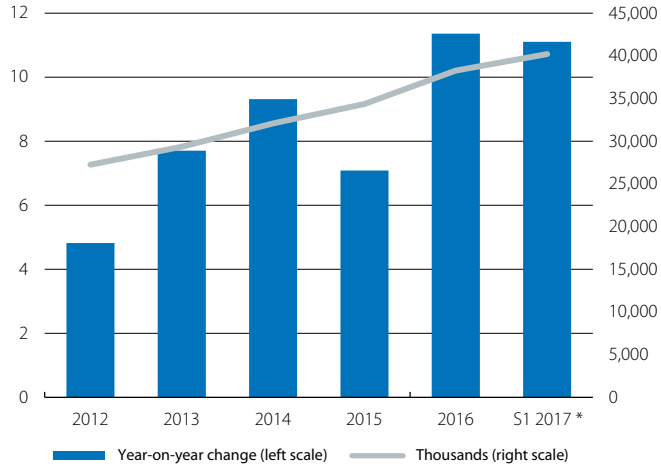
Year-on-year change (%)



Source: *CaixaBank Research, based on data from the Banco de Portugal.*

Portugal: overnight stays by foreign tourists

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



Note: ** Cumulative over 12 months.*
Source: *CaixaBank Research, based on data from the Banco de Portugal.*

FOCUS · The European real estate market: from recovery to boom

The real estate market is recovering at a good pace in most European countries. In the past two years, EU house prices have risen by 3.5% year-on-year on average,[1] compared to average falls of 1.0% year-on-year between 2011 and 2013. Although this increase in prices has been widespread, there are significant differences between countries regarding the speed at which prices are rising. While the increase remains contained in some countries, there has been a sharp acceleration in prices in others, which raises concerns that some sectors may be overheating. This is the case, for example, of Austria, Denmark and Sweden. The UK, on the other hand, constitutes a special case. After years of strong growth, house prices have started to grow at a slower pace (for more details, see the Focus «Brexit and the adjustment in the real estate sector: a dangerous cocktail» in this *Monthly Report*).

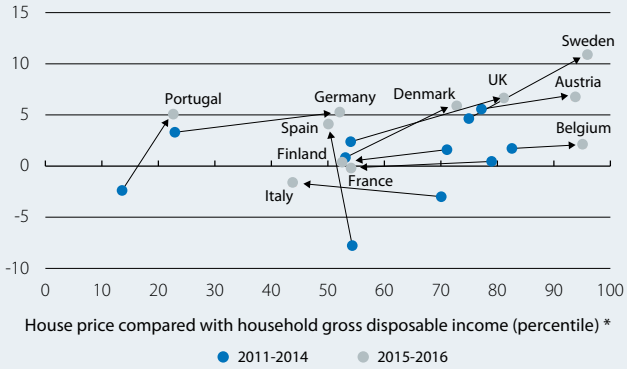
Europe's rising house prices are partly due to the improved economic situation. EU economic growth has become increasingly stronger over the past few years: from an average of 0.8% year-on-year between 2011 and 2014 to 1.9% in 2016. This improved economic outlook, together with a good labour market performance,[2] have led to an increase in household disposable income and wealth, thereby pushing up demand for housing. On the other hand, the recovery of the real estate sector is also due to highly accommodative financial conditions, propitiated by the ECB's monetary policy, with interest rates at an all-time low.[3]

Over the coming quarters, both the favourable macroeconomic outlook and the low interest rates environment will continue to support the recovery of the sector and its prices. However, in countries such as Austria, Belgium, Denmark and Sweden, this could become a cause for concern should this upward trend continues or intensifies. In fact, the ratio of house prices to gross household income (an indicator of access to housing) suggests that, in these countries, prices are already close to an all-time high (see the chart) while the level of household debt is also relatively high (see the table).

Given that this upward trend in prices could have considerable implications for financial and macroeconomic stability, there will probably increase the pressure to normalise monetary policy and/or implement macroprudential tools.

House prices and access indicator

Year-on-year change in house prices (%)



Note: ** Denotes the percentage of below-value historical observations in the specified periods. To calculate the percentiles, we used quarterly data dating from 1995 for all countries except Austria (2000).*
Source: *CaixaBank Research, based on data from Eurostat and the OECD.*

Table of indicators related to the real estate sector

	Denmark	Sweden	Finland	UK	Germany	France	Austria	Belgium
Sector share								
Construction and real estate services (% of GDP)	15.0	14.8	19.6	19.1	15.7	18.5	16.9	14.0
Households								
Ratio of debt to gross disposable income (%, 2015)	243.5	156.9	112.6	124.0	82.3	88.3	86.4	101.3
Debt service costs related to gross disposable income (%, 2016) *	16.1	11.1	7.1	9.7	18.7	6.2	–	7.9
Savings rate (%)	11.7	18.5	5.5	5.2	17.3	14.2	13.8	12.2
Banking sector								
NPL ratio (% total loans)	2.9	0.8	1.6	1.8	2.4	3.5	4.8	2.9
Leverage ratio	4.3	4.4	6.7	5.1	4.5	4.8	6.2	5.0
Capital (CET1, fully loaded)	16.4	20.9	20.0	14.4	14.2	13.8	13.9	13.1
Mortgages (% of GDP)	104.4	65.8	44.2	64.5	36.3	42.5	28.5	33.0
Mortgages (year-on-year change, %, 2016)	1.2	6.8	2.5	–7.9	3.7	3.5	4.3	8.6

Note: ** Costs include repayments of both interest and capital.*
Source: *CaixaBank Research, based on data from Eurostat, BIS, EBA and ECB.*

1. In nominal terms.
2. The unemployment rate has fallen from almost 11% in 2013 to 7.7% in 2016.
3. Idiosyncratic factors in some countries (regulations, tax system, etc.) have also played an important role.

FOCUS · Brexit and the adjustment in the real estate sector: a dangerous cocktail

The UK is going through a delicate moment. Against the backdrop of elevated uncertainty due to Brexit, recent data suggesting that the real estate sector is cooling down raise concerns (see the chart). Indeed, a slump in house prices is a risk to the economy. On the one hand, those sectors that would be hardest hit, namely construction and real estate services, account for around 19% of GDP. On the other, housing is one of the assets most widely used as collateral for credit, so a drop in property prices reduces the capacity of households and companies to access debt and would therefore push down consumption and investment. While the housing market is generally on the up in Europe (for more information see Focus «The European real estate markets: from recovery to boom» in this *Monthly Report*), the change in trend in the UK's real estate sector is mainly due to two specific factors.

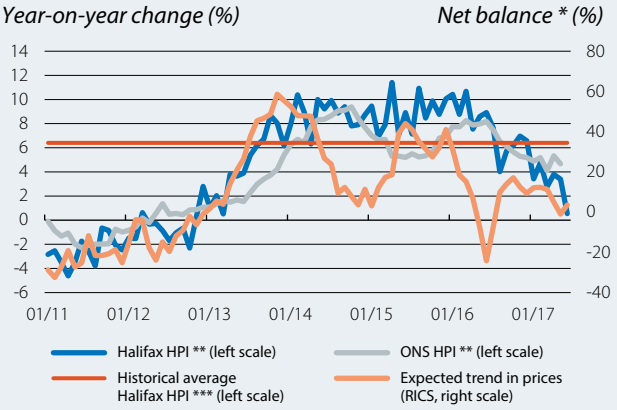
In chronological order, the first factor was the modification made to the country's Stamp Duty Land Tax (SDLT). This is proportional to the property's value and is only applied to real estate worth more than GBP 125,000. At the end of 2015, the government increased SDLT by 3 pp for second house purchases and *buy-to-let* properties, coming into effect as from April 2016. Because of this, the real estate market cooled down after reaching a peak of activity just before the new law came into force.[1]

The other important factor is, of course, Brexit. The pound has fallen substantially since the referendum. As the impact of this depreciation has been passed on to the price chain, it has pushed up inflation and thereby reduced households' purchasing power, consequently lowering demand in the real estate sector. There has also been less growth in investment, both by the British themselves and also by international investors, due to the Brexit related uncertainty.

Given that we expect this Brexit-induced economic slowdown in the UK to be limited, the degree to which the real estate sector will cool down should also be contained. First, because although the positions taken up by the UK and the EU may seem to be far apart at the moment, the most likely scenario is for negotiations to result in a Brexit that will allow the UK to maintain reasonable access to the single market. Second, because UK's banks are well capitalised and the Bank of England is very likely to maintain a highly accommodative stance, tightening monetary policy in a very gradual manner. Finally, the international context also helps, especially the EU's economic recovery.

However, there is the possibility that house prices will adjust more substantially than expected. Household debt to income ratio is only second to Canada among the G-7 group of most developed countries, and the savings rate has dropped to an all-time low of 1.7%.[2] If the economic slowdown were sharper than expected or the Bank of England was forced to raise interest rates more aggressively than planned (due to inflation picking up), households would have little room to manoeuvre. The increase in buy-to-let mortgages is another risk factor. These have gone from accounting for 8.5% of all mortgages in 2007 to 15.6% in Q1 2017. Since it is more sensitive to changes in the expected return on assets, this market segment could push house prices further down should the sector enter a recession.

UK: house prices



Notes: ** Net balance indicating the net percentage of respondents expecting house prices to rise in the coming months. ** HPI means house price index. *** Average since January 1996. We have not used the ONS average for the series as this starts in January 2006.*
Source: *CaixaBank Research, based on data from the Halifax, ONS and Royal Institution of Chartered Surveyors (RICS).*

1. According to data from HM Revenue & Customs, the average number of housing transactions between January 2014 and February 2016 was 102,000 properties per month. There were 170,000 transactions in March 2016. Since June this year, there has been an average of 97,000 transactions per month have been carried out.

