MR10

MONTHLY REPORT • ECONOMIC AND FINANCIAL MARKET OUTLOOK

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ECONOMIC & FINANCIAL ENVIRONMENT

DOSSIER: CONSUMPTION: NEW TRENDS

CaixaBank Research

MONTHLY REPORT - ECONOMIC AND FINANCIAL MARKET OUTLOOK
October 2017

CaixaBank, S.A.
Strategic Planning and Research

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

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Enric Fernández
Corporate Director,
Strategic Planning and Research

Oriol Aspachs
Director, Macroeconomics

Avelino Hernández
Director, Financial Markets

Estel Martín
Director, Banking Strategy

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Consumption and engines of growth

The Dossier in this *Monthly Report* focuses on household consumption, the Spanish economy's main component of gross domestic product (GDP) on the demand side. It accounts for 57% of GDP, a figure that excludes goods supplied by public administrations such as education, health, security and defence (which would account for a further 20% of GDP). It could even be argued that household consumption is a better gauge of well-being than GDP per se. Ultimately, our satisfaction comes from consuming rather than producing.

Some may be surprised to hear that household consumption in Spain, in real terms, is 5% lower than its pre-crisis peak in spite of its recovery over the past few years. Although GDP returned to its pre-crisis level by the second quarter of this year, consumption has yet to catch up. This is because exports have essentially driven the recovery of the Spanish economy.

In fact, cause and effect are often being confused when consumption is deemed to be the engine of economic growth. Consumption certainly helps to explain an economy's cyclical movements. When confidence wanes or uncertainty escalates, consumers tend to postpone decisions to purchase durable goods or spend less on leisure, for example. And as consumption accounts for a very large share of GDP, even small fluctuations in the propensity to consume have a considerable impact on GDP as a whole.

But an economy's long-term growth and its capacity to consume are actually determined by savings and investment. And both help to improve productivity; i.e. producing more with less. Savings finance investment in both physical and human capital. Excessive consumption, or rather insufficient savings, therefore end up having a negative effect on an economy's growth potential. Several factors can boost productivity. One is innovation, such as the development of new products, business models or better production processes. Significant benefits can also be obtained from agglomeration economies, such as clusters, as well as the appropriate allocation of resources according to changes in the environment. Good quality education, a flexible production system that is open to competition, a regulatory environment that encourages the creation and growth of firms and a good system to select public investment are all important factors, although there are many more.

Promoting consumption without promoting all the above is putting the cart before the horse. Those who believe that, at present, a widespread and substantial increase in wages in the Spanish economy would be positive for growth are making this mistake. Some companies or sectors will certainly be able to offer considerably higher wages. Nevertheless, with unemployment above 17%, wage containment is still important to promote job creation and maximise growth in household income.

It is also important, in terms of fairness, that the consumption capacity of young people catches up with that of their elders, given that over the past few years the severest wage cuts have tended to affect the younger segments of the population, as well as continuing to reduce their rate of unemployment.

Enric Fernández
Chief Economist
30 September 2017

CHRONOLOGY

SEPTEMBER 2017

15 Standard & Poor's raises Portugal's sovereign rating by one notch from BB+ to BBB-, up to investment grade.
20 The Fed announces it will start to reduce its balance sheet in October. It will start by allowing USD 6 billion in Treasury securities and USD 4 billion in debt and mortgage-backed securities to mature every month, a figure that will gradually increase over the next few quarters.
21 Standard & Poor's lowers China's sovereign rating from AA- to A+.
25 Angela Merkel wins the general election in Germany.

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.

AGENDA

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).

NOVEMBER 2017

1 Fed Open Market Committee.
3 Registration with Social Security and registered unemployment (October).
8 Industrial production index (September).
15 GDP of Japan (Q3).
17 Loans, deposits and NPL ratio (September).
21 International trade (September).
28 State budget execution (October).
29 Flash CPI (November).
Economic sentiment index of the euro area (November).
30 Balance of payments (September).
Quarterly national accounts (Q3).

A positive outlook post-summer

The world economy is advancing as expected. Economic activity figures for Q3 2017 point to global growth remaining high, probably around 3.5%. As in the past few quarters, this acceleration in growth is widespread, occurring both in the advanced and the emerging economies. No worrying inflationary tensions are in evidence either. There are certainly some international geopolitical risks. However, this is a strong starting point for even higher growth next year of around 3.7%, the best figure in seven years. As the economic situation is progressing as expected, this month attention has focused on political issues (including economic policy) as well as on the area central banks.

A case in point is the US where most eyes have been on hurricanes, the debt ceiling and the Fed. It soon became clear that the impact of the hurricanes, in strictly economic terms, is likely to be contained and temporary. The shutdown of the administration due to a lack of funds could have been more disruptive had the legally established public debt ceiling been reached. Finally, the US President reached an agreement with Congress to extend these funds until December and thereby postpone discussion about raising the debt ceiling until the end of the year, gaining time in budget terms. As a result, attention has mostly turned to the Fed. The central bank is still battling with markets expecting interest rate hikes to be less aggressive than the plan outlined in the Fed's road map over the past few months. In September, the US central bank announced it would begin to reduce its balance sheet in October. It also repeated its interest rate hike scenario (one in 2017 and three more in 2018), a scenario forecast by CaixaBank Research for several months now. Investors are now starting to get the message, especially regarding the next hike, but the market still predicts just one more hike for 2018.

It was a similar situation in Europe: all eyes on politics and the ECB. With confirmation that the euro area's economy is still growing strongly, thanks to dynamic domestic demand (0.6% quarter-on-quarter in Q2 2017, 2.3% year-on-year), interest switched to Frankfurt and Berlin; i.e. to the ECB's meetings and the outcome of Germany's general election. The former was expected to clarify, to some extent, the future direction of monetary policy. Some clarification was also expected from the latter, in this case the political strength of Angela Merkel and her party to tackle the challenges of a new legislature, fundamental for Germany but also for a Europe requiring renewed drive. The first went according to expectations: the ECB confirmed that, in October, it would begin to specify when and how monetary policy normalisation would start. Note that CaixaBank Research expects tapering in 2018, the first hike in the depo rate at the end of 2018 and the first hike in the refi in 2019. Angela Merkel's victory was less decisive than expected, however. After the refusal by the Socialists to continue the «grand coalition», the country now faces a tripartite coalition that is more difficult to manage and has more modest pro-European ambitions.

The Spanish and Portuguese economies are performing well. The latest indicators in Spain, especially for the labour market and also economic activity, such as industrial production, suggest the CaixaBank Research scenario (namely a slight slowdown in growth from 3.1% in 2017 to 2.7% in 2018) will start to emerge given the sustained positive economic situation. Specifically, CaixaBank Research's GDP forecast model predicts 0.8% quarter-on-quarter growth in Q3, significant growth but slightly lower than the previous quarter (0.9%). Turning to Portugal, the S&P ratings agency decided to upgrade the country to «investment grade» (from BB+ to BBB–). This is largely due to its improved economic growth prospects over the past few quarters, the progress made in the fiscal area and fewer risks related to external financing. Another important international institution, the IMF, supported this view in its annual report on Portugal, positively valuing the efforts made by the economy to reduce its near-term risks (fiscal, banks and external financing).

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	3.2	3.5	3.7	3.5	3.6	3.6	3.6	3.7	3.7
Developed countries	*2.1*	*1.7*	*2.1*	*2.1*	*2.0*	*2.2*	*2.1*	*2.1*	*2.2*	*2.1*
United States	2.9	1.5	2.1	2.2	2.0	2.2	2.0	2.3	2.5	2.3
Euro area	1.9	1.8	2.2	2.0	2.0	2.3	2.4	2.2	2.2	2.0
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	1.8	2.1	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	1.8	1.5	2.7	2.2	2.8	3.0	2.7	2.4	2.2	2.2
Spain	3.4	3.3	3.1	2.7	3.0	3.1	3.2	3.2	3.0	2.8
Japan	1.1	1.0	1.4	1.0	1.4	1.6	1.4	1.1	1.1	0.7
United Kingdom	2.3	1.8	1.6	1.4	1.8	1.5	1.6	1.4	1.4	1.5
Emerging countries	*4.3*	*4.3*	*4.6*	*4.8*	*4.6*	*4.6*	*4.6*	*4.7*	*4.8*	*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	4.4	3.4	5.2	5.1	4.5	3.0	3.2	3.3
Poland	3.9	2.7	4.2	3.2	4.2	4.4	4.7	3.6	3.3	3.0
South Africa	1.3	0.4	0.8	1.6	0.7	0.4	0.7	1.2	1.7	1.6
INFLATION										
Global	2.8	2.8	3.2	3.3	3.2	3.0	3.1	3.4	3.2	3.4
Developed countries	*0.3*	*0.8*	*1.6*	*1.8*	*1.8*	*1.5*	*1.5*	*1.4*	*1.5*	*1.8*
United States	0.1	1.3	2.0	2.2	2.5	1.9	1.8	1.7	1.6	2.3
Euro area	0.0	0.2	1.6	1.6	1.8	1.5	1.4	1.5	1.4	1.7
Germany	0.1	0.4	1.7	1.7	1.9	1.6	1.7	1.7	1.5	1.8
France	0.1	0.3	1.2	1.5	1.5	1.0	1.0	1.4	1.3	1.5
Italy	0.1	0.0	1.4	1.4	1.4	1.6	1.2	1.5	1.3	1.4
Portugal	0.5	0.6	1.5	1.6	1.4	1.7	1.3	1.7	1.6	1.7
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	0.4	0.8	0.3	0.4	0.6	0.3	0.9	0.7
United Kingdom	0.0	0.7	2.6	2.5	2.1	2.7	2.7	2.8	2.5	2.5
Emerging countries	*4.7*	*4.3*	*4.1*	*4.5*	*4.0*	*3.9*	*4.0*	*4.6*	*4.5*	*4.6*
China	1.4	2.0	1.9	2.2	1.4	1.4	1.7	2.9	2.2	2.6
India	4.9	4.9	3.5	4.5	3.6	2.2	3.4	4.7	4.8	4.6
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	3.7	4.3	4.9	3.6	3.1	3.2	4.3	4.2
Mexico	2.7	2.8	5.8	3.9	5.0	6.1	6.2	6.0	4.5	3.8
Chile	4.3	3.8	2.6	2.9	2.8	2.3	2.6	2.6	2.6	3.0
Russia	15.5	7.1	4.2	4.1	4.6	4.2	3.9	4.1	4.1	4.1
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	1.6	2.2	1.7	1.5	1.4	1.7	2.0	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	3.0	2.9	2.6	2.4	2.3	2.6	2.6	2.8	2.8	2.5
General government consumption	2.1	0.8	1.0	1.0	0.6	1.1	0.8	1.6	1.1	0.9
Gross fixed capital formation	6.5	3.3	4.5	3.4	4.7	3.5	4.9	5.1	3.4	3.8
Capital goods	11.6	4.9	5.2	3.3	6.2	3.7	4.9	6.1	3.0	4.0
Construction	3.8	2.4	4.3	3.5	3.9	3.6	5.2	4.7	3.6	3.6
Domestic demand (contr. Δ GDP)	3.9	2.5	2.5	2.3	2.4	2.3	2.6	2.9	2.5	2.4
Exports of goods and services	4.2	4.8	5.8	4.2	6.7	4.4	6.2	5.8	3.4	4.6
Imports of goods and services	5.9	2.7	4.5	3.2	5.1	2.3	5.1	5.4	2.0	3.8
Gross domestic product	**3.4**	**3.3**	**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	1.8	1.7	1.9	1.7	1.8	1.8	1.8	1.8
Net lending or borrowing rest of the world (cum., % GDP)[1]	2.0	2.1	2.0	1.9	2.1	1.9	2.0	2.0	2.0	2.0
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	1.75	0.79	1.05	1.25	1.33	1.50	1.58
3-month Libor	0.32	0.74	1.27	1.95	1.07	1.20	1.32	1.51	1.72	1.20
12-month Libor	0.79	1.37	1.81	2.40	1.75	1.75	1.73	1.99	2.21	1.75
2-year government bonds	0.67	0.84	1.37	2.35	1.23	1.28	1.36	1.59	1.90	1.28
10-year government bonds	2.13	1.84	2.34	3.06	2.44	2.26	2.24	2.43	2.71	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	–0.33	–0.26	–0.33	–0.33	–0.33	–0.32	–0.30	–0.30
12-month Euribor	0.17	–0.03	–0.13	0.00	–0.10	–0.13	–0.16	–0.14	–0.08	–0.04
2-year government bonds (Germany)	–0.24	–0.58	–0.71	–0.29	–0.78	–0.74	–0.72	–0.60	–0.50	–0.40
10-year government bonds (Germany)	0.53	0.10	0.41	0.85	0.34	0.31	0.42	0.57	0.66	0.71
EXCHANGE RATES										
$/€	1.11	1.11	1.13	1.18	1.07	1.10	1.17	1.20	1.20	1.19
¥/€	134.33	120.30	127.05	133.13	121.05	122.21	130.38	134.56	134.84	133.69
£/€	0.73	0.82	0.88	0.88	0.86	0.86	0.90	0.89	0.89	0.88
OIL										
Brent ($/barrel)	53.64	45.04	53.10	59.21	54.68	50.92	52.12	54.67	56.83	58.50
Brent (€/barrel)	48.33	40.73	47.06	49.93	51.35	46.34	44.84	45.71	47.46	49.16

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

Forecasts

FINANCIAL OUTLOOK · A generally constructive tone for the main international financial markets

International markets have become constructive after a relatively peaceful summer, particularly the developed bloc. Whereas the summer was relatively stable and even saw a downward trend in the case of European markets, equity firmed up in September and long-term interest rates picked up slightly. Continuing strong economic activity was one of the main factors supporting these positive trends, especially in Europe and the emerging economies. Nevertheless, repeated upswings in risk aversion are a constant reminder that the global financial environment is still sensitive to several sources of uncertainty.

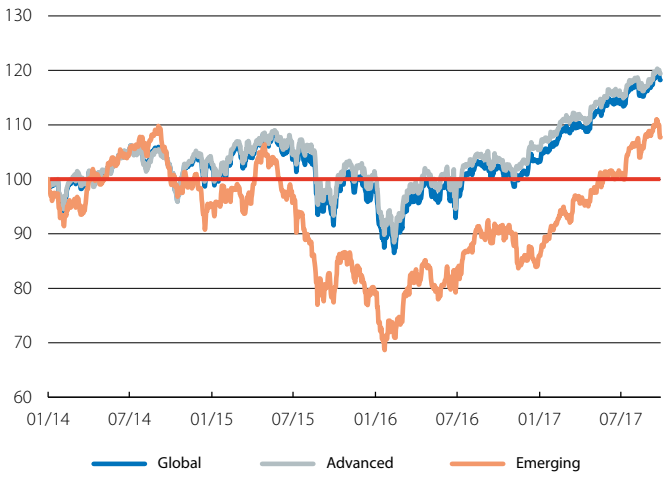
Political risk returns centre stage. Volatility has remained at an all-time low in general. However, the main financial assets were relatively sensitive to upswings in tension. These are due to the (at present mainly verbal) escalation of the conflict between the US and North Korea, especially in emerging assets. So far this risk seems temporary and limited. The boom in US equity is another source of risk, while there are still doubts regarding the health of the US economy, albeit slightly mollified by the solid economic activity data posted recently. On the other hand, there seems to be less risk regarding OPEC's ability to maintain equilibrium in the oil market, at least in the medium term. This is due to the strong commitment of the vast majority of the organisation's members (see the last paragraph of this article for more details).

The ECB is confident about the euro area's economic activity and starts to look at different options to withdraw its asset purchase programme (QE). As expected, at its September meeting the ECB did not alter the parameters of its monetary policy nor did it modify its future stance. The ECB's Governing Council (GC) noted the improved macroeconomic scenario but also mentioned that the euro's appreciation constitutes a source of uncertainty and risk for its growth and inflation forecasts. As announced at its previous meeting, the GC also stated that it had started to evaluate the possible changes it could introduce to QE. As noted by Draghi, such decisions are expected to be taken at the next meeting, set for the end of October. As usual, Draghi stressed that the ECB's strategy will be based on patience, persistence and prudence.

The Fed announces it will begin reducing its balance sheet in October. As expected, the Federal Open Market Committee (FOMC) officially announced its intention to shrink its balance sheet as from October. According to details announced at its June meeting, it will stop reinvesting

International stock markets by region

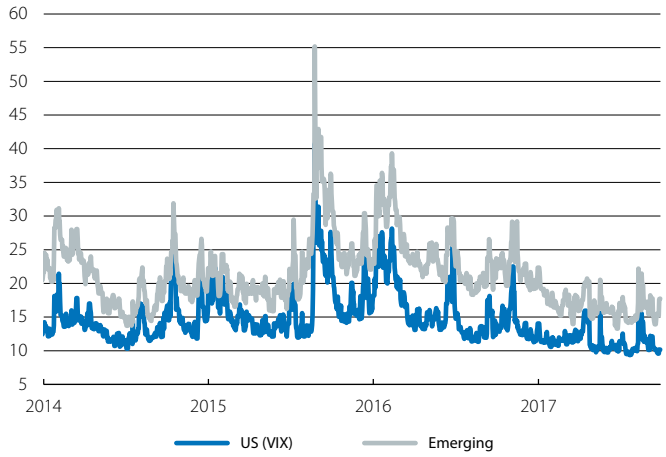
Index (100 = January 2014)



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

US and emerging: implied stock market volatility

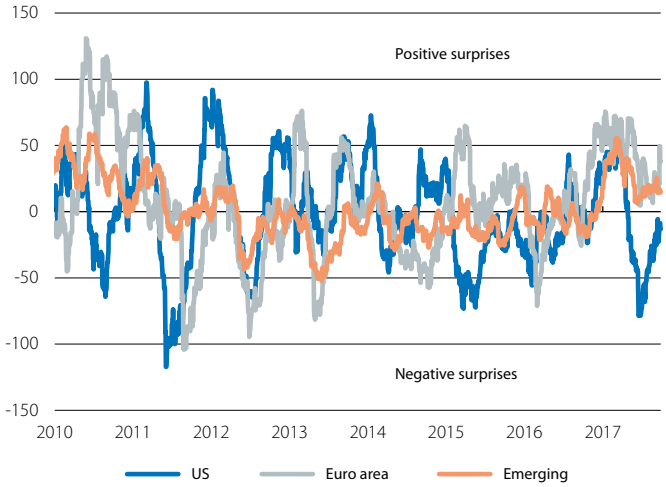
(%)



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

Index of economic surprises

(Index)



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

USD 6 billion of public debt and USD 4 billion of debt and mortgage-backed securities per month, with the rate speeding up over the coming quarters. This announcement, widely expected by the vast majority of analysts and investors, did not cause any big stir in international financial markets. Finally, the Fed kept the fed funds target unchanged at this meeting but left the door open to another interest rate hike in December. This plan is in keeping with the Fed's positive assessment of the macroeconomic trend and its scenario of gradual monetary policy normalisation.

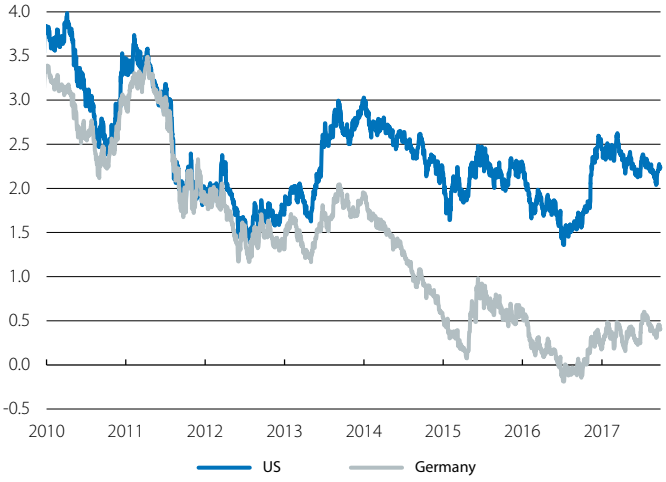
Long-term sovereign bond yields pick up in the developed bloc while risk premia move in Europe. In spite of further declines at the beginning of the month, yields on the developed bloc's main sovereign bonds made gains by the end of September. This trend appeared to stop with increased nervousness due to geopolitical tensions. But the fiscal reform announced in the US and greater expectations of a fed funds interest rate hike in December helped to push up long-term yields towards the very end of the month. The yield on 10-year Treasury bonds went above 2.3% (from 2.1% at the end of August) while the bund came close to 0.5% in Europe. The countries on the Iberian Peninsula saw the biggest changes in their risk premia. Spain's risk premium returned to levels more in line with the beginning of the summer, returning to around 120 points. Portugal's risk premium fell considerably from 240-250 bp, stabilising in the region of 200 points after the country's sovereign rating was upgraded by Standard & Poor's.

The main stock markets remain constructive but are still sensitive to geopolitical risks, particularly the emerging bloc. Equity performed well early on in the month. European and US stock markets made steady gains, in the US case reaching a new all-time high, although this situation is increasingly a cause for concern. At the end of the month, the details announced of Donald Trump's long-awaited tax reform pushed equity back up in the developed bloc and especially the US. This reform includes lowering corporate tax from 35% to 20%. Emerging stock markets benefitted from the improved macroeconomic situation with sustained gains throughout most of the month. But recurring tensions with North Korea led to notable corrections. On this occasion, these losses were exacerbated by greater expectations of a US tax hike. Nevertheless, this increased nervousness in emerging markets should be short-lived.

In the forex market, the US dollar offsets part of its devaluation which began at the start of the year. After strongly depreciating since early 2017, the last part of the summer brought relative stability for the dollar. The US currency then picked up strongly over the last few days of September and corrected part of its depreciation. Greater expectations of another fed funds interest rate hike in December, together with announcements of Donald Trump's new fiscal plan, are the main factors supporting the dollar

Yield on 10-year public debt

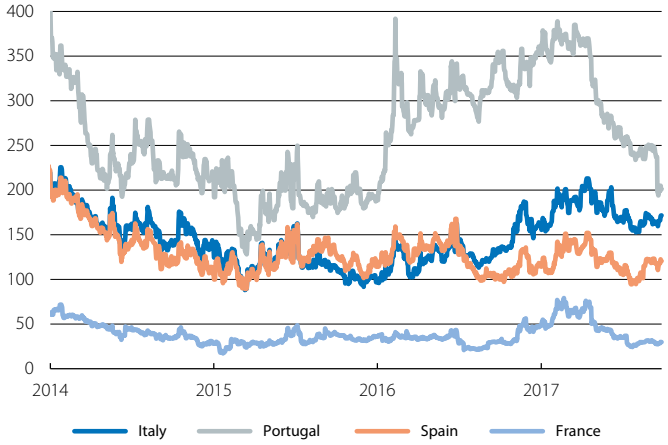
(%)



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

Euro area: risk premia on 10-year public debt

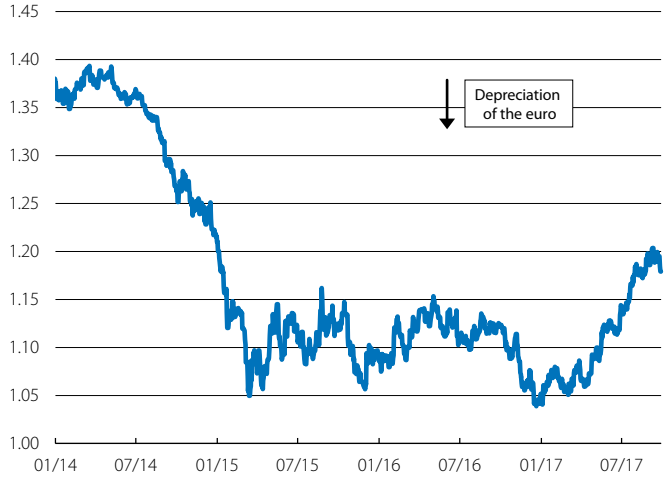
(bp)



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

Dollar-euro exchange rate

(USD-EUR)



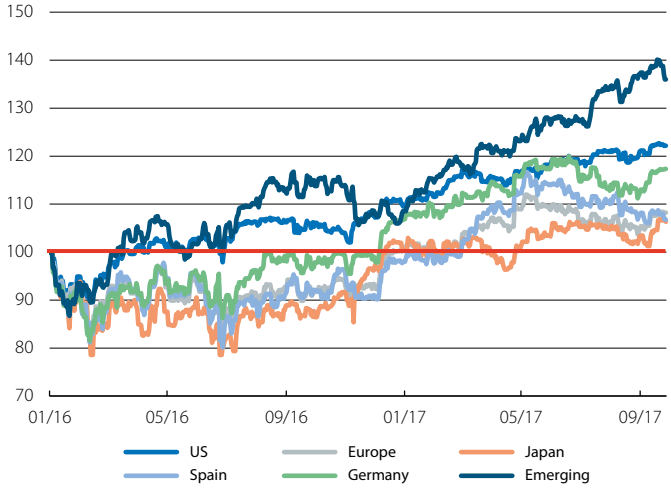
Source: *CaixaBank Research, based on data from Bloomberg.*

against most other currencies. The euro fell below USD 1.18 after briefly topping USD 1.20. At an international level, the strong dollar also affected the main emerging currencies which depreciated in the last week of the month against the US currency.

A considerable rise in oil prices. The price of a Brent barrel increased by almost 10% in September, coming close to USD 60, its highest price since mid-2015. Part of this increase is due to supply factors. The strong commitment of the vast majority of OPEC members has helped to push up crude oil prices. But also, after a referendum in Kurdistan, threats made by Turkey to block the region's exports also contributed to this rise, although this effect should be temporary. The recent spike in demand also helped to balance the oil market, thereby supporting price rises. Crude prices rose sharply in spite of the recovery in US inventories. This upswing is due mainly to the impact of meteorological events at the end of summer, whose consequences should be short-lived and limited. Whether this recovery continues will depend on OPEC members continuing to respect the agreement reached a few months ago. This agreement may also be extended to March 2018, a likely event if supply looks strong. In any case, uncertainty is still high in the oil market, particularly because of doubts regarding the trend in supply.

Main international stock markets

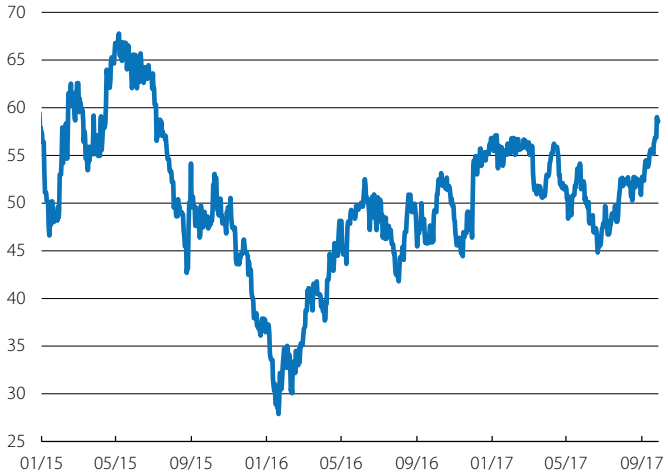
Index (100 = January 2016)



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

Brent oil price

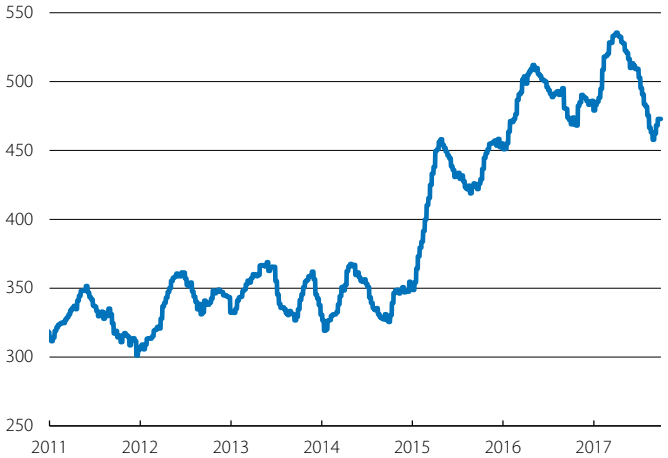
(USD per barrel)



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

*US crude oil stocks **

(Million barrels)



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

FOCUS · Monetary policy frameworks for the future

In September, the Fed put an end to nine years of unconventional monetary policy by announcing it was going to unwind its balance sheet. The Fed intends to return to the conventional monetary policy framework of the period before 2008. However, the emergence of different views regarding how the economy works and the use of unconventional tools have called into question the future framework of operation for central banks. We will examine this below.

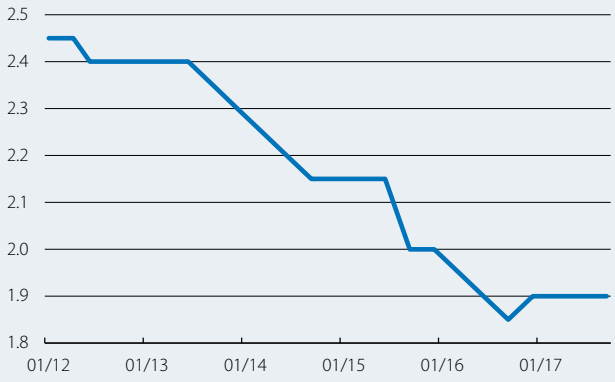
Before the financial crisis erupted in 2008, monetary policy was essentially implemented via a short-run reference interest rate adjusted by central banks to ensure price stability and, directly or indirectly, appropriate capacity utilisation. Moreover, macroeconomic policy did not cover financial regulation. However, this framework -result of the macroeconomic consensus reached between the 1980s and 1990s- has been drastically altered over the past few years. On the one hand, financial regulation now comes under the set of macroeconomic policy tools, given the close connection between financial and macroeconomic stability.

On the other hand, there is a narrative that argues that the interest rate that balances the supply of savings and demand for investment will remain relatively low due to the persistence of structural factors related to demographics, technological change and risk aversion.[1] This narrative has become influential in central banking circles, as shown by the long-term macroeconomic scenario of the committee that decides the Fed's monetary policy (the Federal Open Market Committee or FOMC). As can be seen in the first two charts, the FOMC has revised downwards both the growth potential of the US economy and also the interest rate that they deem appropriate in the long run (the long-run equilibrium interest rate). Moreover, since the benchmark interest rate cannot fall much below 0%,[2] something which, according to this narrative, would be required more frequently than in the past, central banks would lose their room to manoeuvre if they went on using traditional instruments. To avoid this situation, two broad types of action have been proposed. One is to keep interest rates as a core tool and redefine the central bank target. The alternative is to maintain the target (typically, medium-term inflation in the region of 2%) and incorporate new monetary policy tools.