2. According to OECD data for 2015.

KEY INDICATORS

Activity and employment indicators

Values, unless otherwise specified

	2015	2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017	07/17	08/17
Retail sales *(year-on-year change)*	2.6	1.4	1.0	2.2	1.9	2.6	...	...
Industrial production *(year-on-year change)*	2.1	1.5	1.1	2.3	1.4	2.5	...	...
Consumer confidence	–6.1	–7.7	–8.3	–6.5	–5.5	–2.7	–1.7	–1.5
Economic sentiment	104.2	104.8	104.2	106.9	108.0	110.0	111.3	111.9
Manufacturing PMI	52.2	52.5	52.1	54.0	55.6	57.0	56.6	57.4
Services PMI	54.0	53.1	52.6	53.4	55.1	55.8	55.4	54.9
Labour market								
Employment (people) *(year-on-year change)*	1.0	1.4	1.3	1.4	1.5	...	–	...
Unemployment rate: euro area *(% labour force)*	10.9	10.0	9.9	9.7	9.5	9.2	9.1	...
Germany *(% labour force)*	4.6	4.2	4.1	4.0	3.9	3.8	3.7	...
France *(% labour force)*	10.4	10.0	9.9	10.0	9.6	9.6	9.8	...
Italy *(% labour force)*	11.9	11.7	11.6	11.8	11.6	11.3	11.3	...
Spain *(% labour force)*	22.1	19.6	19.3	18.7	18.2	17.3	17.1	...

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	Q3 2016	Q4 2016	Q1 2017	04/17	05/17	06/17	07/17
Current balance: euro area	**3.4**	**3.7**	**3.8**	**3.7**	**3.7**	**3.5**	**3.5**	**3.4**	**...**
Germany	8.5	8.4	8.6	8.4	8.3	7.9	7.9	7.8	...
France	–0.4	–0.9	–1.1	–0.9	–1.0	–1.0	–0.9	–1.0	...
Italy	1.4	2.6	2.5	2.6	2.7	2.6	2.7	2.7	...
Spain	1.4	1.9	1.8	1.9	1.9	1.7	1.7	1.7	...
Nominal effective exchange rate[1] *(value)*	**91.7**	**94.3**	**94.8**	**94.5**	**93.7**	**93.7**	**95.5**	**96.3**	**97.6**

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	Q3 2016	Q4 2016	Q1 2017	04/17	05/17	06/17	07/17
Private sector financing									
Credit to non-financial firms[1]	–0.3	1.8	2.0	2.2	2.3	2.5	2.5	2.0	2.4
Credit to households[1, 2]	0.7	1.7	1.8	1.9	2.3	2.5	2.6	2.6	2.6
Interest rate on loans to non-financial firms[3] *(%)*	1.6	1.4	1.3	1.3	1.3	1.4	1.2	1.3	1.3
Interest rate on loans to households for house purchases[4] *(%)*	2.1	1.8	1.8	1.8	1.8	1.7	1.7	1.7	1.8
Deposits									
On demand deposits	11.1	10.0	9.5	9.3	9.5	10.2	10.3	10.7	10.1
Other short-term deposits	–3.8	–1.9	–1.2	–2.0	–2.3	–2.9	–2.8	–3.0	–3.2
Marketable instruments	2.6	2.7	5.4	4.2	5.7	1.1	1.6	–0.6	–2.8
Interest rate on deposits up to 1 year from households *(%)*	0.8	0.5	0.5	0.4	0.4	0.4	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 · **Economic activity is advancing at a good pace**

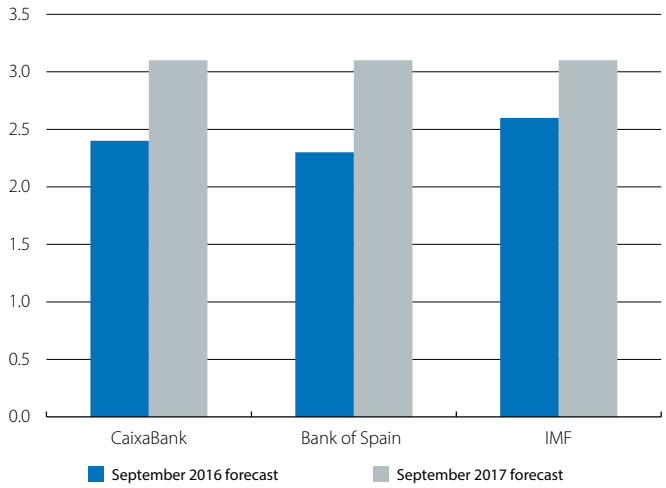
GDP growth is gaining ground. In Q2, the Spanish economy's growth rate accelerated to 0.9% quarter-on-quarter, 0.1 pp faster than in Q1. CaixaBank Research predicts 3.1% growth for the year as a whole, a forecast that coincides with those of the Bank of Spain and the IMF, after the latter raised its growth forecast in July (by 0.5 pp). This exceptional performance by Spain's economy, which has grown by more than 3% for the last three years, has been helped by both external and internal factors which show no signs of weakening, at least for the time being. Domestically, structural reforms and competitiveness gains are having a long-lasting positive effect on economic growth. Externally, the favourable environment is also helping Spain's economy to perform well. The increasing economic expansion in other euro area countries, oil prices remaining relatively low and the fact that monetary normalisation in the euro area should be gradual are all important factors. For the coming year, CaixaBank Research expects GDP to remain strong at 2.7%.

Private consumption regains centre stage. The breakdown of GDP in demand terms shows that domestic demand contributed 2.4 pp to year-on-year growth in Q2, 0.1 pp more than in Q1 and in line with the CaixaBank Research forecast. As expected, private consumption once again came to the fore, up by 0.7% quarter-on-quarter after a temporary slowdown in Q1. Investment slowed down its growth, however (0.8% quarter-on-quarter), owing to a dip in capital goods investment. However, as the series is typically variable, this slowdown does not alter the favourable medium-term view. Investment in construction maintained a similar growth rate to Q1. External demand continued to make a positive contribution to year-on-year growth in GDP, namely 0.7 pp, in spite of both exports and imports being weaker than expected, both of which tend to be highly variable.

The labour market is still positive, consistent with the growth in economic activity. According to the LFS, in Q2 job creation increased notably by 0.9%, seasonally adjusted. The number of employed has now reached 18.8 million, as suggested by the good Social Security registration figures over the past few months. The year-on-year rate of change in employment therefore rose by 2.8% (2.3% in Q1). This rise in employment has helped to considerably reduce the unemployment rate to 17.2%, with a cumulative fall of 2.8 pp over the last year. The total number of unemployed has now fallen below four million for the first time since the crisis began. That said, Q2 tends to record a notable drop in unemployment due to the start of the tourist season. In fact, the services sector generated 75% of all jobs created in Q2. Although permanent employment contracts continue to rise (1.8% year-on-year), there was higher growth among employees on temporary contracts, pushing the temporary employment rate in Q2 up to 26.8%.

GDP growth forecasts in 2017

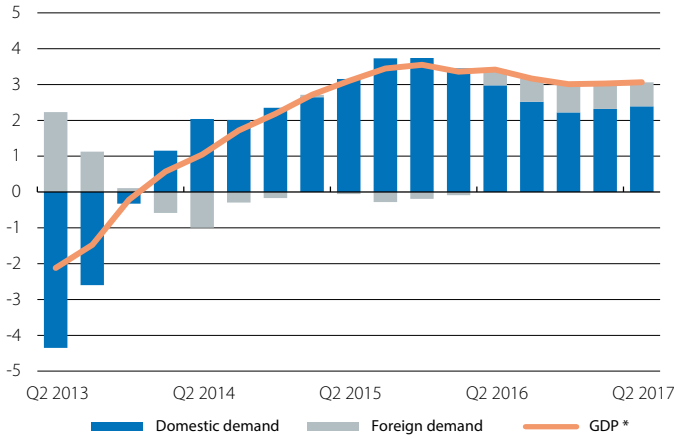
Annual rate of change (%)



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

*Contribution of domestic and foreign demand to GDP growth **

(pp)



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

GDP

Quarter-on-quarter change (%)

	Q3 2016	Q4 2016	Q1 2017	Q2 2017
GDP	0.7	0.7	0.8	0.9
Private consumption	0.6	0.7	0.4	0.7
Public consumption	0.5	–0.2	0.8	0.2
Investment	–0.1	0.5	2.1	0.8
Investment in capital goods	0.0	–0.1	3.6	0.5
Investment in construction	0.1	0.7	1.1	1.1
Exports	–1.2	2.0	3.0	0.7
Imports	–2.0	1.8	3.1	–0.2

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

The labour market continues to perform well in the second half of the year. The rate of increase in registered workers affiliated to Social Security stood at 3.6% year-on-year in July, the largest increase in the month of July since the beginning of the crisis. Registered unemployment also posted good figures, down by 9.4% (10.7% in June). Given Spain's economic growth, the labour market is likely to remain positive over the next few months. This should help to create more than 500,000 jobs between Q4 2016 and Q4 2017.

The recovery in employment and favourable financial conditions boost house purchases. Specifically, house sale transactions rose by 12.1% year-on-year in June (cumulative over 12 months), totalling 235,672 YTD. Apart from growth on the domestic front, purchases by foreigners, which account for 13% of all house sales in Spain, also continued to rise, in spite of a fall in purchases by British citizens (see the Focus «The consequences of Brexit on the real estate sector» in this *Monthly Report*). On the other hand, new building permits slowed down their growth (up by 14% year-on-year in May cumulative over 12 months compared with 20% in April) and are still far from the pre-crisis figures. This fact, together with the rise in demand for housing, will help push up house prices even more.

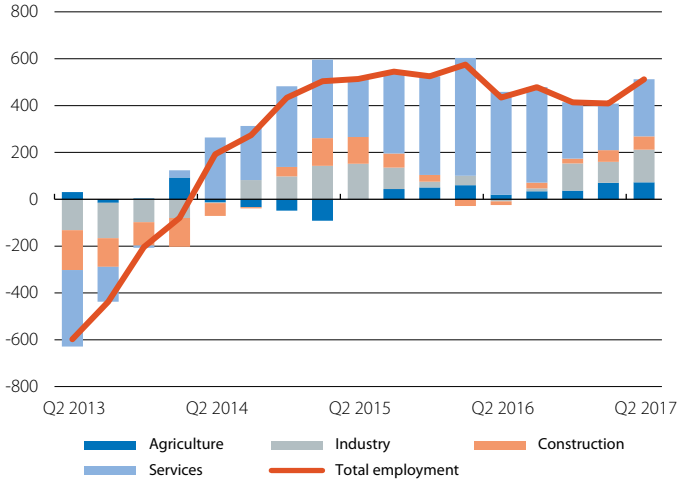
Inflation stabilises due to the trend in oil prices. The year-on-year change in the CPI was 1.6% in August, 0.1 pp higher than July's figure after slowing down considerably compared with the figures of 3.0% recorded at the beginning of the year. Over the coming months, weak oil prices will moderate inflation in the final part of the year. Core inflation (the headline index without unprocessed food or energy products) rose by 0.2 pp in July to 1.4%, boosted by an increase in industrial prices which more than offset the slowdown in the price of electricity.

The onset of the tourist season and a more moderate rise in the price of oil are boosting the foreign sector. In June, the current account surplus totalled EUR 3.57 billion YTD, far below June 2016's figure of EUR 5.754 billion. This worse performance is due to the deterioration in the energy balance caused by higher oil prices in the first few months of the year. However, in the second half of 2017, the more moderate rise expected in the price of oil will contain the increase in the energy bill. The income and services balances are also expected to continue in surplus. In particular, low interest rates are supporting the trend in the income balance (for more detail, see the Focus «The improvement in the income balance» in this *Monthly Report*). The services balance, on the other hand, continues to be boosted especially by tourism. In July, arrivals of international tourists rose by 11.1% year-on-year, reaching 46.9 million YTD.

Economic growth is helping to achieve the deficit target. Good economic activity figures have increased tax revenue by around 6.6% compared with May 2016 (excluding local government corporations) while general government

Employment by sector

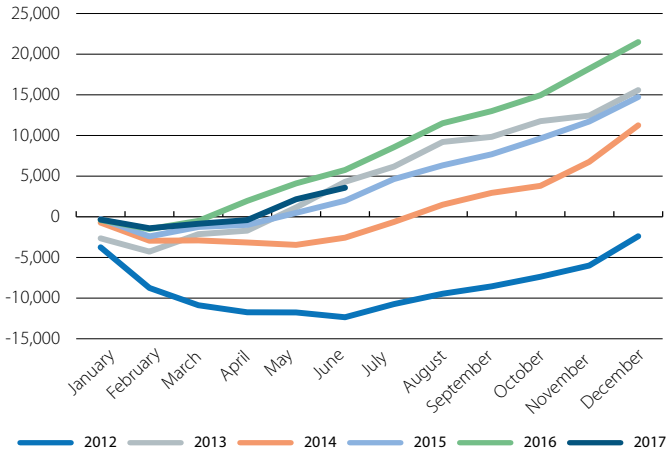
Year-on-year change (thousands)



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

Current account

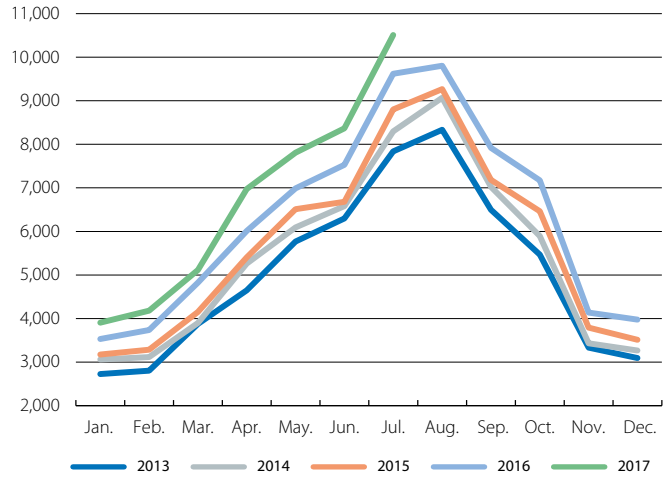
Cumulative YTD
(EUR billion)



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

Foreign tourist arrivals

Number of tourists (thousands)



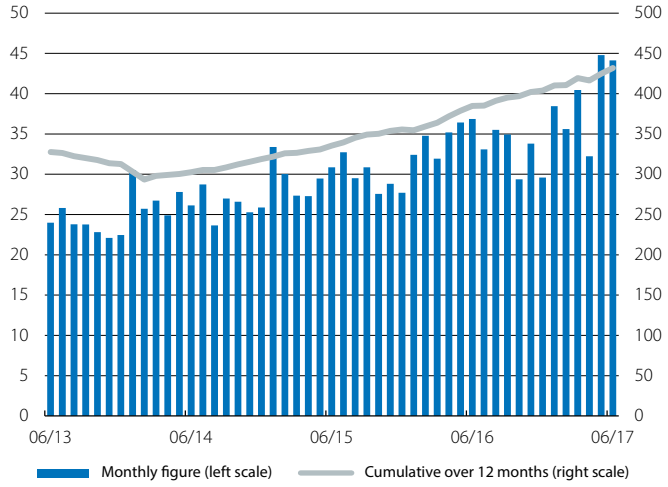
Source: *CaixaBank Research, based on data from the INE.*

spending has fallen by 0.1% compared with the same month. Social Security contributions and personal income tax continue to record moderate growth, albeit slightly lower than expected. The state budget execution, with data available up to June, shows an improvement in the central government deficit of 0.8 pp compared with last year's figure, standing at 1.1% of GDP. Moreover, it is highly likely that contingencies resulting from the motorway toll bail-out will be passed on entirely to 2018. This fact, together with the positive trend in public accounts, will help Spain to meet its deficit target of 3.1% of GDP in 2017.

Spanish banks, now more solvent and robust, are increasing their supply of credit. In July the European Commission published its seventh post-programme surveillance report on the Spanish economy, produced after the financial bail-out carried out in 2014. This report highlights the fact that the restructuring plans for state-invested banks are well underway and should be fully implemented by year-end. It also notes that bank restructuring has gone beyond banks receiving state aid, as the banking sector in general has adjusted its business model. Spain's banks are therefore in an increasingly better position to expand the flow of credit to households and companies, as shown by the figures for new loans granted up to July. Specifically, both loans for consumption and also to buy housing rose by 17% year-on-year, in cumulative figures YTD. In the case of non-financial firms, while loans to SMEs continued to rise significantly (8% year-on-year), new loans for large firms were only up by 0.2% year-on-year. This is because of the good conditions available for financing via corporate bonds. The trend will continue for the rest of the year given that the ECB will maintain its expansionary monetary policy. This will foster favourable financing conditions via banks and the corporate bond markets.

House sales

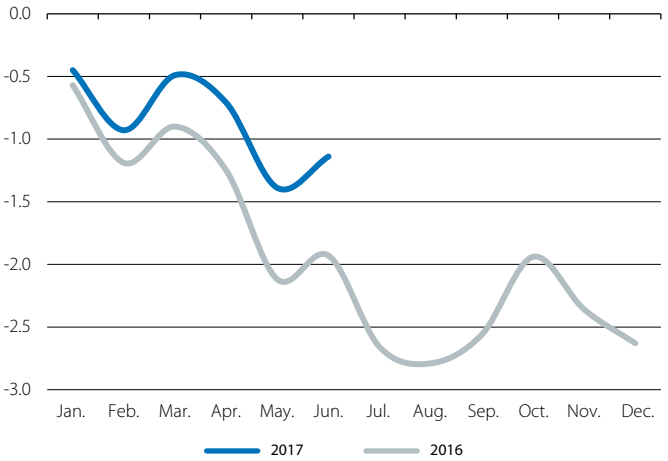
(Thousand residences) Cumulative over 12 months (thousand residences)



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

Central government balance

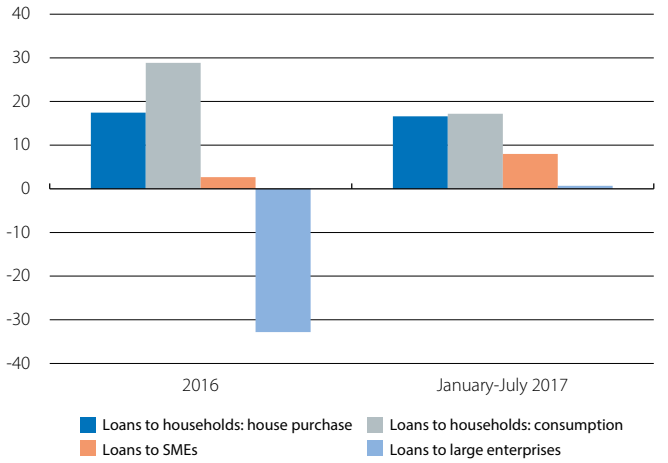
(% of GDP)



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

New loans granted

Year-on-year change (%)



Note: *Loans to households exclude refinancing.*
Source: *CaixaBank Research, based on data from the Bank of Spain.*

FOCUS · Spain's labour force: ageing and educational level

In spite of the large number of jobs created in the past three years, the labour force is still shrinking. Specifically, between Q1 2014 and Q1 2017 the labour force[1] decreased by 190,600 people. The working age population (over 16) increased by 121,000 people over the same period, so this reduction in the labour force is due entirely to a drop in the activity rate, which stood at 58.8% in Q1 2017, 0.6 pp lower than in Q1 2014.[2] This reduction, as we will see below, is mainly due to the ageing of Spain's population.