1. See the Focus «What is the new equilibrium interest rate?» in MR09/2017.
2. This lower limit exists because there is an alternative course of action, namely withdrawing deposits and keeping resources in cash, with an interest rate equal to 0% (or slightly negative, taking storage costs into account).

FOMC forecasts: potential GDP growth

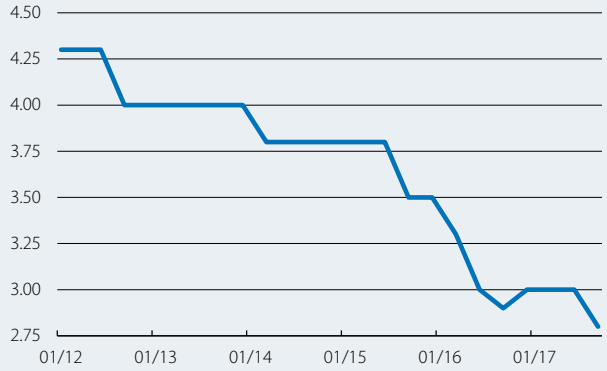
Central trend of FOMC members (%)



Source: *CaixaBank Research, based on projections by the Federal Open Market Committee (FOMC).*

FOMC forecasts: equilibrium reference rate

Median of FOMC members (%)



Source: *CaixaBank Research, based on projections by the Federal Open Market Committee (FOMC).*

Should the benchmark interest rate be kept as the main tool, the central bank can gain leeway by setting a target that allows a higher inflation rate so that the equilibrium nominal interest rate does not fall as much as the equilibrium real rate. There are three main options in this case: setting a higher inflation target, setting the target in price-level terms or setting the target in terms of nominal GDP. Raising the inflation target minimises any changes in the underlying framework although it permanently imposes the cost of higher inflation. On the other hand, with a price-level target the central bank would not ignore events resulting in temporary deviations in inflation (such as energy price fluctuations). In fact, in response it would allow inflation to temporarily deviate in the opposite direction to offset this.

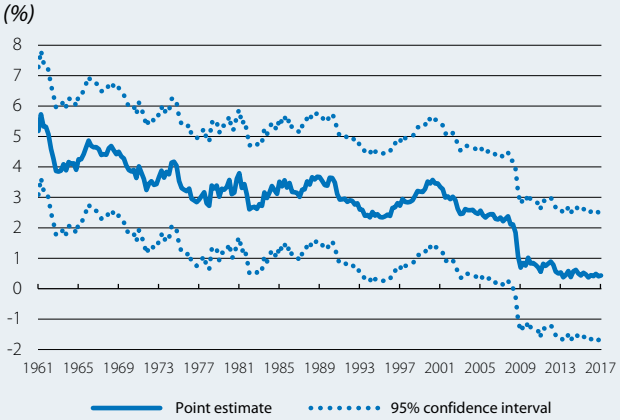
For instance, if a drop in aggregate demand pushed inflation down to 1%, the central bank would tolerate a period of inflation above 2% in order to return to its price level target. In this case, investors would automatically anticipate the intention to keep interest rates low for longer, thereby also relaxing long-term interest rates. The option of setting a target in terms of nominal GDP uses a similar mechanism. However, both alternatives could result in unpopular policies. For example, an exogenous rise in energy prices, as in the 1970s, would force a central bank to tighten monetary policy even during an economic recession.

Given that any changes in the target could entail a considerable cost in credibility terms, one alternative framework is to keep the present targets and use unconventional measures (negative interest rates, forward guidance and balance sheet policies such as QE) in addition to the more typical tools of central banks. One advantage of this option is that such measures can be more accurately gauged to the particular needs of the time. On the one hand, negative interest rates support traditional transmission mechanisms, albeit with decreasing returns due to the erosion of financial sector margins. They may even lose their effectiveness entirely at very negative levels.[3] At this point, forward guidance and asset purchases are a way of continuing to push down longer term interest rates, as employed by the main central banks over the past few years. The Bank of Japan has gone even further and explicitly targeted long-term interest rates. Although this measure is more precise than QE, it is difficult to use systematically because its effectiveness depends on a central bank's credibility with the markets. If they are convinced, the market rate will be the same as the rate announced by the central bank, even if the latter makes no purchases that directly influence bond prices. But if the markets are not convinced, the central bank would have to buy up most of the assets to bring the interest rate to its target, to such an extent that its balance sheet might go out of control. And the problem could be even worse. To convince the market, the long-run interest rate announced would have to be in line with the expected trend in the short-run interest rate, which constantly changes depending on the trend in economic activity indicators.

Before choosing one of these alternatives over another, it should be noted that they are based on a relatively uncertain view of the world.[4] This can be seen in the imprecise estimates of the equilibrium real interest rate. As shown by the third chart, although there is a clear downward trend in the equilibrium real interest rate,

3. One drastic solution to get rid of this ceiling would be to eliminate cash.
4. See Beyer, R. and Wieland, V. (2017), «Instability, imprecision, and inconsistent use of equilibrium real interest rate estimates», IMFS, Working Paper.

Real natural rate of interest: estimate and uncertainty



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

we are still unable to determine its level with a reasonable degree of confidence. Such imprecision is actually a sign of the uncertainty surrounding the traditional relationships between interest rates, economic activity and inflation, which are used to estimate the equilibrium interest rate. For example, the predominant narrative for central banks assumes a strong relationship between economic activity and inflation on the domestic front. A central bank can control inflation via the impact of financial conditions on economic activity. However, there are signs that the relationship between a country's inflation and its economic activity is weakening. Among other factors, this is due to the globalisation of goods and services markets, the offshoring of production and global value chains. If this is the case, central banks will have lost their ability to influence inflation,[5] at least individually (and must therefore aim for more coordinated action between central banks). In this respect, there is an underlying and much wider discussion concerning what we actually mean by price stability. This currently focuses on the consumer price of goods and services. However, monetary policy strongly influences the price of financial assets and has a consequent impact on financial instability. It can therefore be argued that central banks should pay more attention to such areas.

In short, there are different options available for monetary policy to offset lower equilibrium interest rates. But just how suitable they are is far from certain. One long-term solution entailing relatively few distortions consists of directly addressing the factors responsible for the decline in equilibrium interest rates. This involves stimulating long-term growth and thereby demand for investment via measures that promote education, research and infrastructures.

5. See Borio, C. (2017), «Through the looking glass», BIS, OMFIF City Lecture.

FOCUS · Oil: a look at demand

Over the past few years, discussions regarding the oil price trend have tended to focus on the supply of this «black gold». An understandable emphasis given the recent importance of supply factors on the movement of the price of crude oil, particularly the rise in shale. But what about demand? What are the recent changes in this side of the equation and the likely developments in the near future? What effect will the trend in demand have on the price of oil?

Recently, demand has being showing signs of getting stronger. The year-on-year increase in 2Q 2017 was 2.4%, reaching 97.9 million barrels per day (mb/d). This strong growth in demand has led the International Energy Agency (IEA) to raise its forecast for world oil demand in 2017 by 1.6 mb/d (up to 97.7 mb/d on average for the year as a whole). This revision is based mainly on the higher demand coming from the OECD and particularly Europe and the US. Steady growth in world oil demand is expected in 2018, exceeding 100 mb/d by the end of the year.

Taking a longer term view, the trend in demand depends largely on one country in particular whose share in world demand has grown sharply on the past few years: China. Between 2005 and 2015, China's oil consumption rose by 4.8 mb/d, representing almost half the total increase in oil demand, while China's share of world oil consumption has reached 12%.

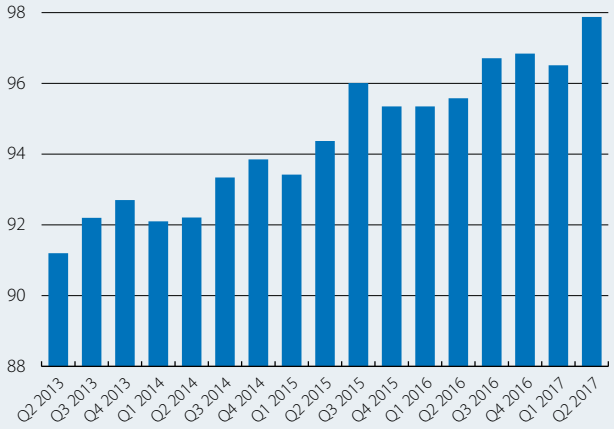
Moreover, the Asian giant's share is likely to continue increasing significantly over the coming years. For example, in a scenario of around 4% economic growth per year, which is lower than the past few years, as well as a moderate increase in demand sensitivity to GDP growth, oil demand would go from 11.5 mb/d in 2015 to 15.2 mb/d in 2025. But if economic growth remains high (around 7%) and demand continues its historically observed pattern, China's demand could reach 20.8 mb/d in 2025, more than the total demand by the US at present.

This second, more extreme case could have a considerable impact on the price of oil. For instance, recent estimates by the Federal Reserve Bank of San Francisco suggest that oil prices could reach USD 172 if China's demand goes on increasing significantly and there is only a moderate rise in supply. This estimate is based on an extreme scenario and is therefore not very likely but it illustrates just how important Chinese demand will be.

Finally, it is important to remember that long-term estimates of demand's impact are notoriously uncertain. China's oil demand in particular and world demand in general will depend on the country's economic growth but also on its energy policy decisions. China's economy is expected to go on growing quite rapidly, which should boost its demand for oil, but there are more doubts regarding its energy policy. The increase in oil consumption could vary greatly depending on the path taken. One sign of this are the recent announcements by the Chinese government regarding its intention to gradually phase out the sale of traditional vehicles as from 2019.

World oil demand

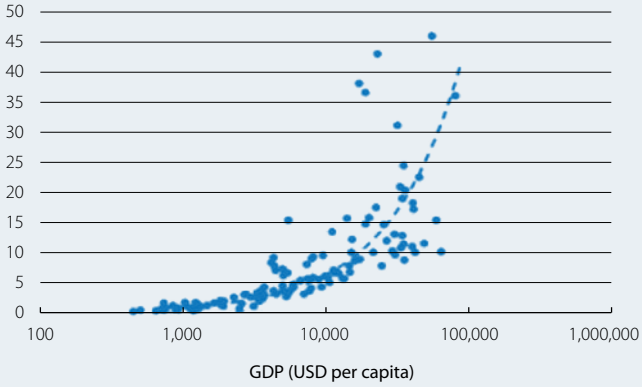
(Millions of barrels per day)



Source: *CaixaBank Research, based on data from the International Energy Agency (IEA).*

Oil consumption and wealth in 2015

Oil demand (barrels per capita)



Note: *Each point on the chart represents a country's oil demand and its GDP per capita.*
Source: *CaixaBank Research, based on data from the Federal Reserve Bank of San Francisco, International Energy Agency and IMF.*

KEY INDICATORS

Interest rates (%)

	29-Sep	31-Aug	Monthly change (bp)	Year-to-date (bp)	Year-on-year change (bp)
Euro area					
ECB Refi	0.00	0.00	0	0.0	0.0
3-month Euribor	–0.33	–0.33	0	–1.0	–2.8
1-year Euribor	–0.17	–0.16	–1	–8.8	–10.6
1-year government bonds (Germany)	–0.72	–0.73	1	8.1	–7.1
2-year government bonds (Germany)	–0.69	–0.73	4	7.6	–0.7
10-year government bonds (Germany)	0.46	0.36	10	25.2	57.9
10-year government bonds (Spain)	1.60	1.56	4	21.6	72.0
10-year spread (bps) [1]	114	120	–6	–3.7	14.0
US					
Fed funds	1.25	1.25	0	50.0	75.0
3-month Libor	1.33	1.32	1	33.2	47.6
12-month Libor	1.78	1.71	7	9.4	22.8
1-year government bonds	1.29	1.22	7	47.9	70.5
2-year government bonds	1.48	1.33	15	29.2	71.8
10-year government bonds	2.33	2.12	21	–11.4	73.6

Spreads corporate bonds (bps)

	29-Sep	31-Aug	Monthly change (bp)	Year-to-date (bp)	Year-on-year change (bp)
Itraxx Corporate	57	55	2	–15.4	–15.7
Itraxx Financials Senior	59	53	6	–33.9	–41.7
Itraxx Subordinated Financials	137	124	13	–84.5	–104.5

Exchange rates

	29-Sep	31-Aug	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
$/€	1.181	1.191	–0.8	12.3	5.2
¥/€	132.920	130.980	1.5	8.1	16.7
£/€	0.882	0.921	–4.2	3.3	1.8
¥/$	112.510	109.980	2.3	–3.8	11.0

Commodities

	29-Sep	31-Aug	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
CRB Commodity Index	427.3	435.6	–1.9	1.0	6.2
Brent ($/barrel)	57.5	52.4	9.9	1.3	17.3
Gold ($/ounce)	1,280.2	1,321.4	–3.1	11.1	–2.7

Equity

	29-Sep	31-Aug	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
S&P 500 (USA)	2,519.4	2,471.7	1.9	12.5	16.2
Eurostoxx 50 (euro area)	3,594.9	3,421.5	5.1	9.2	19.7
Ibex 35 (Spain)	10,381.5	10,299.5	0.8	11.0	18.2
Nikkei 225 (Japan)	20,356.3	19,646.2	3.6	6.9	23.7
MSCI Emerging	1,081.7	1,087.7	–0.5	25.5	19.7
Nasdaq (USA)	6,496.0	6,428.7	1.0	20.7	22.3

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

ECONOMIC OUTLOOK · **Solid growth in economic activity**

Global economic activity indicators continue to post notable increases in Q3 in spite of some sources of uncertainty. In August, the global purchasing manager index (PMI) for manufacturing was in a comfortable expansionary zone at 54.7 points. This was due to an improved aggregate figure both for the advanced and for the emerging economies. This endorses the CaixaBank Research scenario which predicts that world growth will speed up moderately to 3.5% in 2017 (3.2% in 2016). Nevertheless, the balance of global risks is still tilted slightly to the downside due to uncertainty. In geopolitical terms, tensions with North Korea have worsened over the past few weeks. On the political front, the CDU (Angela Merkel's party) winning the German elections has reinforced the European project. However, the narrowness of this victory means it could take weeks of negotiating to achieve a coalition. Finally, on the other side of the Atlantic, natural disasters have battered the Caribbean islands, Mexico and the US.

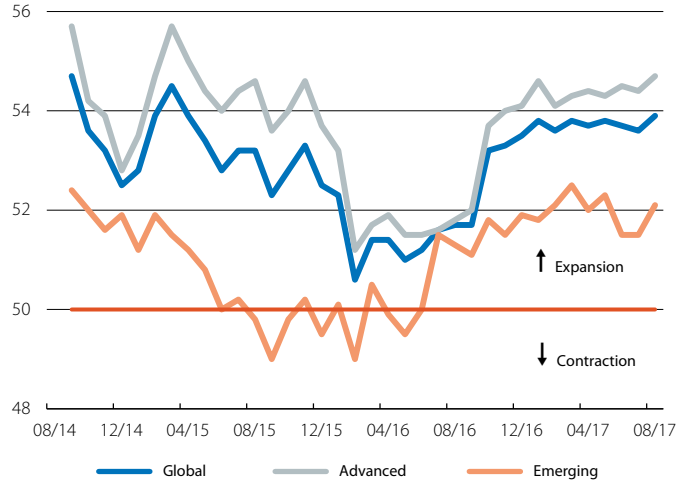
UNITED STATES

Hurricanes Harvey and Irma will have a temporary effect on US economic activity. Beyond the number of deaths, initial estimates for the economic costs in Texas and Florida exceed USD 100 billion (around 0.6% of GDP). These natural disasters will impact US GDP growth although the effect is expected to be slim and short-lived. The disruption to economic activity in August (in Texas) and September (in Florida) will result in slightly lower Q3 GDP growth than expected a few months ago (around 0.6 pp lower in quarter-on-quarter and annualised terms). On the other hand, the reconstruction of lost capital is likely to support slightly higher GDP growth than previously estimated over the coming quarters. The industrial production index, retail sales and different real estate indicators all posted poorer figures in August compared with previous months. On the other hand, economic confidence indicators (ISM, consumer confidence) have remained relatively stable at a high level.

In spite of the expected temporary slowdown, the Fed keeps to its road map for monetary normalisation. After maintaining to 1.00%-1.25% the interval for the fed funds rate at its September meeting, the institution presented a largely unchanged macroeconomic scenario. This still indicates another hike at the end of the year and three more in 2018, in line with CaixaBank Research forecasts. The Fed also announced it would start reducing its balance sheet in October. It will stop reinvesting USD 6 billion of public debt and USD 4 billion of debt and mortgage-backed securities per month.

Economic activity indicators: PMI

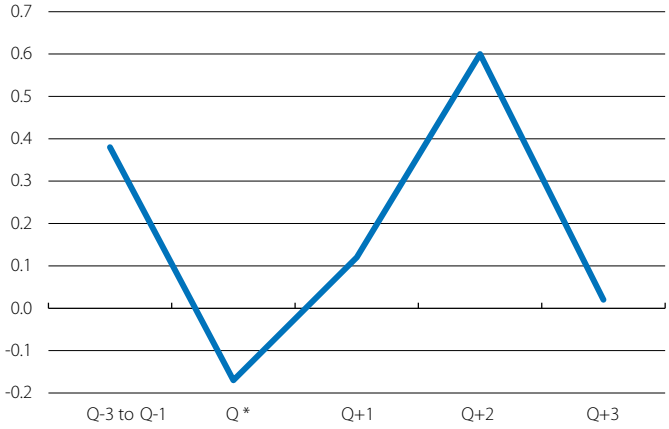
Level



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

US: GDP around 10 most costly disasters

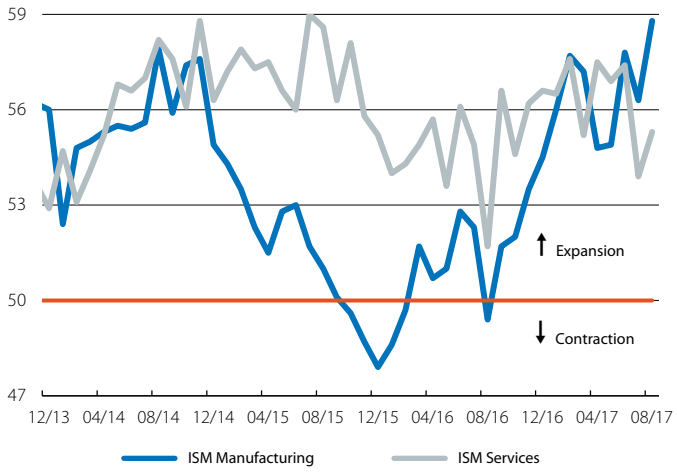
Month-on-month change (%)



Note: ** Q indicates the time the natural disaster occurred.*
Source: *CaixaBank Research, based on data from Goldman Sachs.*

US: economic activity indicators

Level



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

The Fed's decision is endorsed by a strong labour market and rising inflation. 156,000 jobs were created in August. Although this figure is lower than previous months, it is still considerable given the mature stage of the US economic cycle. By way of example, the US economy has posted positive growth rates for the last eight years, the third longest expansionary period in its history. The unemployment rate remained almost unchanged at 4.4% while wages increased by an appropriate 2.5% year-on-year. Considering this mature context, inflation has been weaker than expected. Even the Fed Chair, Janet Yellen, mentioned at the monetary institution's last meeting that the latest inflation figures seem to be based on factors relatively unrelated to the country's good economic performance. She even classified the trend in inflation as a «mystery». In any case, in August inflation rose to 1.9%, 0.2 pp above July's figure and also higher than most analysts' predictions. Core inflation remained at 1.7%. Over the coming months we expect inflation to rise slightly given the end of economic slack, weak dollar and disappearance of temporary factors in some CPI components that have pushed down inflation over the past few months (especially the price of wireless communication services).

Tax reform is finally underway. The White House has presented its tax reform proposal. This includes lowering taxes both for individuals and companies. The maximum marginal rate for individuals would fall from 39.6% to 35% while going from 35% to 20% for companies. But this proposal is merely the starting point for debate in the US Congress. Discussions will continue over the coming months and some adjustments might be made, although we do not expect them to be significant.

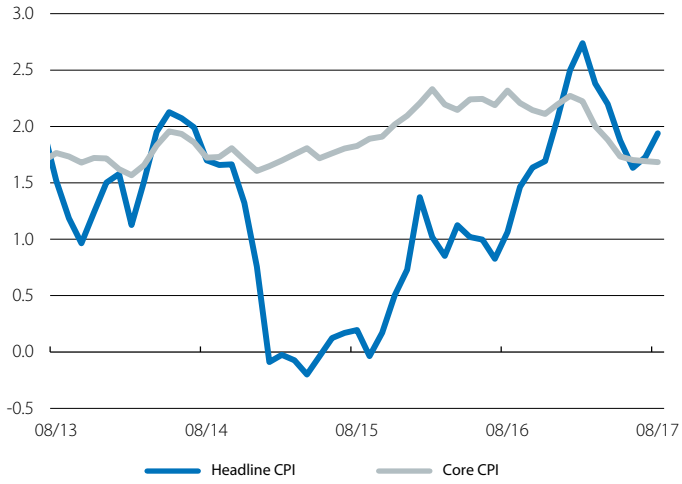
JAPAN

Early elections called in Japan. The Japanese Prime Minister, Shinzo Abe, has called early elections to gain a stronger mandate given the growing threat from North Korea and his aim to continue with far-reaching structural reforms. Abe particularly stressed the need to increase spending on education to improve the country's productivity. He also endorsed greater pressure on North Korea with the support of other nations.

Japan continues to make good economic progress in spite of lowering its GDP estimate for Q2. Economic activity grew by 0.6% quarter-on-quarter in Q2. This means the country has posted six consecutive quarters of positive growth, a first since 2006. Growth was supported by private consumption and higher investment (especially public). Nevertheless, and as tends to be the case with Japanese data, the Statistics Office substantially revised its GDP growth figure for Q2 in its second estimate. This revision was downward: from the previously estimated figure of 1.0% to the aforementioned 0.6% (and from 2.1% in year-on-year terms to 1.6%). Although this progress is still good, the lower growth rate has led CaixaBank Research to reduce its annual estimate for 2017 (now at 1.4%).

US: CPI

Year-on-year change (%)



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

Japan: revised GDP for Q2 2017

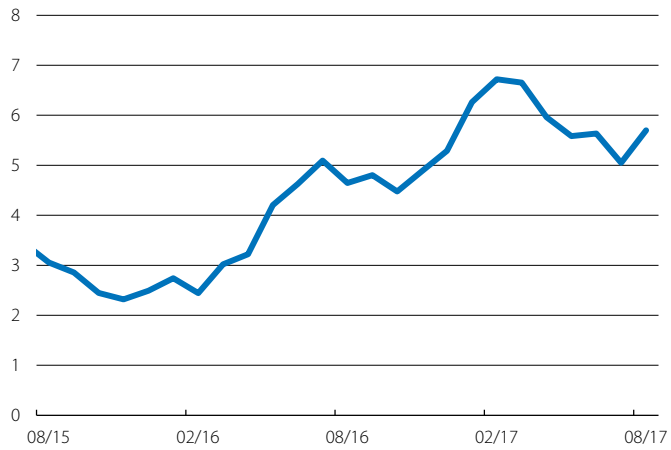
Quarter-on-quarter change (%), unless otherwise indicated

	1st est.	2nd est.	Difference
GDP	1.0	0.6	–0.3
Private consumption	0.9	0.8	–0.1
Public consumption	0.3	0.4	0.1
Investment	2.8	1.7	–1.1
Changes in stock	0.0	0.0	–0.1
External demand	–0.3	–0.3	0
GDP *	**2.1**	**1.6**	**–0.5**

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

Emerging economies: IIF growth indicator

Annualised quarter-on-quarter growth, three-month average (%)



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

EMERGING ECONOMIES

Emerging economic activity remains strong although risks persist. As we have already mentioned, the emerging countries are enjoying considerable economic growth in general. This can be seen in the IIF growth tracker which estimates the aggregate increase for the main countries at above 5% in Q3. In this context, portfolio inflows for these economies continued to record considerable volumes of foreign capital in August.

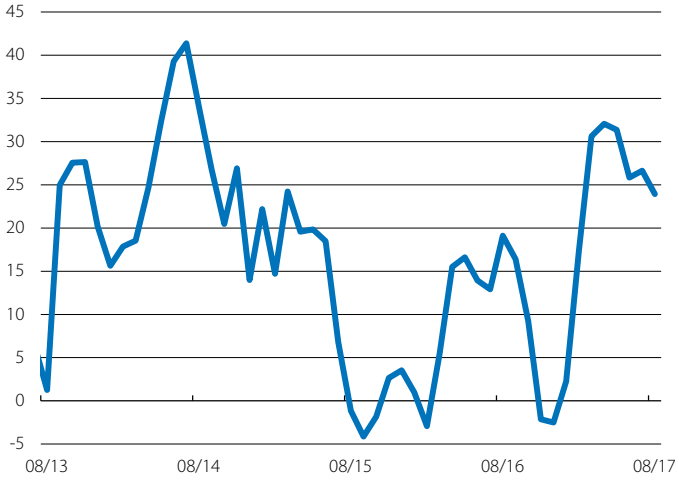
China's latest rating downgrade, however, is an indication of one of the biggest risks at a global level: Chinese debt. Following Moody's downgrade a few months ago, S&P decided to cut the country's rating from AA– to A+ due to its high and growing level of debt. Over the past eight years, Chinese debt has grown by more than 100 pp of GDP. At the beginning of 2017 it reached 260% of GDP, mainly due to heavy corporate leveraging. Nevertheless, China is still on course for a soft landing in growth terms. The Asian giant posted more moderate economic activity data in August but these figures were still considerable. Retail sales grew by 10.1% (10.4% in July) while industrial production was up by just 6.0% (0.4 pp less than July). This is due to the government's intense anti-pollution campaign, resulting in a reduction in the production of base metals and cement.

Brazil's economy is still slowly exiting the recession while its political sphere continues to be a source of concern. The Latin American country saw its second consecutive quarter of quarter-on-quarter growth in Q2 (0.3% in year-on-year terms compared with -0.4% previously). In quarter-on-quarter terms, and from the demand side, the two key components supporting this weak exit of the recession are private consumption and exports. Given this situation, the latest charges filed against President Temer by the Supreme Court endorse the scenario proposed by most analysts: the President is likely to be replaced but early elections are not expected.

Turkey continues to post notable growth in Q2. GDP grew by 5.1% year-on-year, in line with Q1 growth and supported, among other factors, by a strong rise in credit. By demand components, Turkey's dynamic performance was largely helped by solid domestic demand (higher investment and stable private consumption). It is also noteworthy that exports contributed positively to growth. Nevertheless, CaixaBank Research expects the Turkish economy to lose momentum towards the end of 2017, although ending the year with higher than expected growth given the dynamic first six months (4.4% for 2017 as a whole).

*Emerging economies: capital inflows **

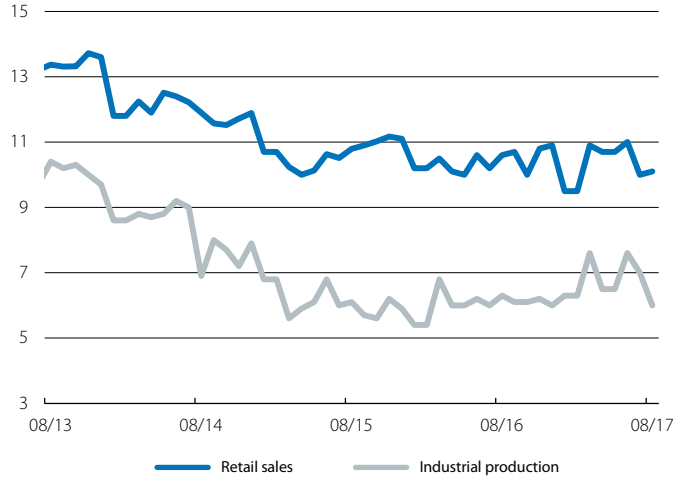
Moving three-month average (USD billion)



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

China: economic activity indicator

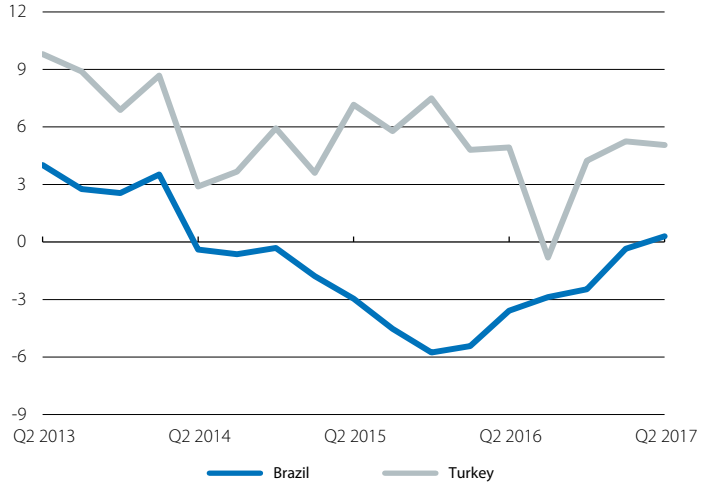
Year-on-year change (%)



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

Brazil and Turkey: GDP

Year-on-year change (%)



Source: *CaixaBank Research, based on data from the respective statistics offices.*

FOCUS · China's Game of Thrones: the keys and complexities of the political system

Much will be said over the coming weeks about the 19th National Congress of the Communist Party of China (CPC), which begins on 18 October and will renew the Party's most important governing bodies. But before we can effectively gauge the importance of this Congress, we first need an overall view of the Chinese political system to understand how it works and how the CPC relates to the rest of the country's political powers.

One fundamental feature is that the CPC currently constitutes the core of China's political power and exerts a direct influence on all the other political institutions. The CPC's supremacy is formally expressed in the preamble to the Chinese Constitution, drawn up in 1982, which defines the Asian giant as a «people's democratic dictatorship (...) under the leadership of the Communist Party». 88 million citizens belong to the CPC in China (6.5% of the population). Every five years, various local CPC committees choose the 2,300 delegates for the Party Congress.[1] Formally, these delegates elect the Party's Central Committee, made up of just under 400 members who, in turn, elect the Politburo (25 members) and the Standing Committee, a small group[2] at the very top of the hierarchy. At its head is the General Secretary of the Party, the supreme leader of the CPC, although major decisions must be agreed with the rest of the members of the Standing Committee.