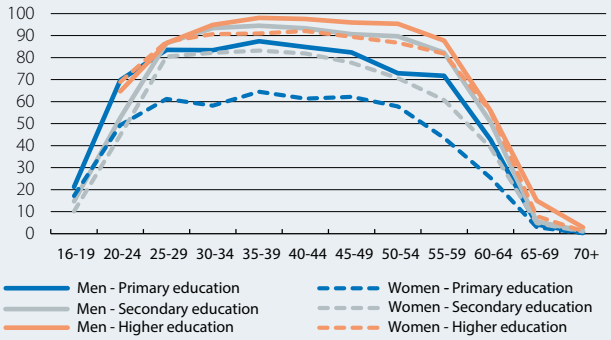
In general, the trend in the activity rate related to age takes the form of an inverted U: the share of young people that participates in the labor market is relatively low because it coincides with training and education, participation in the labor market increases gradually with age and reaches a peak between the ages of 35 and 45, then falling sharply again as people approach retirement age. Spain's ageing population has therefore lowered the activity rate.[3] In fact, if we calculate the activity rate specifically for the population aged between 16 and 64, in other words without taking into account those people who have passed retirement age, it can be seen that this has remained constant at 75%, highlighting the fact that the reduction in the labour force is due to a drop in the working age population.

There is a sharper rate of decline in the activity rate by age among those with a lower level of education. People with higher qualifications who, at first, delay their entry into the labour market, record higher activity rates for the rest of their working lives and tend to delay their exit from the labour market (see the first chart). The higher educational level of Spain's new generations is helping to offset the fall in the labour force due to the ageing population. The second chart shows that the reduction in the labour force is more concentrated in the population with only a primary level education (–531,000). On the other hand, the labour force with secondary and university qualifications has grown over the same period, by 310,000 and 139,000 people, respectively.

The projections available[4] point to the labour force continuing to shrink as a larger number of people reach retirement age. Although part of this reduction will be offset by the higher educational level of new generations and the associated higher activity rate, this will not be enough. The labour force is expected to decrease by 1.7 million between 2016 and 2029 and the activity rate to decline to 53.8% by 2029. In summary, the ageing population is one of the biggest challenges facing the Spanish economy in the medium term and, within this context, policies aimed at encouraging older workers to continue working could help to slow down the decline in the labour force.

Activity rate by educational level, age and gender*

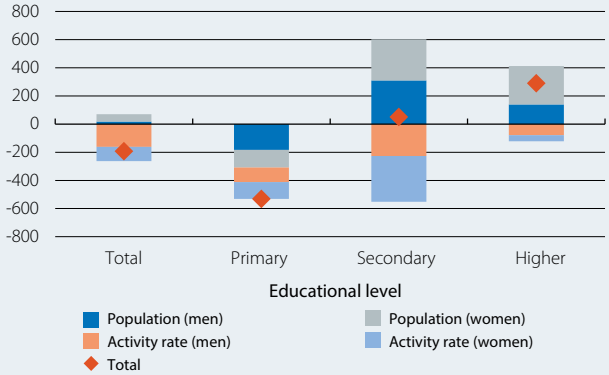
(% of workers out of the total population of people aged 16 and over)



Note: ** Highest educational level achieved. Data from Q1 2017.*
Source: *CaixaBank Research, based on data from the INE (LFS).*

Breakdown of the change in the labour force by educational level

Change between Q1 2014 and Q1 2017 (thousands)



Note: *For each educational level, the change in the labour force between Q1 2014 and Q1 2017 is broken down into two factors: the change in the population aged 16 and over and the change in the activity rate. This has been calculated separately for men and women.*
Source: *CaixaBank Research, based on data from the INE (LFS).*

1. The labour force consists of employed and unemployed people aged 16 and over.
2. The activity rate measures the percentage of the labour force compared with the whole population aged 16 and over.
3. Between Q1 2014 and Q1 2017, the percentage of the population aged over 50 (the age at which the activity rate tends to start falling) increased by 2 pp, reaching 39% of the total.
4. Projected activity rates 2016-2029 (INE).

FOCUS · The consequences of Brexit on the real estate sector

Real estate has now embarked on a new upward cycle, as shown by the trend in house purchases with growth in double-digit figures for the past two years. Although domestic demand has been boosted by the upturn in employment and favourable financial conditions, foreign demand is also far from negligible: up by 14% in Q1 2017, cumulative over four quarters.

This positive situation for foreign demand conceals several different trends, however. On the one hand, most purchases are concentrated on the Mediterranean coast and islands, these locations accounting for over 30% of all purchases in some provinces (see the enclosed map).

On the other hand, the trend in house purchases varies widely by nationality. In this respect, the uncertainty regarding Brexit and the pound's depreciation are having an effect on house purchases by citizens of the United Kingdom, the main foreign buyers of real estate in Spain. Purchases made by British citizens fell by 13% year-on-year in Q1 2017. Nevertheless, this drop is more than offset by the dynamism of purchases made by French, German, Belgian and Swedish citizens which, in Q1 2017, were rising at a rate of 20% year-on-year or more.[1]

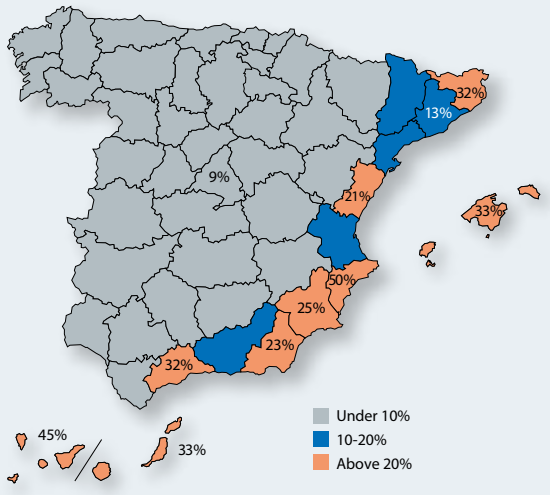
The different trends observed among international buyers have altered each country's relative share of total house purchases, as well as helping to reduce the degree of concentration of foreign buyers. Although the UK still leads the ranking of purchases by foreign citizens, it now accounts for just 15% of all foreign purchases in Q1 2017 compared with 21% in 2015.

Looking to the future, house purchases by British citizens may pick up again should the Brexit negotiations go well and the pound recover. However, any episodes of high uncertainty regarding Brexit, or a hard Brexit, could mar this recovery since, historically, house purchases by British citizens have been very sensitive to their country's economic conditions. On a more positive note, the good economic outlook for the rest of the main countries that buy Spanish property, together with continuing accommodative monetary conditions and lower political uncertainty in the euro area countries, represent an opportunity for Spain's real estate sector.

1. Cumulative figures over four quarters.

House purchases by foreigners in Q1 2017

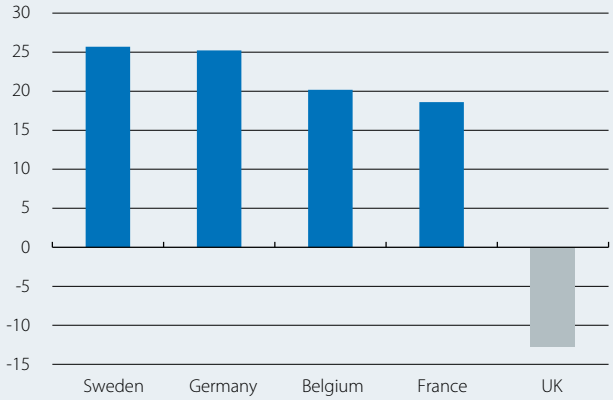
(% of all sales)



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

House purchases by nationality in Q1 2017

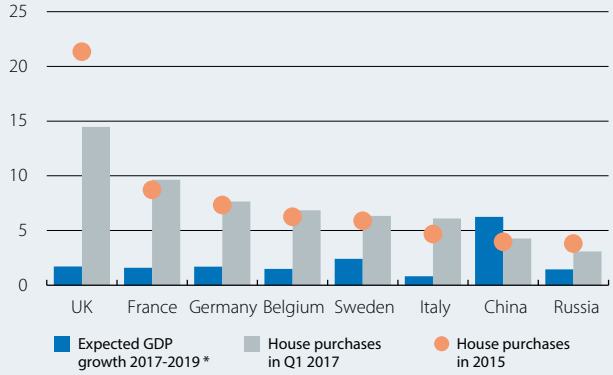
Year-on-year change (%)



Note: *Cumulative figures over four quarters.*
Source: *CaixaBank Research, based on data from the Spanish Land Registry.*

Growth in GDP and house purchases by nationality

(% of all purchases by foreigners)



Note: ** Year-on-year change (%).*
Source: *CaixaBank Research, based on data from the Spanish Land Registry and the IMF.*

FOCUS · The improvement in the income balance

The Spanish economy's current account has improved considerably since 2008, going from a deficit of 10.2% of GDP to a surplus of 1.9% in Q1 2017. During this period the current account increased by EUR 124.34 billion, of which 29.9% (EUR 36.516 billion, 3.2% of GDP) can be attributed to a smaller deficit in the primary and secondary income balance.[1]

The income balance has improved owing to a reduction in payments, EUR 39.717 billion, which far outweighs the drop in income of EUR 3.201 billion. Looking at the net figures (income minus payments) for the different primary and secondary income components, most of the improvement over this period, namely 86.7%, comes from net property income.[2] The second contribution in order of importance, accounting for 10.7% of the total improvement in the income balance, comes from net personal transfers, including a reduction in remittances by foreign immigrants to their countries of origin. In third place are temporary and seasonal wages, contributing 4.1% of the total. The other components all made a more modest contribution.