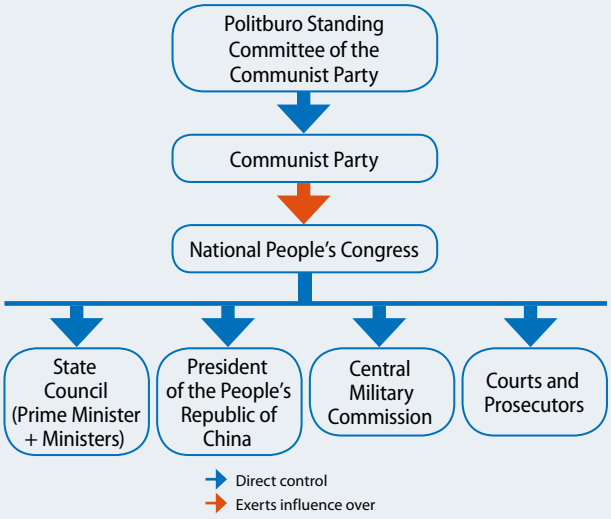
This election process has two key aspects, however. Firstly, the Party's most influential leaders tend to meet before the Congress is actually held to agree on who should form part of the Standing Committee and Politburo, appointments subsequently approved by the Central Committee. Secondly, the composition of the Communist Party's organs reflects the balance of power between its different factions. At present, the two most important ones are the conservative and the reformist. The conservative faction, from which comes the current General Secretary Xi Jinping, believes in strong state control and emphasises economic growth while the reformist movement, which Prime Minister Li Keqiang belongs to, shows more concern for social issues.

Given the CPC's hegemony, we should now examine its connection with the rest of the country's institutions. The 1982 Constitution separated Party and State in an attempt to prevent personality cults, such as in the Mao era. According to the Constitution, all state institutions are subordinate to the National People's Congress, «the supreme organ of state power». This has the power to reform the Constitution and is responsible for passing laws and electing members of the State Council, the Prime Minister, the President of China, the Central Military Commission and the courts of justice. The Congress (3,000 members) is chosen every five years after the CPC National Congress.[3] Local assembles are set up via elections in which all citizens can vote. Provincial representatives are chosen from the elected members and so on, until reaching the upper layer of the hierarchy, the National People's Congress. The whole procedure is relatively controlled by the CPC although some independent candidates managed to get into the Congress in 2012.

The State Council, which is led by the Prime Minister, is responsible for day to day policy but also has a very close relationship with the CPC. Of the 33 members of the current government, 32 are prominent CPC members. Moreover, both the Prime Minister and the four Vice Prime Ministers are members of the Politburo.

Our analysis cannot end without highlighting two other interesting points. The first is that the President of China is a merely institutional figure. However, since 1993 this position has been held by the General Secretary of the CPC to be able to represent China at important international events. Secondly, although there is an unwritten rule that the General Secretary of the CPC should step down after two five-year terms in office, there are other ways to lead the country or at least continue to influence its decisions. Special approval can be sought from the Party to act as a leader for a longer period. This was the case of Deng Xiaoping, who led the country between 1978 and 1992 although he was not the General Secretary of the CPC. Another way, employed by Jiang Zemin between 2002 and 2005 after completing two terms as President, consists of presiding over the Central Military Commission, a key body that controls the Armed Forces.

The structure of political power in China



Source: *CaixaBank Research.*

1. Swelling the ranks of the CPC is an arduous process. For example, in 2011 only 15% of the applications were accepted.
2. This has ranged between five and nine members and is currently made up of seven people.
3. Elections are held after the Party Congress in autumn and take place in different cities up to March, when the new composition is announced at the annual session.

FOCUS · Latin America - paying the price of US protectionism?

One of the slogans for the US's new policy is «America First». When it comes to international trade, this has become an explicit plan to reduce what the US administration considers to be excessive trade deficits. In order to achieve this, the US has decided to review its policy of multilateral trade agreements. For instance, August saw the start of negotiations to revise the North American Free Trade Agreement (NAFTA). The country may also unilaterally impose duties on imports from certain countries (such as the recent case with aircraft from Canada). CaixaBank Research's main scenario expects the NAFTA negotiations to be constructive, resulting in a partial and more conservative rebalancing of US relations with Mexico (and Canada), as well as achieving some kind of conciliation with China and Europe. However, it is important to examine the consequences of a potentially more protectionist revisionism for Latin America. The US is a major trading partner in the region, being the first or second export market for most LatAm countries.

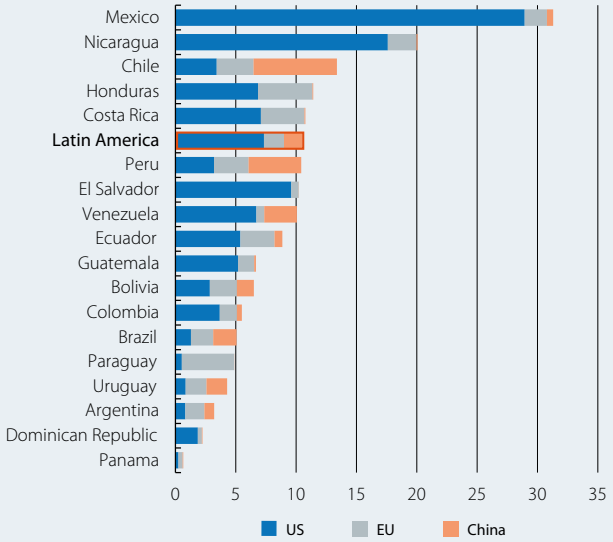
On studying the data we can see that, firstly, the US trade imbalance with the region is concentrated. The US only has trade deficits with Mexico, Venezuela, Nicaragua, Ecuador, Colombia and Bolivia. And this deficit is large solely in the case of Mexico and, at some distance, Venezuela. It is also relevant that direct trade exposure is only very high in Mexico: 82% of Mexican exports go to the US, accounting for 29% of its GDP. At some distance come the countries of Central America while, in the rest of the region, the share of US exports is notably lower and less than 6% of GDP in all cases.

Although there is little direct exposure, could Latin American economies be indirectly affected by the US becoming more protectionist (i.e. through the channel of trade with other, third party countries)? The data suggest that, with regard to intraregional flows, this is only in the case of Central American countries, where around 20% of their total exports go to Mexico and other Central American countries and they are therefore indirectly exposed to the US.

Neither does this indirect channel appear to be particularly important for other geographical destinations outside the region. Some countries have very close trade relations with China (which generates almost half the US trade deficit on its own) and the EU (20% of the US trade deficit). This is the case of Chile, whose total exports to China and the EU account for 10% of its GDP. However, a protectionist shift in the US would have to end up affecting Europe or China's economic growth to have any marked impact on the Chilean economy. A scenario which, for the present, seems unlikely.

Latin America: exports to the US, EU and China

(% of GDP)



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

Latin America: composition of exports

(Percentage of total exports, 2016)

	Agriculture	Fuels	Mining	Industry
Argentina	65.8	3.5	5.6	25.1
Brazil	40.4	7.3	16.0	36.3
Chile	35.8	0.7	49.9	13.5
Colombia	23.2	47.5	1.2	28.2
Mexico	8.4	5.0	1.2	85.4
Peru	21.8	6.0	58.8	13.4
Latin America *	**23.5**	**12.1**	**11.6**	**54.8**

Note: ** Weighted average.*
Source: *CaixaBank Research, based on data from the IIF.*

KEY INDICATORS

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

UNITED STATES

	2015	2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017	08/17	09/17
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	3.3	...
Consumer confidence *(value)*	98.0	99.8	100.7	107.8	117.5	118.1	120.4	119.8
Industrial production	–0.7	–1.2	–1.2	–0.1	0.6	2.1	1.5	...
Manufacturing activity index (ISM) *(value)*	51.4	51.5	51.1	53.3	57.0	55.8	58.8	...
Housing starts *(thousands)*	1,107	1,177	1,150	1,248	1,238	1,165	1,180	...
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	4.4	...
Employment-population ratio *(% pop. > 16 years)*	59.4	59.7	59.8	59.7	60.0	60.1	60.1	...
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	1.9	...
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	08/17
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	43.3
Industrial production	–1.2	–0.2	1.0	2.8	4.9	5.8	5.4
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	0.6
Core consumer prices	1.4	0.6	0.4	0.2	0.1	0.0	0.2

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

CHINA

	2015	2016	Q3 2016	Q4 2016	Q1 2017	07/17	08/17
Activity							
Real GDP	6.9	6.7	6.7	6.8	6.9	–	...
Retail sales	10.7	10.4	10.5	10.6	10.0	10.4	10.1
Industrial production	6.1	6.0	6.1	6.1	6.8	6.4	6.0
PMI manufacturing *(value)*	49.9	50.3	50.2	51.4	51.6	51.4	51.7
Foreign sector							
Trade balance [1] *(value)*	608	512	554	512	466	456	447
Exports	–2.3	–8.4	–7.0	–5.3	7.8	7.2	5.5
Imports	–14.2	–5.7	–4.7	2.1	23.9	11.3	13.4
Prices							
Consumer prices	1.4	2.0	1.7	2.2	1.4	1.4	1.8
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	6.8	6.7

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

ECONOMIC OUTLOOK · **The euro area is still growing at a good pace**

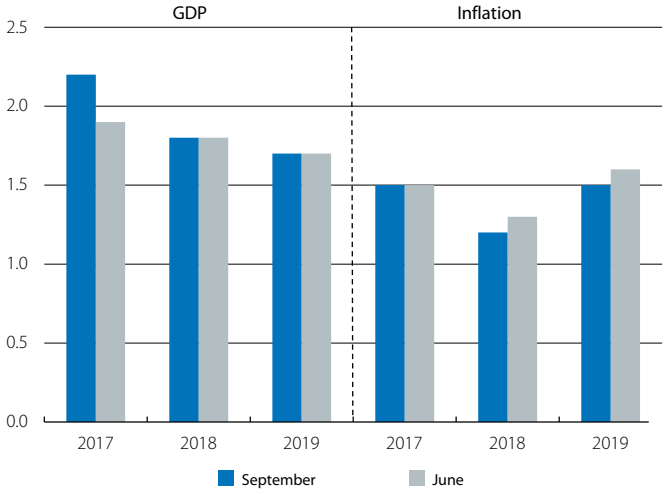
The solid economic figures posted for the first six months confirm economic activity is speeding up in the euro area. The recovery is occurring simultaneously across all the area's countries, accompanied by improved confidence. Rising demand, supported by very favourable credit conditions, has created a good climate for investment, employment and, in short, economic growth. This can be seen in the ECB's revised GDP growth figure for the euro area in 2017, from 1.9% to 2.2%, in line with the CaixaBank Research forecast. But there are still a lot of challenges ahead. After elections in France and Germany, the euro area has a window of opportunity to embark on far-reaching reforms, in both policy and institutional terms. This opportunity has been marred by the rise of the far-right in the German elections. Nevertheless, Merkel and Macron's victories, together with a positive economic climate, should provide some leeway for reforms. In fact, Macron has embarked on a cycle of reforms with an already-approved labour market reform discussed in detail in the Focus « French labour reform: Emmanuel Macron's soft revolution» in this *Monthly Report*. Across the channel, all eyes are on developments in the Brexit negotiations, which remain stuck on the issue of the UK's payments to the EU for financial obligations acquired through its membership. In recent statements, and in an attempt to move negotiations forward, Theresa May has said the UK is willing to negotiate a transition deal with the country maintaining its status quo for approximately two years.

Domestic demand still drives Q2 euro area growth, contributing 1.9 pp to GDP growth out of a total of 2.3% year-on-year. In line with previous quarters, all subcomponents of demand have seen solid growth. Foreign demand posted a notable change in trend in its contribution to growth. After deducting points from GDP growth because of a sharp rise in import-intensive categories such as private consumption and investment, foreign demand now contributes 0.4 pp to GDP growth, both because of a faster rise in exports and slower rise in imports. Over the coming quarters we expect domestic demand to continue boosting GDP, supported by greater confidence and very favourable credit conditions.

Economic activity indicators point to euro area growth maintaining its momentum in Q3. After a slight drop in July and August, the composite business sentiment index (PMI) for the euro area as a whole picked up in September to 56.7 points, above the 56.1 points average of the first six months. The euro area's Economic Sentiment Index (ESI) rose by 1.1 points in September to 113 points, its highest since summer 2007. Finally, the industrial production index recovered slightly in July, up by 0.1% month-on-month after a dip in June (0.6%).

Euro area: ECB forecasts for GDP and inflation

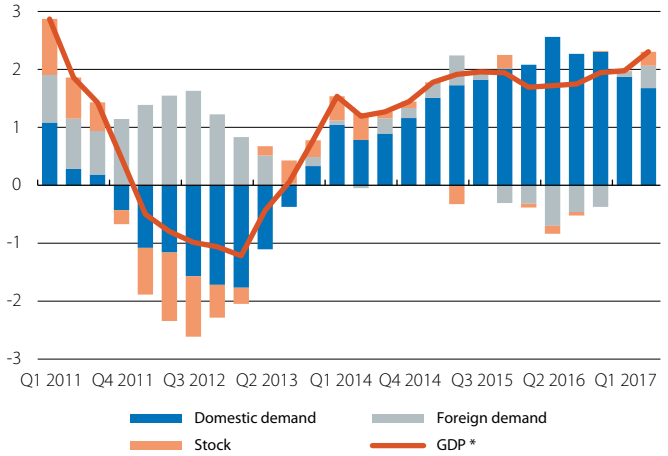
Annual rate of change (%)



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

Euro area: GDP

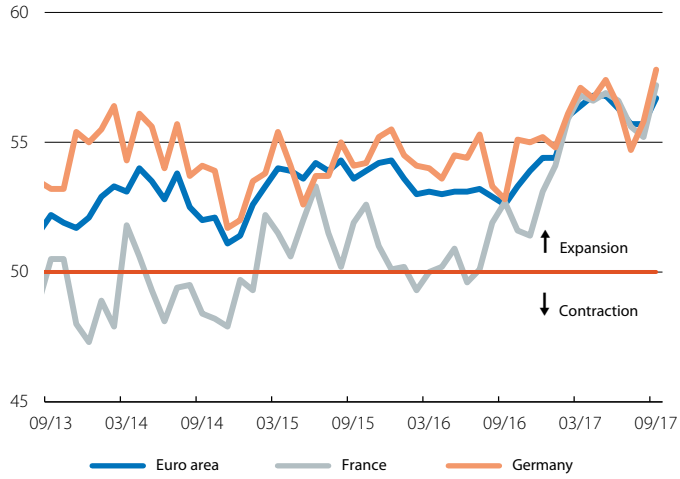
Contribution to year-on-year growth (pp)



Note: ** 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.*

Household consumption is still driving economic growth, supported by the labour market's good performance, very favourable credit conditions and improved economic outlook. This can be seen in euro area retail sales figures which grew by 2.4% in the year to July, slightly below the 3.1% figure posted the previous month but far above the 1.4% average for 2016. The consumer confidence index also rose by 0.3 point to –1.2 points, its highest level since May 2007. Over the coming months, we expect the aforementioned factors to continue supporting household consumption.

The labour market continues to create jobs, supporting the economic recovery. Euro area employment increased 1.6% year-on-year in Q2, raising the total employment figure to 155.6 million, an all-time high. Although employment growth was widespread, there were notable year-on-year increases in Spain (2.8%) and Germany (1.5%). Wage costs also rose significantly in the area, up 2.0% year-on-year in Q2, 0.7 pp more than the previous quarter. Nevertheless, this increase is largely due to the contributions of Germany and Portugal, where wages grew, year-on-year, by 2.9% and 2.8%, respectively. Wage moderation continued in Italy and Spain, however, with year-on-year rates of 0.7% and 0.4%, respectively. This situation should not be seen as a source of concern. Stronger wage growth in Germany encourages the country's households to consume, while wage moderation in Southern Europe's two main countries makes their exports more competitive. All this helps to reduce imbalances in the euro area. Given the favourable economic outlook, we expect employment growth to remain solid and continue to support household consumption growth.

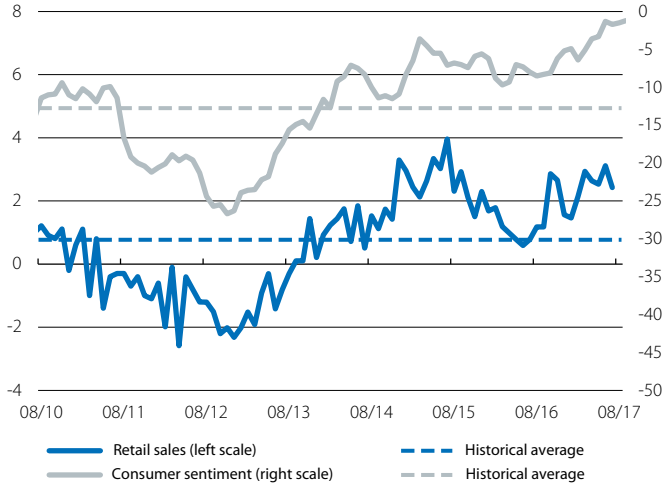
Prices continue to rise moderately. In September, the harmonised index of consumer prices (HICP) increased at the same rate as the previous month, 1.5%, with energy prices making the largest contribution to growth. Core inflation, which excludes data for the volatile components (energy and unprocessed food), remained stable at 1.3% for the third consecutive month. According to ECB forecasts, headline inflation will slow down slightly in 2018 due to base effects of rising oil prices during the first half of 2017, subsequently recovering in 2019 as a result of robust economic activity. Nevertheless, according to ECB projections, inflation in 2019 will remain below its medium-term target of below, but close to 2%.

PORTUGAL

Economic activity indicators suggest Portugal's economic activity will continue to expand at a good pace in Q3. Portuguese GDP grew by 3.0% year-on-year in Q2. In quarter-on-quarter terms, however, growth was 0.3%, much lower than the Q1 rate (0.9%). Nevertheless, we should not reach any alarming conclusions based on a single figure, especially considering the historical volatility of Portugal's GDP series. A review of Q3 economic indicators suggests economic activity remains solid. September's Economic Sentiment Index (ESI)

Euro area: consumption indicators

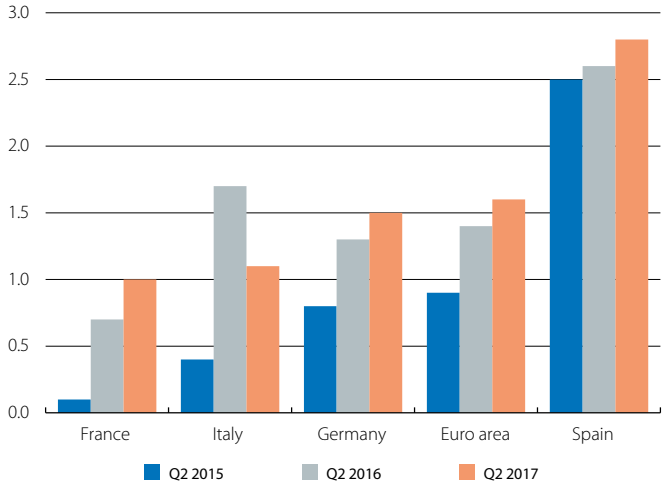
Year-on-year change (%) *Level*



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

Employment

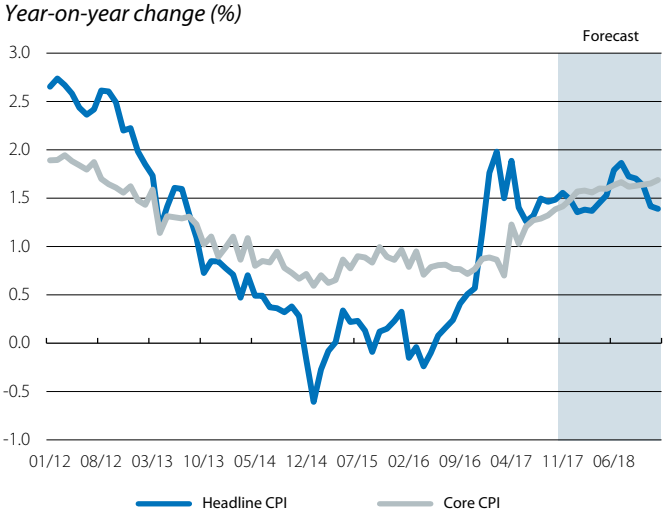
Year-on-year change (%)



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

Euro area: harmonised index of consumer prices

Year-on-year change (%)



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

was up 2.4 points to 114.4 points, well above the Q1 average (110.4 points). Both industrial production and retail sales data were strong in July, with year-on-year growth of 5.2% (4.5% Q1 average) and 3.9% (3.0% Q1 average), respectively. In summary, although GDP grew less than expected, overall indicators point to a favourable economic outlook for the country. This can be seen in September's update of the IMF's forecasts for the Portuguese economy, which raised GDP growth for 2017 from 1.7% to 2.5%. The organisation approved of the government's efforts to reduce the fiscal deficit and reinforce the banking sector.

The labour market continues to support economic growth. In Q2 2017, employment grew by 3.4% year-on-year (equivalent to 158,000 new jobs), the highest growth rate since the economic recovery began. This has been accompanied by a decline in the share of long-term unemployed workers, reaching 5.2% in Q2 2017, 0.8 pp below the previous quarter. It is also worth highlighting that growth, in yearly terms, of employees on permanent contracts has exceeded that of employees on temporary contracts for four months in a row.

The country's good economic performance is helping to improve its public finances. The general government deficit stood at 1.4% of GDP (cumulative over 12 months), 0.2 pp less than that of the previous quarter and much lower than that of the same quarter the previous year (3.6%). This improvement is due to the simultaneous impact of a 0.3% rise in revenue and a 0.1% fall in expenditure compared with the previous quarter. Against the backdrop of favourable GDP growth prospects and improved public finances, the ratings agency Standard & Poor's upgraded Portugal's rating to «investment grade» (from BB+ to BBB–). As a result, Portugal's risk premium has fallen considerably which, in turn, should boost public finances further. One source of risk regarding the deficit trend comes from Eurostat, which is studying the possibility of including the cost of recapitalising the Caixa Geral de Depósitos bank in Portugal's public deficit figures. In this case, the 2017 deficit would increase by around 1.2% of GDP. However, this rise would be temporary and therefore not impact the downward trend of the past few years.

IMF forecasts

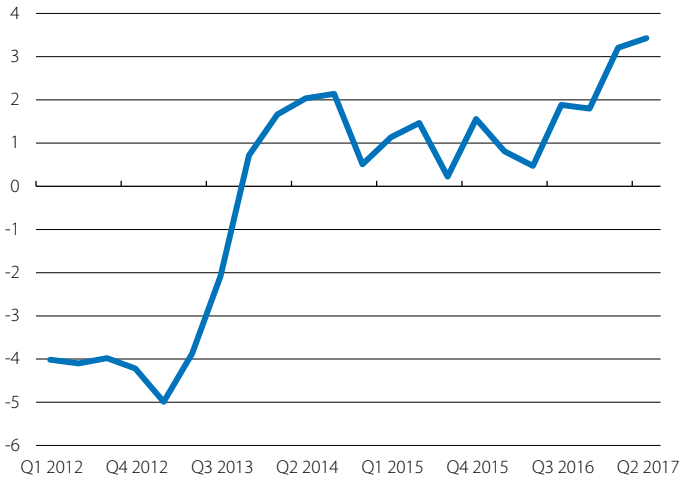
Annual rate of change (%)

	Forecast		
	2017	2018	2019
GDP	2.5	2.0	1.7
Private consumption	2.2	1.8	1.4
Public consumption	0.6	0.5	0.2
Investment (GFCF)	6.9	5.7	4.8
Exports	7.6	5.2	4.5
Imports	7.3	5.1	4.5

Source: *CaixaBank Research, based on data from the IMF (Article IV consultation - Staff Report, September 2017).*

Portugal: employment

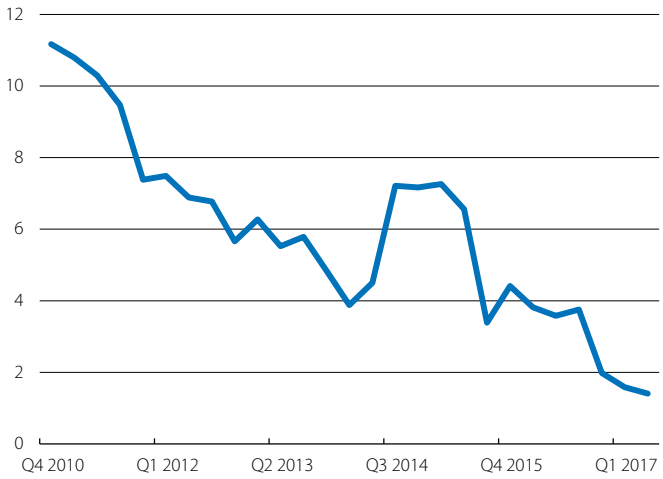
Year-on-year change (%)



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

Portugal: general government deficit

(% of GDP)



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

FOCUS · French labour reform: Emmanuel Macron's soft revolution

France's new *Loi Travail* is now in force. After four months in office, the French President has managed to get approval for one of his key campaign promises: a labour reform to make the rigid French job market more flexible. The aim is to reduce the proportion of temporary jobs and make French firms more competitive. So to what extent will it achieve its goals?

To increase the flexibility of the labour market, the approved reform concentrates on increasing the legal certainty of dismissals, gives priority to collective bargaining at company level and promotes social dialogue between owners and workers. Regarding dismissal procedures, costs for unlawful dismissal, previously decided by the *prud'hommes* courts on a case by case basis, are now established by law with a minimum and maximum based on the worker's time at the firm. On the other hand, severance pay has been increased, going from 20% to 25% of the monthly salary each year for the first 10 years worked (around eight days per year worked).

To improve companies' internal flexibility, the reform prioritises collective bargaining at company level for most aspects of labour relations, such as working time or salary and other bonuses. However, there is still collective bargaining at a sector level for certain aspects such as establishing the minimum wage, training and rules for hiring temporary and permanent employees.

Finally, the reform has also introduced new social dialogue measures by merging, in a single committee, the workers' and health and safety committees for companies with more than 50 employees. Companies with fewer than 50 employees can also negotiate directly with the workers' representative (without trade union presence). In this way, the labour reform, in this and other aspects, makes small and medium-sized companies more flexible.

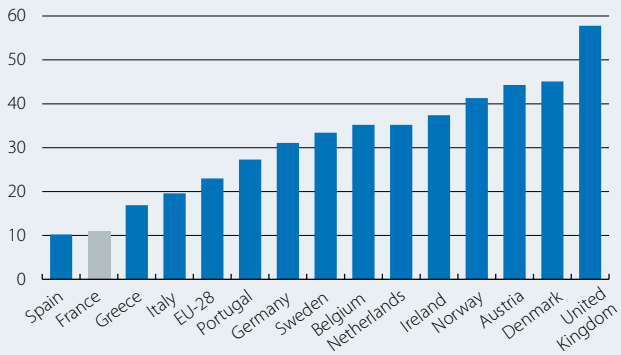
The labour reform's impact may be very positive in terms of creating jobs and increasing competitiveness in the medium and long term. On the one hand, greater legal certainty in dismissal procedures will encourage companies to hire workers on permanent contracts, which should particularly benefit low-skilled workers as they tend to have a higher rate of temporary employment. It should also make it easier to reallocate production resources, which could boost growth in productivity. On the other hand, the changes in collective bargaining and social dialogue make companies more flexible internally and more able to adapt to changes in technology or demand. They also bring wage rises more in line with productivity. Nevertheless, in the short term the reform could lead to job losses, so it is particularly important that the reform is implemented during the current expansionary phase. In fact, employment growth is still expected to post positive figures.[1]

The increase in severance packages and the maintenance of collective bargaining at a sector level for certain areas have helped to secure support for the reform from two of France's major trade unions, the CFDT and Force Ouvrière.[2]

What will be the reform's ultimate effect? The key lies in the practical application of all these changes, which has yet to begin, and how social agents adapt to these new circumstances since the new framework is designed for owners and trade unions to work cooperatively, like the Nordic labour relations model. In fact, the inspiration for Macron's project is largely the Danish model, based on what is known as the golden triangle of flexicurity. The labour reform already approved corresponds to the first side of the triangle, which makes both hiring and firing more flexible. But its ultimate impact also depends on reforming the second side of the triangle, namely unemployment benefits to give workers a safety net, and the third side, active employment policies which prepare workers for change. The plan is to carry out both reforms in the coming months. Macron's project is certainly not lacking in ambition.

Transition rates from temporary to permanent contracts, 2015 *

(%)



Note: ** Employees aged 15-64 on a temporary contract in 2014 but declaring having been hired on a permanent contract in 2015.*
Source: *CaixaBank Research, based on data from the OECD (OECD Economic Survey France 2017).*

1. IMF (2016), «Time for a Supply-Side Boost? Macroeconomic Effects of Labor and Product Market Reforms in Advanced Economies», Ch. 3, World Economic Outlook.
2. France's second trade union, the CGT, has strongly opposed the reform.

FOCUS · Brexit, the road ahead

The outcome of the referendum on the membership of the UK in the EU represented a watershed both for the country itself and the EU. Never in the history of the EU had a member decided to leave the club.[1] The path the UK must take to extricate itself from the maze of institutions, treaties and policies that define the EU is such a huge task it is even hard to gauge just how the process is progressing. This Focus reviews the major challenges that need to be tackled by the UK before exiting the EU and the most significant hurdles it faces.

The UK is expected to leave the EU in March 2019, after which EU treaties will no longer apply in the UK. Formal negotiations between the UK and EU began on 19 June 2017 and are expected to finish by the end of 2018, in time for both sides to ratify the agreements before the deadline of March 2019. This period might also see a transition agreement being reached which would, *de facto*, prolong negotiations beyond the deadline.

There is therefore very little time for these negotiations although the issues to be decided are both numerous and complex. Broadly speaking, the UK faces two challenges. Firstly, the British government must transpose relevant EU law into UK law.[2] If not, there will be a legal vacuum in several areas once the UK exits the EU. Examples include workers' rights, bank regulations and quality standards of non-EU imports. To speed up this process, the plan is to give the government temporary powers (known as a Henry VIII clause) to amend these laws without the need for parliamentary scrutiny. Nevertheless, parliament would impose guidelines on the government regarding the exercise of such powers. Although this may appear to be mere parliamentary procedure, in practice it could seriously destabilise the political situation. This is due, on the one hand, to the government being able to legislate at will and, on the other, to its currently weak state, with a very small majority in parliament.