A more detailed analysis of property income points clearly to lower interest rates playing a key role. Interest income and payments fell by EUR 17.186 and EUR 39.255 billion respectively, producing a net contribution of EUR 22.069 billion (60.4% of the improvement in the income balance). Spain is benefitting from the low interest rate environment because the amount of debt (public and private) held by foreign investors is much higher than the foreign debt held by Spanish investors (1.3 trillion compared with 0.5 trillion in Q1 2017).

Income on equity contributed a cumulative increase of EUR 9.651 billion, 26.4% of the total improvement in the income balance between Q2 2008 and Q1 2017. This is due to the larger rise in non-debt investment (equity and investment fund shares) for assets compared with liabilities.

The two main factors behind this improvement in the income balance are expected to continue. On the one hand, the benefits produced by low interest rates should continue or, at most, only diminish slightly according to current CaixaBank Research forecasts, projecting a gradual but moderate rise in interest rates over the coming quarters. The positive contribution made by returns from equity should also continue over the next few years since direct investment tends to be long term.

1. The current account is made up of the trade balance in goods and services and the income balance which, in turn, is made up of primary income (income from work and investment, production-related taxes and subsidies) and secondary income (personal current transfers, taxes on income and wealth and social contributions and benefits).
2. The net figure resulting from income from investment made by Spaniards resident abroad and payments resulting from income on investment made by foreign residents in Spain.

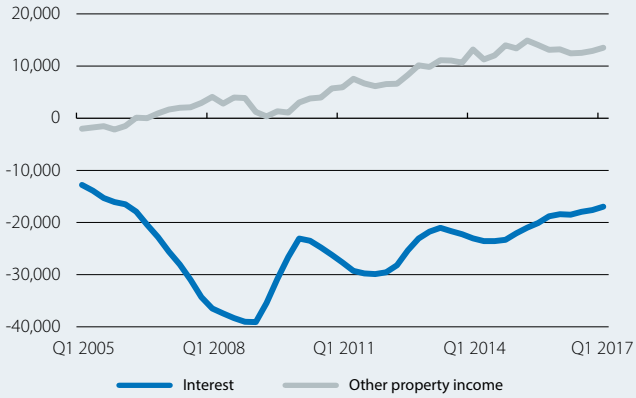
The improvement in the income balance

	Q2 2008 (EUR million)	Q1 2017 (EUR million)	Change (EUR million)	Contribution to improvement in the income balance (%)
Income balance *	**–45,654**	**–9,138**	**36,516**	**100.0**
Primary income	**–29,956**	**2,019**	**31,975**	**87.6**
Compensation of employees	740	2,221	1,481	4.1
Property income	–35,160	–3,440	31,720	86.9
Interest	–39,034	–16,965	22,069	60.4
Non-interest	3,874	13,525	9,651	26.4
Other production-related taxes and subsidies	4,464	3,238	–1,226	–3.4
Secondary income	**–15,698**	**–11,157**	**4,541**	**12.4**
Personal transfers	–17,317	–13,392	3,925	10.7
Other transfers, taxes on income and wealth, insurance	1,619	2,235	616	1.7

Note: ** Cumulative over four quarters. Balances.*
Source: *CaixaBank Research, based on data from the INE.*

*Net property income **

(EUR million)



Note: ** Revenue minus payments (cumulative over four quarters). Account for the rest of the world.*
Source: *CaixaBank Research, based on data from the INE.*

KEY INDICATORS

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

Activity indicators

	2015	2016	3Q 2016	4Q 2016	1Q 2017	2Q 2017	07/17	08/17
Industry								
Electricity consumption	1.7	0.1	0.4	0.0	1.4	1.5	1.1	1.6
Industrial production index	3.3	1.9	1.9	1.9	1.9	2.1	...	...
Indicator of confidence in industry *(value)*	–0.3	–2.3	–3.8	–0.6	0.3	–0.5	–1.8	–0.6
Manufacturing PMI *(value)*	53.6	53.2	51.4	54.4	54.8	54.9	54.0	52.4
Construction								
Building permits *(cumulative over 12 months)*	20.0	43.7	44.8	36.9	24.5	...	...	...
House sales *(cumulative over 12 months)*	10.9	13.0	13.4	13.7	14.9	12.0	...	...
House prices	1.1	1.9	1.6	1.5	2.2	...	–	...
Services								
Foreign tourists *(cumulative over 12 months)*	5.6	8.2	9.3	10.1	10.0	10.2	10.4	...
Services PMI *(value)*	57.3	55.0	54.9	54.9	56.4	57.8	57.6	...
Consumption								
Retail sales	3.0	3.6	3.8	3.0	0.5	2.5	0.4	...
Car registrations	21.3	11.4	11.0	8.9	7.8	6.3	2.5	13.0
Consumer confidence index *(value)*	0.3	–3.8	–6.1	–3.2	–2.8	1.5	2.0	–0.2

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

Employment indicators

	2015	2016	3Q 2016	4Q 2016	1Q 2017	2Q 2017	05/17	06/17	07/17
Registered as employed with Social Security [1]									
Employment by industry sector									
Manufacturing	2.2	2.8	2.7	2.8	3.0	3.1	3.2	3.1	3.1
Construction	4.7	2.6	2.7	3.3	5.3	6.1	6.3	6.0	6.3
Services	3.5	3.2	3.3	3.5	3.4	3.8	3.8	3.8	3.7
Employment by professional status		3.5							
Employees	3.5	3.5	3.5	3.8	4.0	4.4	4.5	4.4	4.2
Self-employed and others	1.9	1.0	0.9	0.9	0.9	0.9	1.0	0.9	0.8
TOTAL	**3.2**	**3.0**	**3.0**	**3.3**	**3.4**	**3.8**	**3.9**	**3.8**	**3.6**
Employment [2]	**3.0**	**2.7**	**2.7**	**2.3**	**2.3**	**2.8**	**2.8**	**–**	**–**
Hiring contracts registered [3]									
Permanent	12.3	14.2	17.9	13.3	15.4	10.2	14.8	12.2	10.6
Temporary	11.2	7.2	7.1	6.6	12.1	9.6	16.1	8.5	5.8
TOTAL	**11.3**	**7.8**	**7.9**	**7.1**	**12.4**	**9.6**	**16.0**	**8.8**	**6.2**
Unemployment claimant count [3]									
Under 25	–11.0	–12.6	–14.4	–13.2	–13.3	–17.3	–17.5	–16.5	–11.9
All aged 25 and over	–7.2	–8.2	–8.6	–9.0	–9.2	–10.3	–10.5	–10.2	–9.2
TOTAL	**–7.5**	**–8.6**	**–9.1**	**–9.4**	**–9.6**	**–10.9**	**–11.1**	**–10.7**	**–9.4**

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	3Q 2016	4Q 2016	1Q 2017	2Q 2017	07/17	08/17
General	**–0.5**	**–0.2**	**–0.2**	**1.0**	**2.7**	**2.0**	**1.5**	**1.6**
Core	0.6	0.8	0.8	0.9	1.0	1.1	1.4	...
Unprocessed foods	1.8	2.3	3.5	1.0	4.1	2.5	–1.0	...
Energy products	–9.0	–8.4	–8.6	1.6	15.3	8.0	4.1	...

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

Foreign sector

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

	2015	2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017	04/17	05/17	06/17
Trade of goods									
Exports *(year-on-year change)*	4.3	1.7	4.3	–1.1	3.2	14.1	–2.0	15.2	5.7
Imports *(year-on-year change)*	3.7	–0.4	–0.3	–3.7	3.0	16.5	0.5	16.7	5.0
Current balance	**14.7**	**21.5**	**18.5**	**20.0**	**21.5**	**21.1**	**19.1**	**19.5**	**19.3**
Goods and services	26.2	32.7	29.3	31.2	32.7	30.0	29.4	29.1	29.3
Primary and secondary income	–11.5	–11.2	–10.8	–11.2	–11.2	–8.9	–10.3	–9.6	–10.0
Net lending (+) / borrowing (–) capacity	**21.7**	**23.3**	**24.0**	**24.3**	**23.3**	**23.5**	**21.5**	**21.9**	**21.5**

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

Public sector

Percentage GDP, cumulative in the year, unless otherwise specified

	2015	2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017	04/17	05/17
Net lending (+) / borrowing (–) capacity [1]	**–5.1**	**–4.5**	**–3.0**	**–2.8**	**–4.5**	**–0.4**	**–**	**–**
Central government	–2.6	–2.7	–1.9	–2.6	–2.7	–0.5	–0.7	–1.4
Autonomous regions	–1.7	–0.8	–0.6	–0.1	–0.8	–0.2	–0.3	–0.4
Local government	0.5	0.6	0.1	0.5	0.6	0.1	–	–
Social Security	–1.2	–1.6	–0.6	–0.6	–1.6	0.1	0.2	0.2
Public debt *(% GDP)*	**99.8**	**99.4**	**101.1**	**100.4**	**99.4**	**100.4**	**–**	**–**

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	Q2 2016	Q3 2016	Q4 2016	Q1 2017	04/17	05/17	06/17	Balance 06/17 [1]
Financing of non-financial sectors [2]										
Private sector	–3.9	–2.6	–2.9	–2.0	–2.1	–1.1	–0.6	–0.6	–1.3	1,621.4
Non-financial firms	–4.0	–2.7	–3.2	–2.1	–2.2	–0.7	0.2	0.1	–1.1	906.1
Households [3]	–3.6	–2.3	–2.5	–2.0	–1.9	–1.6	–1.5	–1.5	–1.5	715.4
General government [4]	4.0	3.9	4.2	4.6	3.2	3.4	3.4	3.3	2.9	1,138.9
TOTAL	**–1.0**	**–0.1**	**–0.2**	**0.5**	**0.0**	**0.7**	**1.0**	**1.0**	**0.4**	**2,760.3**
Liabilities of financial institutions due to firms and households										
Total deposits	–1.0	–0.3	–0.3	–0.3	–0.1	–0.6	–0.6	–1.4	...	...
On demand deposits	16.0	14.6	14.2	14.1	15.4	16.8	16.8	16.2	...	...
Term and notice	–15.0	–16.9	–16.0	–17.1	–19.3	–23.6	–25.3	–27.2	...	...
Rest of liabilities [5]	–13.0	–15.7	–16.3	–11.3	–18.6	–16.7	–16.8	–11.9	...	...
Deposits in foreign currency	–0.8	1.1	0.9	2.3	–0.4	–1.7	–6.6	–8.9	...	...
TOTAL	**–2.2**	**–1.6**	**–1.7**	**–1.2**	**–1.6**	**–1.8**	**–1.9**	**–2.2**	**...**	**...**
NPL ratio *(%)* [6]	**10.1**	**9.1**	**9.4**	**9.2**	**9.1**	**8.8**	**8.9**	**8.7**	**...**	**–**
Coverage ratio *(%)* [6]	**58.9**	**58.9**	**58.7**	**59.3**	**58.9**	**59.1**	**58.6**	**59.4**	**...**	**–**