Secondly, the UK needs to negotiate the terms of the withdrawal from the EU and a future trading relationship with the EU. In this respect, both sides have agreed to start with the terms of separation. Specifically, they are debating the rights of UK citizens living in the EU and EU citizens living in the UK at the time of Brexit; the problems related to the Republic of Ireland/Northern Ireland border,[3] and how much the UK should pay the EU (known as the financial settlement or Brexit bill) to honour the financial obligations undertaken by the UK when it formed part of the EU. This last point is the main hurdle to negotiations since the idea of the UK paying to leave the EU is naturally very unpopular in the country.

As soon as the European Council deems enough progress has been made regarding such issues, something which is expected to occur around the end of this year, negotiations will be able to move on to the treaties that will define the UK's future relationship with the EU.

As we have already mentioned, this stage of the negotiations should be completed by the end of 2018 but the two sides are quite likely to agree a transition period. Both the Labour Party and some in the Conservative Party are in favour of the UK remaining in the single market for several more years to enable a very gradual transition. The EU might accept this proposal if the UK continued paying into the EU budget, which would mean the 2014-2020 budgets could remain unchanged. In fact, this formula could help to move the aforementioned Brexit bill negotiations forward.

Apart from a transition agreement, the EU also wants the treaty ultimately agreed with the UK to respect the balance of benefits and obligations entailed by access to the single market. The UK would like an ambitious agreement regarding the free movement of goods and services with the EU. However, in exchange the EU is likely to demand concessions related to the principles of free movement of people and capital, and potentially contributions to the European budget. The more inflexible the UK is regarding these points, the less ambitious the EU trade deal is likely to be. Some also believe that the relationship established with the UK once it leaves the EU should be sufficiently unfavourable to deter other member states from exiting the EU in order to benefit from a similar deal.

The UK is likely to put pressure on its main EU trading partners (such as Belgium, the Netherlands and Portugal) or on those countries whose citizens most wish to work in the UK (from Eastern Europe) in a bid to secure more favourable conditions. However, the final agreement will not have to be unanimously supported by all EU member states but rather a qualified majority,[4] thereby limiting the UK's ability to create divisions within the EU. In fact, the UK government has recently softened its «red lines» stance, i.e. those issues it considers to be non-negotiable, such as the European Court of Justice having no jurisdiction whatsoever over the UK once the country leaves the EU. This highlights the country's unfavourable negotiating position at present.

1. Greenland, which left the European Economic Community in 1985, could be deemed the only exception.
2. Estimated at around 12,000 laws.
3. The Good Friday agreement removed the «hard border» between the Republic of Ireland and Northern Ireland. However, this would reappear once the UK leaves the Customs Union.
4. Minimum 20 member states of the EU-27, representing at least 65% of the EU-27 population.

KEY INDICATORS

Activity and employment indicators

Values, unless otherwise specified

	2015	2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017	07/17	08/17	09/17
Retail sales *(year-on-year change)*	2.6	1.4	0.9	2.4	2.1	2.8	2.6	...	...
Industrial production *(year-on-year change)*	2.1	1.5	1.0	2.3	1.3	2.7	3.2	...	...
Consumer confidence	–6.1	–7.7	–8.3	–6.5	–5.5	–2.7	–1.7	–1.5	–1.2
Economic sentiment	104.2	104.8	104.2	106.9	108.0	110.0	111.3	111.9	113.0
Manufacturing PMI	52.2	52.5	52.1	54.0	55.6	57.0	56.6	57.4	58.2
Services PMI	54.0	53.1	52.6	53.4	55.1	56.0	55.4	54.7	55.6
Labour market									
Employment (people) *(year-on-year change)*	1.0	1.4	1.4	1.4	1.6	1.6	–	...	–
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	Q2 2017	07/17	08/17
Current balance: euro area	**3.4**	**3.7**	**3.8**	**3.7**	**3.7**	**3.4**	**3.3**	**...**
Germany	8.5	8.4	8.6	8.4	8.3	7.8	7.9	...
France	–0.4	–0.9	–1.1	–0.9	–1.0	–1.0	–1.1	...
Italy	1.4	2.6	2.5	2.6	2.7	2.7	2.7	...
Spain	1.1	1.9	1.7	1.9	1.9	1.8	1.8	...
Nominal effective exchange rate[1] *(value)*	**91.7**	**94.3**	**94.8**	**94.5**	**93.7**	**95.2**	**97.6**	**99.0**

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	Q2 2017	07/17	08/17
Private sector financing								
Credit to non-financial firms[1]	–0.3	1.8	2.0	2.2	2.2	2.3	2.4	2.5
Credit to households[1, 2]	0.7	1.7	1.8	1.9	2.3	2.6	2.7	2.7
Interest rate on loans to non-financial firms[3] *(%)*	1.6	1.4	1.3	1.3	1.3	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	1.8	...
Deposits								
On demand deposits	11.1	10.0	9.5	9.3	9.5	10.3	10.1	10.6
Other short-term deposits	–3.8	–1.9	–1.2	–2.0	–2.3	–2.9	–3.2	–2.7
Marketable instruments	2.6	2.7	5.4	4.2	5.7	0.7	–2.4	–1.4
Interest rate on deposits up to 1 year from households *(%)*	0.8	0.5	0.5	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 · **A slight slowdown, as expected**

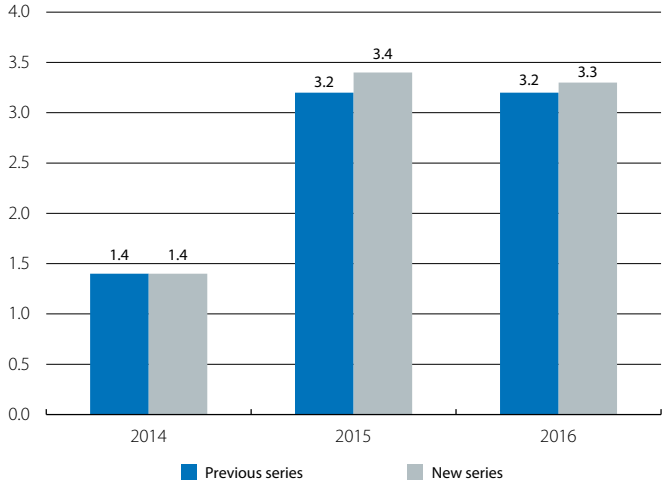
Growth looks like continuing. The Spanish economy has been growing for three years at an annual rate of more than 3%. This trend has been confirmed by the recent revision of the GDP series, carried out by the INE every September. Growth in 2015 and 2016 was also slightly higher than previously announced. Neither has there been a change in the international tailwinds boosting the Spanish economy over the past few years. These are euro area growth, the destination for just over half Spanish exports, low interest rates, and the moderate recovery in oil prices. The only doubts are the effect a stronger euro might have on export volumes, one of the economy's main drivers. But the impact of the euro's appreciation could be offset by recent productivity gains and contained labour costs. A strong euro also reduces the energy bill. This will help to contain the increase in energy imports in nominal terms.

Q3 economic activity indicators suggest a modest slowdown compared with the fast growth posted in Q2. CaixaBank Research's leading GDP indicator for Q3 shows 0.8% quarter-on-quarter growth, slightly below the 0.9% in Q2. This slight moderation in the growth rate is in line with CaixaBank Research forecasts and does not substantially detract from the Spanish economy's good performance. We have therefore kept our GDP growth forecast for 2017 unchanged at 3.1%. A more detailed analysis shows that supply indicators such as PMI business sentiment indices fell in August but are still in the expansionary zone, especially in services which account for most private employment. The Economic Sentiment Index was stronger, rising to 109.9 points in September, clearly above the average for the first six months. Demand picked up, with retail sales posting 1.6% year-on-year growth in August after a three-month slowdown. This suggests that private consumption, the largest GDP component with a share of almost 60%, is still one of the key drivers of economic growth. For a detailed analysis of the factors driving consumption growth, see the article «The recovery of consumption in Spain: reasons and outlook» in this Dossier.

The labour market remains positive. The job creation rate slowed down in August to 3.4% year-on-year (3.6% in July). As tends to happen in August, the number of registered workers affiliated to Social Security decreased (by 179,000 people, not seasonally adjusted). But on this occasion the decline was larger than in previous years. The seasonally adjusted figure also provided a drop of 14,976 people. In the past few 12 months, however, the number of people affiliated has risen by more than 600,000. After August's dip, we expect the favourable trend in the labour market to continue. In this context, hourly labour costs grew by 0.3% quarter-on-quarter in Q2 2017 (–0.2% in Q1 2017) according to the harmonised labour cost index, continuing the trend of moderation

Revision of the GDP series

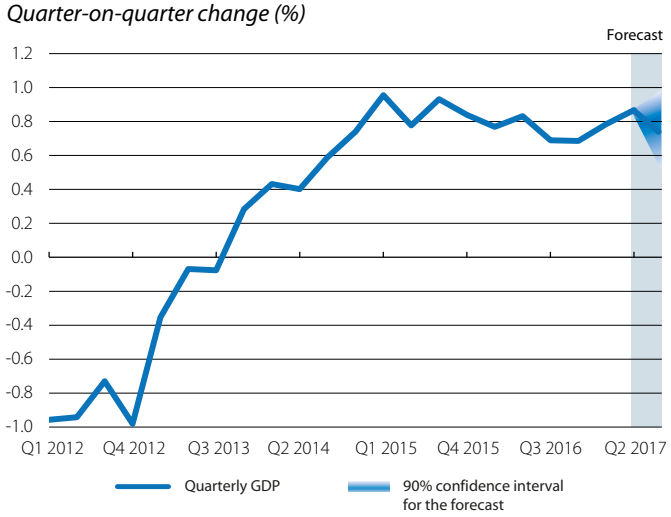
Annual rate of change (%)



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

GDP

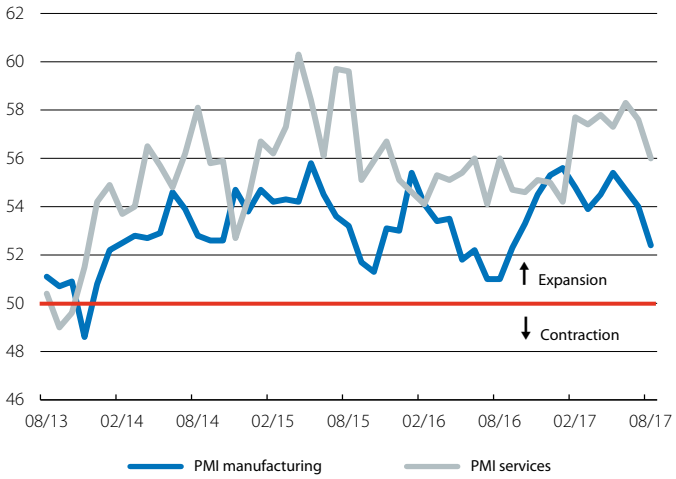
Quarter-on-quarter change (%)



Note: *90% confidence interval.*
Source: *CaixaBank Research, based on data from the INE.*

Economic activity indicators

Level



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

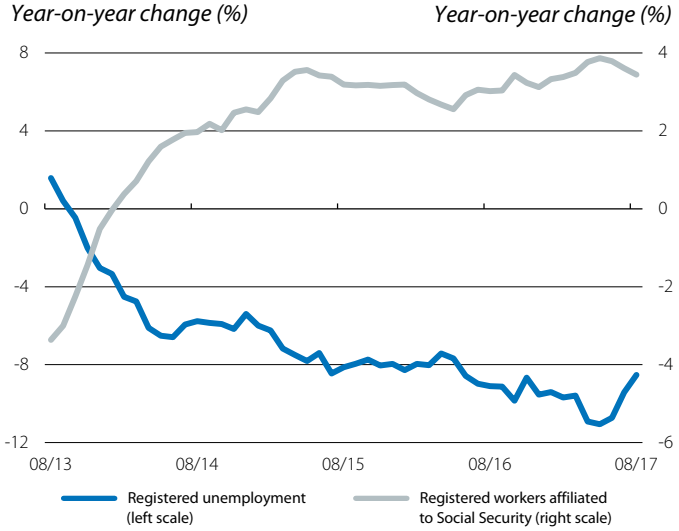
observed in the past few years. More specifically, the wage rises agreed in August were a contained 1.3%.

Temporary rise in inflation. Headline inflation increased by 0.3 pp to 1.9% in September. Although the details by component are not available, this rise might be due to the prices of food and non-alcoholic beverages. Inflation had already risen by 0.1 pp in August, up to 1.6% due to the upswing in fuels (7.0% year-on-year). Nevertheless, price increases are still very contained, as shown by core inflation which fell by 0.2 pp in August to 1.2%. Most of this decrease was due to the combined slowdown, in year-on-year terms, in the price of package holidays, whose 6.2% year-on-year rise was nonetheless lower than its July figure (8.2%), telephone services and insurance. Over the coming months, headline inflation will slow down until February 2018, mainly due to base effects of electricity prices. One year ago there was a sharp upswing in electricity prices that ended in January 2017 (when prices were 19.3% higher than the previous August). For the year as a whole, the CaixaBank Research forecast still predicts 1.8% for headline inflation and 1.1% for core inflation.

The foreign sector continues to perform well. July's current account stood at EUR 20,892 million, 1.8% of GDP (cumulative over 12 months), only 0.1 pp below the peak reached in December 2016. Exports of goods and tourism are strong and the income balance is gradually improving, benefiting from low interest rates. This is offsetting higher oil prices, which are no longer rising as quickly as earlier in the year, and the increase in domestic demand, resulting in a bigger appetite for imports. Customs data for July show that exports of goods grew by 6.8% year-on-year (cumulative over 12 months), the highest growth rate since July 2012, while non-energy exports, more closely related to underlying trends, also grew by a strong 5.9%. Imports also speeded up, supported by domestic demand and higher oil prices, posting 7.7% year-on-year growth (6.2% year-on-year for non-energy imports). The tourist season continues to break records. In August, 10.4 million foreign tourists came to Spain, 10.1% more than August 2016 (cumulative over 12 months). Tourism income contributed 5.1% of GDP to the current account surplus up to July (cumulative over 12 months), while payments by Spanish tourists abroad totalled 1.6% of GDP, resulting in a net tourism balance of 3.4% of GDP. CaixaBank Research predicts a current account surplus of 1.8% of GDP for 2017 as a whole.