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.*

EUROPE'S MOMENT

The European Union: the keys to a rebirth

Things are not exactly going well for the construction of Europe at present. In fact, on the 60th anniversary of the signing of the Treaty of Rome, Europe seems to be facing an increasing number of challenges. Over the past few years, the EU has had to tackle several economic shocks (the Great Recession of 2008-2009 and the sovereign debt crisis), political setbacks (the rise in populism and Brexit), migratory pressures (handling refugees and mass migrations around the Mediterranean), threats to its domestic security (terrorism) and geostrategic troubles (Russia's resurgence, heightened Middle East tensions and the US's isolationist shift). Such immediate challenges may be overwhelming but its long-term outlook is hardly encouraging either. In a deceptively distant future lies the prospect of demographic decline and an ageing society which will affect both economic performance and the welfare state, a core feature of the European social contract.

Such a situation brings to mind the words of Jean Monnet, who said that «Europe will be forged in crises, and will be the sum of the solutions adopted for those crises». Precisely the spirit endorsed by this month's Dossier and by this first article in particular. Here our aim is to examine how a new EU might be forged that would be able to tackle its current and future challenges with some degree of success. The solutions and constitutive parts of this renewed EU may be found by analysing certain current critical areas (economic union, fiscal union, etc.). But before determining the ideal nature of this future Europe, and following Monnet's lead, we should first examine those past solutions which have forged the EU we know today. There are several different ways to carry out such an analysis. However, one particularly useful approach is based on a somewhat stylised version of what are known as the «great visions» (sometimes also called the stories, narratives or philosophies) of European integration. According to our analytical framework, a vision consists of a set of basic premises of a conceptual nature which, in decision-making, help to tip the balance in one way or another. When, for instance, at the end of the 1980s, a decision had to be taken on how excessive public deficits should be controlled in a future Economic and Monetary Union (EMU), the final solution chosen was a combination of preferences, interests and technical reasons but also of pre-existing ideas regarding the ultimate aim of this EMU. In short, ideas are more than mere intellectual pretexts. So what are these «great visions» of European integration?

The two visions in play throughout Europe's history

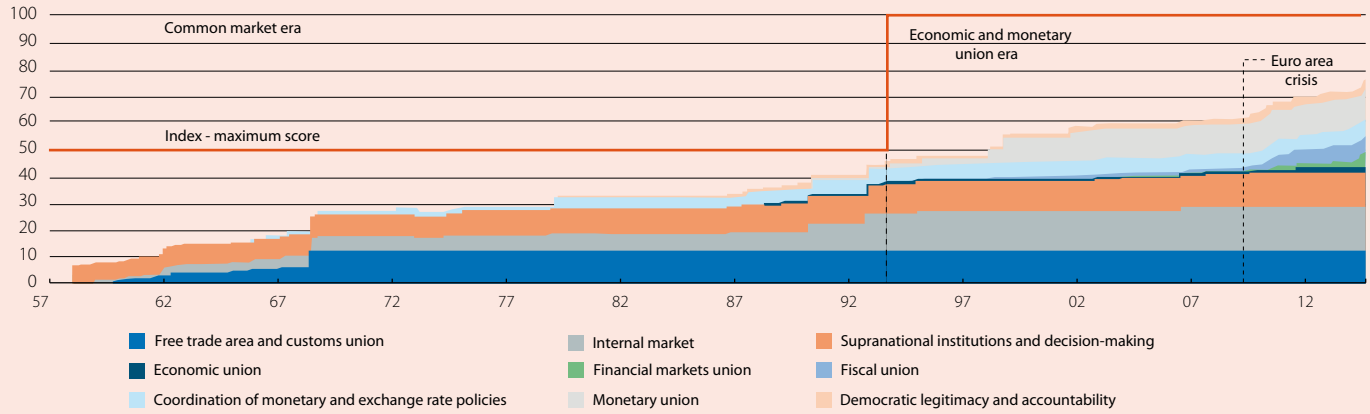
Perhaps the main vision underpinning the very nature of European integration is clearly Germanic in origin. Sometimes called the «German vision» of European integration since Germany was largely responsible for it, there can be no doubt regarding its vital role as a conceptual anchor. At different times, when critical decisions had to be taken regarding institutional design, such as extending the EU's powers, etc., these have been directly inspired by this vision. Essentially, the German vision believes that European integration involves the creation of an order, or framework of reference, by defining a series of rules or norms.[1] This general philosophy is based on three broad notions. Firstly, maximum concern for moral risk, applying what is sometimes called the principle of accountability. This means that whoever takes the risk in decision-making processes deserves any benefit resulting from their actions but they are also accountable for any negative consequences. A second key notion is that markets act as a counterweight to governments, for instance by pointing out the consequences of public decisions. In this respect, the supranational order must allow markets to carry out this signposting function without interference. Thirdly, governments must uphold the framework of stability and intervene when necessary to ensure accountability. Applying these three notions, and in line with the German vision, the «natural» political instrument to achieve integration is by creating supranational legislative frameworks, expressed politically through a federal model. In perhaps overly simplistic terms, the aim is to create a European federal order which is integrated (or is compatible) with the state federation, which is Germany.

Of course, decisions related to the construction of Europe are not based entirely on this vision. Although the term is perhaps somewhat imprecise, there is also an opposing stance to the German vision that is sometimes called the «French vision». We say this term may be imprecise because, while German ordoliberalism is a relatively homogeneous doctrine defended on numerous occasions by German politicians in key decisions on the construction of Europe, the French vision is not so clearly articulated.

1. This vision is sometimes dubbed ordoliberalism. Ordoliberalism is the economic doctrine underlying the domestic economic policy of the Federal Republic of Germany when it was set up after the Second World War. The German vision of European integration would therefore be a version adapted to the supranational order entailed by the EU.

Index of European Institutional Integration

Level (100 = max.)



Note: *The index quantitatively maps developments in European Institutional Integration from 1958 to 2015. The maximum level in the common market era (1958-1993) is set at 50 and in the EMU era at 100. The gap from the maximum indicates how much remains to achieve a steady state in the integration process.*
Source: *CaixaBank Research, based on Dorrucci, E.* et al. *(2015), «The Four Unions "PIE" on the Monetary Union "CHERRY": A New Index of European Institutional Integration», ECB Occasional Paper Series 160.*

Rather it is a body of doctrine implicitly inferred by the positions very often upheld by France but also, on other occasions, by Mediterranean countries in the EU and even others aligned against the German stance. To characterise this diverse set of proposals, it is useful to compare «French-style» and «German-style» integration. So regarding the issue of how integration should be achieved, the former advocates a series of supranational institutions to which a set of previously exclusively national powers is transferred. The approach taken by the latter, remember, is integration via rules. As in the case of the German vision, the political design par excellence of the French vision is also federalist but with a different logic. The French vision tends to prefer a transfer of powers to a supranational level. But not the German vision. In this approach powers should only be transferred when necessary to create a supranational political framework. A second feature of many of the proposals inspired by the French vision (we insist: not always or only endorsed by France) is that it is not so important to strike a fine balance between public and private counterweights. On the other hand, the French vision is much more in favour of direct intervention by institutions, frequently via sector-based policies such as the common agricultural policy or industrial policy.

For a greater insight into how these very general principles have influenced the «solutions» (in Monnet's sense of the word) adopted by the EU over time and indeed have defined it, we can examine a specific series of decisions related to the initial creation of EMU. Looking at the defining features of the original EMU, namely that established in the Maastricht Treaty of 1993, almost all its design clearly bears the mark of the German vision. It sets up a mechanism to control deficits based on rules, on the non-monetarisation of government debt, on no bailouts (the aforementioned principle of accountability), on market signposting, on relaxed coordination (i.e. based on peer pressure and on the aforementioned market signposting) and on the establishment of criteria (rules again) for nominal convergence. In other words, all EMU governance mechanisms are based on the German approach: the creation of a public finance stability framework without the need for strong institutionalisation. What was the alternative? France's proposal at the time, repeated almost every time EMU governance has been reviewed, was to create a system of quasi European economic governance with clearly attributed budgetary control powers and the capacity to intervene in the case of a public finance crisis. As we have said, the German vision prevailed.

However, that same Treaty also created the ECB, one of the EU's most powerful supranational institutions. This seems to be an institutional «solution» clearly in line with the spirit of the French vision. Nevertheless, the decision to create the ECB highlights the fact that the ideas embodied by these visions operate within certain limits. In this case, a kind of technical consensus predominates that a single currency has a greater chance of success if it is supported by a single central bank. Cohen (1993) found that, in seven international monetary unions prior to EMU, whenever a single currency is created a central bank is also set up, while a system that coordinates the members' national central banks is only chosen when the aim is to maintain national currencies linked by a fixed but differentiated exchange rate.[2]

2. See Cohen, B. (1993), «Beyond EMU: The Problem of Sustainability», Economics and Politics, no. 5.2: 187-203.

Ideas have therefore been very important in the past and are likely to influence the necessary reinvention of the EU in the future. This renewed EU will probably arise from a combination of challenges and ideas, taking the form of a series of proposals largely inspired by the German and French visions in the two critical areas on which the EU stakes a large part of its future: economic integration and the coordination of economic policies. But do not be fooled. Although the adjective «economic» is used for these two areas, both, and especially the second, have a fundamental political aspect, as we will see later on.

Economic integration and convergence

In the first of these areas, economic integration needs to be reinforced with policies that allow the movement of people, capital, goods and services. The euro area is still less synchronised than other monetary unions, such as the US dollar, as shown by the article «Economic synchronisation in a common economic and monetary area» in this Dossier. This factor is related to the EU's lower degree of economic integration than the US. One key policy required to achieve a truly domestic market is the development of a («German-style») common legislative and regulatory framework. The EU has traditionally focused on regulatory harmonisation and this has certainly been productive in some sectors, such as telecommunications. But, in general, such approaches will have to be more innovative in the next few stages of economic integration. The EU's progress towards banking union could be an indicator of how economic integration might move forward.

As noted by Arqué, Fernández and Plata (2017), banking union was actually undertaken as a result of the explicit need to remove the harmful link between sovereign risk and bank risk during the last sovereign debt crisis. This union has nevertheless become a vital cornerstone to completing the euro area's design, in the sense used by Gual (2012) of advancing towards the efficient provision of capital at a pan-European level.[3] In this construction, the instrument of harmonising bank sector regulation has been combined with the creation of other elements that reinforce, in practice, the degree of institutionalisation. Harmonisation involved the creation of a single legislative code for all financial institutions containing the necessary capital requirements and rules for handling banks in difficulty. In terms of institutionalisation, an already-existing institution, the ECB, was strengthened by turning it into a single supervisor for all euro area banks as from 2014 and by starting up the Single Resolution Mechanism (SRM), in operation since 2016. One important aspect that is, at present, still absent is a European Deposit Guarantee Fund. This is therefore an example of integration via rules plus reinforced institutionalisation, a solution that takes elements from both of the aforementioned visions, German and French.

But this is unlikely to be enough to overcome the obstacles to achieving a sufficient degree of economic integration and convergence. In addition to banking union, the financial area is also undergoing a union of capital markets. Although progress has been made, there is a possible problem. Considering the drive to carry out such convergence was at its height when the euro area's financial crisis was in full swing, might there be less incentive to achieve this at less financially stressful times? Essentially, this highlights one of the biggest difficulties in achieving deeper integration; namely the lack of an underlying political factor. In 2012, Gual put his finger on it: «successful deep economic integration (...) requires profound economic reforms. Indeed, they are so significant and touch upon so many aspects of the social and economic fabric that it is unrealistic to expect that they can be imposed from Brussels with the current institutional arrangements and without resorting to a radically higher degree of political union».

Coordination of economic policies

The demand for greater political integration is even more evident in the coordination of economic policies. Improving the coordination of economic policies to tackle asymmetric shocks across countries may seem to be a strictly technical issue. This is far from the truth, however, since the obstacles to achieving this are clearly political in nature.

As noted in the article «Fiscal union and the long road towards Eurobonds» in this Dossier, there must be better coordination of economic and fiscal policy across different euro area countries. So how can this coordination be improved? Surely by combining elements from the German and French visions. The ultimate need for stabilising powers that can tackle asymmetric shocks in the future is unlikely to be possible without a high degree of institutionalisation, more in line with the French approach of creating supranational instruments. But clear boundaries are also required, with strict conditions that offset any relaxation of the principle

3. On this issue in detail, see Arqué, G., Fernández, E. and Plata, C. (2017), «¿Un sistema europeo de garantía de depósitos?», Anuario del Euro 2016, Fundación ICO and Fundación de Estudios Financieros, and also Gual, J. (2012), «European Integration at the Crossroads», "la Caixa" Economic Papers, no. 8.

of accountability. For instance, a stabilisation system could be designed with no permanent assignment of powers but temporary transfers, limited to the moment of the asymmetric shock and with strong restrictions on unsustainable fiscal policies (such as debt ceilings in constitutions). This would reduce the moral risk (traditionally a German concern) of non-prudent fiscal policies being implemented.

Towards a combined vision: ideas, instruments and policy

In short, our review of the EU's history and analysis of its future suggest that Europe is entering a new phase; one that is much more demanding but also much more promising than the last decade. Almost all the examples we have given reveal a combination of ideas based on both the German and French visions. In our opinion, a new combined vision is being created, capable of responding to problems that cannot be resolved using just one of these approaches. In our review of the challenges still pending and the obstacles to be overcome, we have also seen that, one way or another, the response contains elements that entail greater political integration, albeit embryonic. In such a situation, the most typical resource is what is known as «flexible integration». Whereas, in the past, the aim was to achieve an «ever closer union», as proposed by the Maastricht Treaty, at present achieving unanimous agreement in many of the aforementioned areas is not only extremely difficult but also bordering on the impossible. But the impossibility of achieving a common single goal must not impede ambitious reforms within the EU. One way of overcoming this impasse is integration at different speeds and levels.[4] Many proposals to develop the EU are indeed possible provided members can opt in or out and deeper integration is achieved at several different levels. And, perhaps, as these new areas of integration prove their worth, other member states might also choose to join in.

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4. See, for instance, Morillas, P. (2017), «Formes per a una unió: del "ever closer union" a una diferenciació flexible després del Brèxit», Notes Internacionals, CIDOB 166.

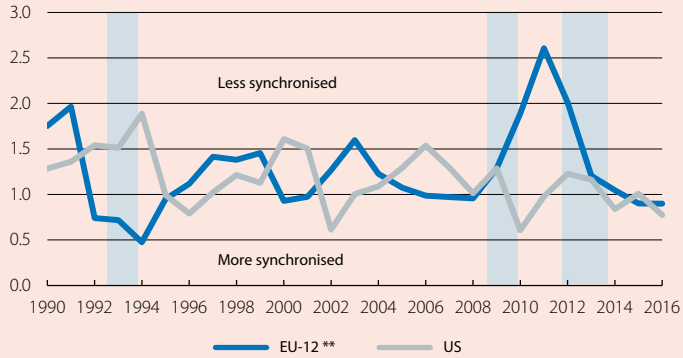
Economic synchronisation in a common economic and monetary area

In 2008, to celebrate the tenth anniversary of the birth of the euro, the European Commission published an extensive document discussing the experience of Economic and Monetary Union.[1] Although this document covered both successful and less successful areas, the following conclusion was drawn: «Ten years into its existence, the euro is a resounding success». Nine year's after this document's publication, and having gone through a global economic crisis, few would be willing to support such a view. This change in perception is related to those problems already flagged up in the debate prior to the euro's creation. This article focuses on the dangers that emanate from a lack of business cycle synchronisation among euro area countries. We will review the reasons why this should be the case, assess the degree of economic synchronisation between the different member states and discussing some factors that limit its degree.

The debate prior to setting up the euro revolved around the concept of the «optimum currency area». This concept, largely originating from work by the winner of the Nobel Prize for Economics, Robert Mundell, establishes that countries sharing a common currency should have a synchronised economic cycle. To avoid confusion, whenever we talk about synchronisation of the economic cycle in this article, we mean that a group of countries goes through expansionary and recessionary phases of the cycle simultaneously and that the economic shocks affect members of the group in a similar way. When a group of countries establishes a common currency area, by definition each country gives up sovereignty over its monetary policy and exchange rate, thereby losing two valuable tools to stabilize the economic cycle. The loss of these tools does not lead to tension provided all the countries experience a synchronised cycle of similar intensity since the policy implemented by the central monetary authority will be suitable for all member states. However, if the cycles are not synchronised or differ in their intensity, the absence of such tools could be problematic.

Indicator of economic cycle synchronisation *

Standard deviation



Notes: ** The indicator is the standard deviation of GDP growth for each country minus the average growth of the euro area (or US). Ireland is excluded from the 2015 figure due to a change in the definition of its GDP series. The standard deviation is calculated using a measure weighted by each country's population.*
*** Some euro area countries have been excluded due to a lack of data.*
Source: *CaixaBank Research, based on data from the OECD and BEA.*

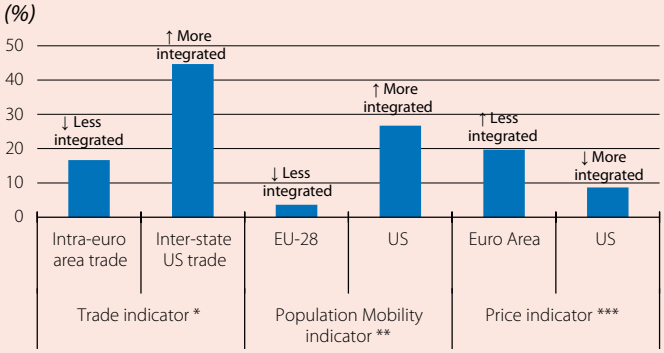
We therefore need to look at the degree of synchronisation of the economic cycle between euro area member states over the past few decades. In this article we use a measure of dispersion of GDP growth rates to gauge the degree of synchronisation. There are other measures, such as those based on the correlation of growth rates or a breakdown of GDP growth into common and idiosyncratic factors for each country. However, correlations are not sensitive to growth rates differentials and measurements based on the decomposition of GDP growth rates require arbitrary assumptions. We therefore believe that our measure based on the degree of dispersion of GDP growth rates is the most appropriate one.[2]

The chart compares the synchronisation indicator for a group of 12 euro area countries with that of the eight large regions of the US.[3] The higher the indicator, the lower the degree of synchronisation. Shaded areas indicate those years when the euro area was in recession. As can be seen, the degree of cycle synchronisation for the US regions has remained relatively stable over the period in question. In the case of the euro area, we can see that, after a sharp rise in synchronisation at the beginning of the 90s, probably due to the harmonising efforts to create the single market in 1993, it remained relatively constant and at a similar level to the US for the rest of the 90s and early 2000s. In fact, if we had written this article in 2008, based on the indicator shown, we would have reached the same conclusion as the European Commission article mentioned above, namely that the euro area had achieved an apparently satisfactory degree of synchronisation.[4] However, the degree of synchronisation in the euro area declined significantly during the years of the global financial crisis, something which did not happen in the US. In spite of an apparently good degree of synchronisation before the crisis, the indicator suggests there are shocks that affect euro area countries in a very asymmetric way.

1. European Commission (2008), «EMU@10, Successes and challenges after ten years of Economic and Monetary Union», European Economy, vol. 2.
2. See the article by the European Commission (2008) for a more detailed explanation of the problems related to each measure.
3. The countries included within the euro area are: Germany, Austria, Belgium, Spain, Finland, France, Greece, Netherlands, Ireland, Italy and Portugal. The US regions are: New England, Mideast, Great Lakes, Plains, Southeast, Southwest, Rocky Mountains and Far West. These eight regions cover the whole of the US.
4. The alternative indicators mentioned previously would have also suggested a good degree of synchronisation before the crisis.

The extent of the recession varied greatly across different euro area countries because of several factors. As mentioned in the other two articles in this Dossier, this was partly due to the euro area's institutional architecture not being ready to tackle such huge shocks. Another difference between the US and the euro area is the degree of integration of their respective markets. This is important because the greater the market integration, the greater the synchronisation. The enclosed chart shows three indicators: commercial integration, population mobility and price spread. In a highly integrated market, we would expect member states to trade a lot with each other, for there to be a lot of people living in states other than where they were born, and for the prices of goods and services to be relatively similar. As can be seen in the chart, the euro area compares very badly with the US in such aspects.

Market integration indicators



Notes: ** Exports of goods between member states of the euro area (or US) as a percentage of GDP of the euro area (or US). Data from 2012. ** Percentage of people living in a member state of the EU-28 (or US) but who were born in another member state of the EU-28 (or US). Data from 2015. *** Coefficient of the change in the price series compared with the series average (as a percentage). Data from 2015. For the euro area, we have used the price index series for household final consumption. For the US, we have used the implicit regional deflator.*
Source: *CaixaBank Research, based on data from Eurostat, US Bureau of Transportation Statistics, US Census Bureau and BEA.*

If the four principles underpinning the single market are the free circulation of people, goods, services and capital, why is the euro area market so fragmented? Fragmentation is largely due to the very nature of the euro area itself. The single market is made up of countries with very different languages, cultures and laws. This heterogeneity may create a rich, diverse continent but it also limits the capacity of euro area countries to integrate if the right measures are not taken.

Since the single market was set up with the signing of the Single European Act in 1987, considerable progress has been made in its composition. But a greater degree of integration is possible. For instance, to increase the mobility of people, a fast system could be put in place to approve academic and professional qualifications. More guarantees could be implemented to be able to transfer pension plans or medical insurance between member states. In the products market, the circulation of goods and services throughout Europe would be boosted by reforms harmonising regulations and technical specifications. The unification of administrative procedures and legal requirements to do business in each euro area country would also encourage more circulation. A greater degree of interconnectivity in sectors such as energy, and creating a single regulator, would also increase economic efficiency and reduce price differences between member states. Finally, in terms of the circulation of capital, the euro area's banking sector is still highly fragmented in spite of the progress made through banking union. Measures that would help to improve integration in this area include the harmonisation of insolvency procedures, getting rid of the supervisory discretions that still exist between countries as well as unifying criteria (for example, how non performing loans are defined). In addition, the Single Resolution Fund should be given the appropriate amount of funding to be able to act as a fiscal backstop, and a European deposit guarantee scheme needs to be set up to increase the mutualisation of risk across countries. A lot remains to be done.

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Fiscal union and the long road towards Eurobonds

Despite the reforms implemented over the past few years aimed at improving the euro area's institutional architecture, the Economic and Monetary Union remains incomplete.[1] This is shown by the constant stream of statements made by Europe's major political leaders in favour of making progress towards reforming the euro area institutions. Fiscal union is one of the areas that attracts most attention, because of its importance and because, over the past few months, some detailed proposals have been made.

A fiscal union includes many different elements and often proposals are made in only one or two areas. The reforms that need to be implemented can be divided into two broad areas. On the one hand, the improvement of the mechanisms that guide and support fiscal policy in Euro area economies. This includes both the set of rules that guide each country's fiscal policy as well as, eventually, setting up a body at a European level which could take over some economic policy competences. The other broad area of fiscal union is related to the financing of such competences.[2]

Over the past few months, the debate has intensified on both fronts. On the one hand, Chancellor Angela Merkel has come out in favour of setting up a European Finance Ministry (for euro area member states) provided that the current rules that govern the fiscal policy of euro area countries are reinforced. Her French counterpart, Emmanuel Macron, has gone one step further and specified what areas this Ministry should be responsible for: infrastructure investment, emergency financial assistance and support for member states in a recession. The French President, who is familiar with the German vision, also added that this Ministry should only be able to give aid to those countries that comply with the common fiscal rules. Although a definitive move towards fiscal union is still far from defined German and French positions appear to be nounc closer together make further progress, it is important to define the future Finance Ministry's rules and responsibilities with enough precision to secure the approval of the German position. At the same time, however, the French position will also require this Ministry to have enough room for manoeuvre so as to ensure that any policies implemented are truly effective.

The second broad area of fiscal union is even less defined. Little has been said on whether the future European Finance Ministry will be funded via ordinary transfers from member states or whether, alternatively, the via partial or total revenue from some tax. On the other hand, an interesting debate has certainly arisen regarding whether the creation of a Finance Ministry could be accompanied by the creation of a European debt instrument, a so-called Eurobond. Interest in this area is twofold. On the one hand, this could increase the scope of the policies carried out by the future Ministry of Finance. In recessionary periods, for example, when available resources are more limited but, at the same time, more necessary, the budget could be maintained or increased by issuing debt.

On the other hand, Eurobonds could contribute to increase financial stability in the euro area. This is because a significant share of each country's public debt is held by banks whose business is concentrated in that very same country. During the crisis, this meant that shocks were passed on from the public sector to the banking sector (and vice versa), amplifying its overall economic impact.

Thus, the creation of a European safe asset could encourage banks to diversify their sovereign bond holdings, which would help to break the loop between banks and sovereigns. Ultimately, it is also believed that the commitment countries would acquire when creating Eurobonds could help to eliminate the risk of a euro break-up – this weighed very heavily on the banking and public sectors of peripheral countries at the height of the crisis.

In this context, the European Commission proposed, in a recent article, the setting up of a euro area Treasury which would be responsible for jointly issuing a common debt instrument. However, this is seen as a medium and long-term goal. First, an agreement must be reached regarding the creation of a future Finance Ministry. In other words, before euro area countries can accept a new asset whose risk is shared by all members, an agreement must be reached regarding the use of these funds.

1. Specifically, changes were made to the governance framework at an EU level by setting up the European Semester, aimed at coordinating economic policies, and the Six Pack, to reinforce fiscal compliance. The Fiscal Compact and Two Pack were also approved to increase supervision and coordination of fiscal policies in euro area countries. Mechanisms were also set up to handle crises, such as the ESM (to recapitalise banks and provide member states in difficulty with liquidity), as well as making important advances towards financial union.
2. See, for instance, Allard, C. et al. (2013), «Toward a Fiscal Union for the Euro Area», IMF Discussion Note, September.

In the shorter term, the European Commission suggests that it might be useful, and feasible to introduce sovereign bond-backed securities or SBBS.[3] This proposal is based on the one made a few years ago by M. Brunnermeier *et al.,* whereby one or more credit institutions (public or private) would buy a diversified portfolio of euro area sovereign bonds on the secondary market using a transparent and predictable weighting system.[4] In order to finance this portfolio, two types of security would be issued: senior (European Safe Bond Assets or ESBies) and junior (European Junior Bonds or EJBies).[5] The latter would be the first to absorb any losses resulting from a country defaulting on its debt.

This initiative is unrelated to the creation of a European Finance Ministry and is aimed at improving financial stability in two ways. First, through an increase in the supply of risk-free assets in the euro area (assets denominated in euros with an AAA rating). Second, through a reduction in bank's exposure to sovereign risk in their home country by providing them with an instrument to help diversify their bond portfolio. This second element is important because, as it breaks the link between each country's sovereign risk and bank risk, economic shocks would have a lower impact.

To sum up, although fiscal union may seem like a distant goal that is difficult to achieve, some of the pieces of the puzzle are, little by little, being put in place. Europe has always progressed slowly. Nevertheless, there are moments in its history when far-reaching decisions have been taken. We are probably on the brink of one of those moments. And fiscal union is one of the areas where real progress could be made over the next few years.

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3. See Brunnermeier, M. et al. (2011), «European Safe Bonds», The Euronomics Group, abstract available at voxeu.org.
4. For instance, Brunnermeier, M. et al. (2016), «The Sovereign-Bank Diabolic Loop and ESBies», American Economic Review Papers and Proceedings, vol. 106, no. 5.
5. SBBS would be completely guaranteed by the underlying portfolio. In other words, the nominal value of ESBies and EJBies would equal the total nominal value of the member state sovereign bonds underlying these securities.

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As of 31 March 2017

	MILLION €
Customer funds	338,053
Loans and advances to customers, gross	227,934
Profit attributable to Group, YTD	403
Market capitalisation	24,085
Customers (million)	15.8
Employees	37,638
Branches	5,525
Branches in Spain	4,990
Self-service terminals in Spain	9,461

"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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