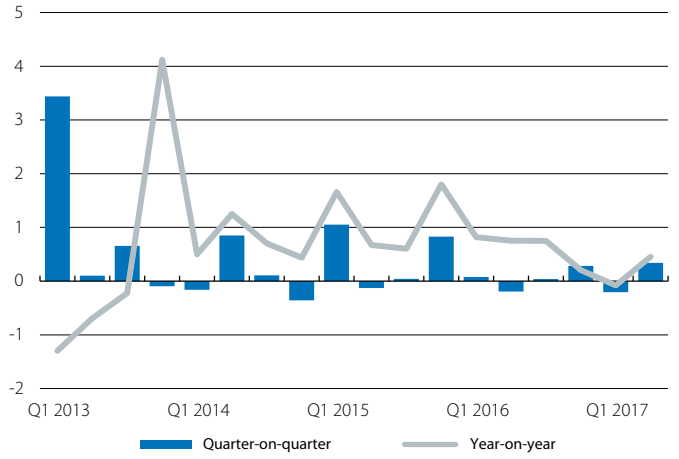
The Q2 general government deficit stood at 2.1% of GDP (including local government corporations). This represents an 8 pp adjustment compared with the Q2 2016 figure, just over half the 1.3 pp required to achieve the deficit target of 3.0% of GDP in 2017 (3.1% including bank restructuring costs). This positive trend in national accounts will help to achieve the deficit target. It will also be helped by the impact of contingencies resulting from the toll road bail-out very probably being allocated entirely to 2018. By administration, the central government deficit, whose data are available up

Registered workers affiliated to Social Security and registered unemployment



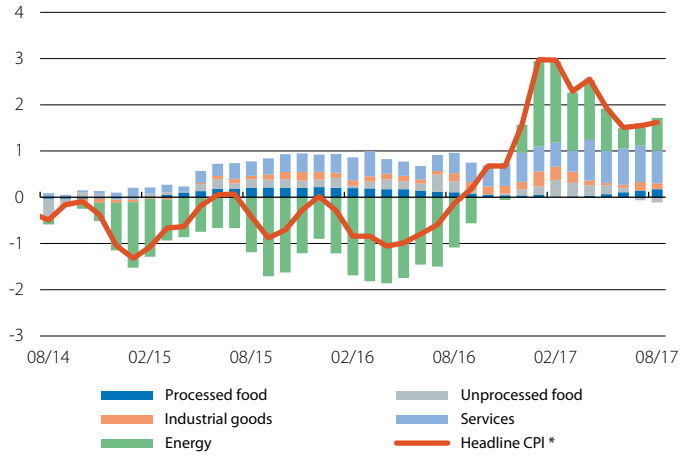
Source: *CaixaBank Research, the Ministry of Employment and Social Security.*

*Labour cost per hour **



Note: ** Data adjusted for seasonal and calendar effects.*
Source: *CaixaBank Research, based on data from the INE (ICLA).*

Contribution to inflation by component



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

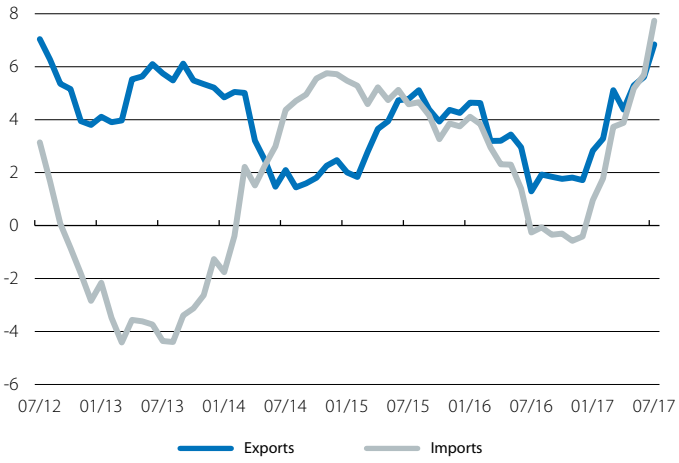
to August, fell to 1.8% of GDP compared with 2.9% in August 2016. Social Security, with data available up to July, also posted a deficit of 0.5% of GDP (the same figure as July 2016), while autonomous communities posted a zero balance, improving on July 2016's figure by 0.1 pp.

The real estate market remains positive. The house prices published by the INE, based on transactions, rose by 5.6% year-on-year in Q2 (2.0% quarter-on-quarter) and are tending to speed up. This recovery in the market is very uneven, however. While prices rose by 10.9% and 9.3% in Madrid and Catalonia, respectively, in Castile-La Mancha, Extremadura and Murcia gains were 0.8%, 0.4% and 0.3%, respectively, with a 3.0% fall in Asturias. There was a surprising decline in the prices published by the Ministry of Public Works, which are based on valuations. These rose by just 0.3% quarter-on-quarter in Q2 (1.6% year-on-year), a slowdown compared with the 0.9% posted in Q1 although such fluctuations are typical for this series. In demand terms, house purchases in the first seven months rose by 13.8% year-on-year (13.5% cumulative over 12 months), slightly above expectations (see the Focus «Leaving home: a dream or reality for young adults?» in this *Monthly Report*, on household formation). Regarding the supply of housing, new building permits increased by 14% in May (cumulative over 12 months). Although this figure is almost double the level of December 2014, it is only one fifth of the average for the period 1995 a 1999 (both inclusive).

Positive trend in new bank loans. In July, new loans granted to households to purchase housing were up 16.6% year-on-year YTD, reflecting the recovery in real estate demand. New consumer loans are slowing down slightly but growth is still high (17.2% year-on-year YTD). The favourable trend continues for loans to SMEs (8.0%) and new transactions for large firms grew for the first time since the beginning of 2016 (0.2%). Given this extremely dynamic situation for bank credit, the NPL ratio increased slightly in July up to 8.47%. Nevertheless, the current NPL ratio is still the lowest for the past five years. It is likely to fall further over the coming months due to sales of portfolios of non-performing assets.

Exports and imports of goods *

Year-on-year change (%)



Note: ** Cumulative over 12 months.*
Source: *CaixaBank Research, based on data from the Customs Department.*

Budget execution by administration

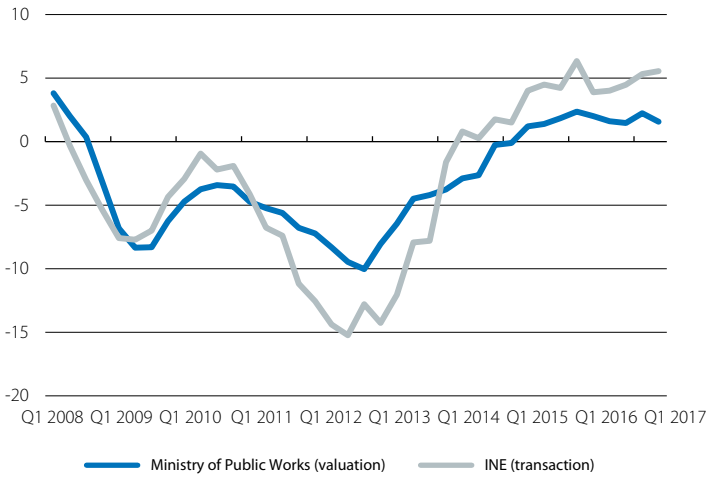
(Cumulative YTD)

	Latest figure	EUR million		% of GDP	
		2016	2017	2016	2017
Central government	August	–31.913	–21.502	–2.9	–1.8
Social Security	July	–5.843	–5.61	–0.5	–0.5
Autonomous Communities	July	–771	35	–0.1	0.0
Total administrations (without local govt. corp.) *	July	–35.293	–26.94	–3.2	–2.3
Local government corporations	June	1.169	1.874	0.1	0.2
Total administrations *	**Q2 2017**	**–32.768**	**–25.108**	**–2.9**	**–2.1**

Note: ** Excluding bank recapitalisation.*
Source: *CaixaBank Research, based on data from the State Public Accounts.*

Price of non-subsidised housing

Year-on-year change (%)



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

FOCUS · The three strong points of Spain's tourism industry

2017 looks like being another record year for Spain's tourism industry. The country received 46.9 million international tourist arrivals in the first seven months of the year, 11.3% up on 2016 and 49.4% more than in 2010. Tourism expenditure is also growing at a faster rate. However, the terrorist attempts of 17 August in Barcelona and Cambrils, at the height of the season and in emblematic tourist spots, have aroused concerns regarding the potential consequences for the sector. The aim of this Focus is to highlight three strong points in Spain's tourism industry that could help to maintain its role as the driving force of the country's economy.

The first strong point is that a substantial part of the sector's health is due to the quality of the tourism on offer. Demand factors such as the euro area's economic recovery and instability in rival destinations such as North Africa and the Middle East, in addition to an upward trend in global tourism, are boosting Spain's tourism significantly and cannot be ignored. However, it is equally true that Spain boasts a highly competitive sector. According to the latest biennial report on the travel and tourism industry produced by the World Economic Forum (WEF) in April 2017,[1] Spain once again leads the ranking of 136 countries, ahead of France, Germany, Japan and the US.

The travel and tourism competitive index rates the performance of each country according to 14 pillars which, in turn, are divided into 90 individual indicators. Every country is given a score for each pillar and indicator and a ranking out of 136 economies based mainly on surveys carried out with people in the industry. Within the different pillars, Spain not only ranks highly in the classic areas of natural and cultural resources but also scores well in those in investment and institutional quality, such as infrastructure and safety and security. This last aspect, security, is particularly important at present and represents the country's second strong point.

In the WEF report, the pillar of safety and security includes five indicators that rate the costs of crime and violence, homicide rate, cost and incidence of terrorism and police reliability. It is interesting that the large European countries (France, Germany, United Kingdom and Italy) all have notably worse scores in safety and security than would be expected given their overall ranking (see the enclosed table). They score even lower in terms of the business costs of terrorism. Spain has a relatively good position (18th in overall safety and security and 60th in the business costs of terrorism). Although the international perception of Spain's security may have worsened after the recent terrorist attacks, this might be offset by the positive perception of police effectiveness. By way of example, deterioration in perceived security in France and the UK between 2015 and 2017 was contained, in spite of the terrible attacks occurring in those countries.

A third strong point of Spain's tourism industry is the European origin of its visitors. Taking France as a case in point, foreign tourist arrivals in the region of Gran Paris fell by 8.3% in 2016. By origin, most of this drop occurred among Japanese, Russian and Chinese tourists (41%, 28% and 13%, respectively). These groups seem to be more sensitive to changes in perceived safety and security and accounted for 12.6% of all foreign tourists visiting Gran Paris in 2015. In Spain, however, they only account for 2.6% of foreign tourist arrivals (data from July 2017, cumulative over 12 months). In short, Spain's tourism industry has strengths that lead us to be optimistic about it continuing to perform well in the future.

Competitiveness of the tourist industry

	General		Safety and security		Reliability of police services		Business costs of terrorism	
	2015	2017	2015	2017	2015	2017	2015	2017
Spain	1	1	31	18	20	16	83	60
France	2	2	62	67	30	29	108	112
Germany	3	3	20	51	19	39	60	84
United Kingdom	5	5	63	78	26	21	82	91
Italy	8	8	48	70	42	71	54	78

Note: *Ranking out of 136 countries. The best position within the group is in red.*
Source: *World Economic Forum, (2015 and 2017), «The Travel and Tourism Competitiveness Report».*

1. World Economic Forum, (2017), «The Travel & Tourism Competitiveness Report».

FOCUS · Leaving home: a dream or reality for young adults?

In the past few years the number of new households being formed has started to rise. In 2016 68,200 new households were created, up by 45% on 2015. However, net household formation is still very low, especially compared with the pre-crisis years when almost 400,000 new households were created each year.[1]

To understand the dynamics behind household formation we need to examine how its main determining factors are changing: namely demographics and socioeconomic conditions. Since household formation is particularly concentrated among young adults, we focus our analysis on this segment.

Demographics are undeniably important. While the population under 35 years of age accounted for 42.8% of the total population in 2008, this share is now 36.5%. As there are fewer young adults, fewer households are being formed. By way of example, in the past nine years around 33,000 fewer households have been formed per year due to the demographic effect on the young adult segment of the population.[2]

Economic factors are also playing their part, however. Fewer young adults are leaving the parental home to set up their own household, as shown by the ratio of young households to the total young adult population falling from 14.3% in 2008 to 10.8% in 2017.

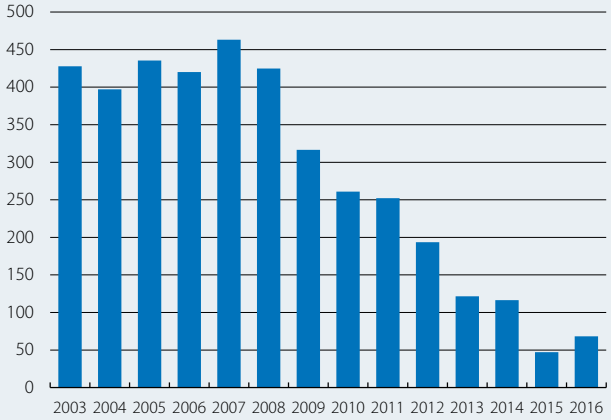
One key aspect is undoubtedly the change in the age at which young people start work. This is partly due to them studying for longer. The average age at which people under 35 finish their education has gone from 18.4 years in 2008 to 19.1 at present. But the nature of the labour market itself also seems to be a key factor. Although jobs are now being created at a good rate, youth unemployment is still high and it is difficult to reduce the temporary nature of employment, especially among the young. 46.1% of people aged under 35 who are in work are on a temporary contract (42.5% in 2008). Unemployment for this group is also at a high level of 24.3%, although this figure has fallen by over 12 pp since its peak in 2013. The average wage for workers aged between 25 and 29 also fell by 8% from 2008 to 2015 in nominal terms.

Finally, one additional factor to take into account is the growing pressure on property prices. Young adults tend to live particularly in large cities such as Barcelona and Madrid, where real estate prices are rising the most.

While house prices have increased by 4.9% overall since 2015, in Barcelona and Madrid this rise has been 18.3% and 11.0%, respectively.[3]

Net households formed

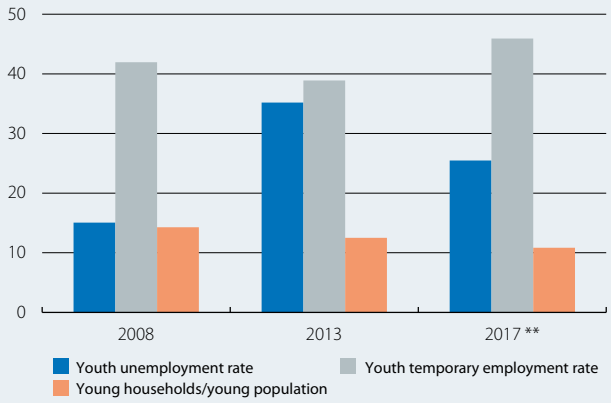
(Thousands)



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

*Young households and the quality of youth employment **

(%)



Notes: ** Population aged under 35. ** Data from Q2 2017 (cumulative over four quarters).*
Source: *CaixaBank Research, based on data from the INE.*

1. Annual average from 2003 to 2010.
2. Assuming the share of young people forming a household out of all young people remains constant at current values.
3. Growth in the appraised value of residences available for sale, published by the Ministry of Public Works, from Q1 2015 to Q2 2017.

KEY INDICATORS

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

Activity indicators

	2015	2016	4Q 2016	1Q 2017	2Q 2017	07/17	08/17	09/17
Industry								
Electricity consumption	1.7	0.1	–0.1	1.6	1.2	0.8	1.6	–1.5
Industrial production index	3.3	1.9	1.9	1.9	2.1	1.7	...	...
Indicator of confidence in industry *(value)*	–0.3	–2.3	–0.6	0.3	–0.5	–1.8	–0.6	2.1
Manufacturing PMI *(value)*	53.6	53.2	54.4	54.8	54.9	54.0	52.4	54.3
Construction								
Building permits *(cumulative over 12 months)*	20.0	43.7	36.9	24.5	18.4	22.0	...	...
House sales *(cumulative over 12 months)*	10.9	13.0	13.7	14.9	12.0	13.5	...	...
House prices	1.1	1.9	1.5	2.2	1.6	–	...	–
Services								
Foreign tourists *(cumulative over 12 months)*	5.6	8.2	10.1	10.0	10.2	10.4	10.1	...
Services PMI *(value)*	57.3	55.0	54.9	56.4	57.8	57.6	56.0	...
Consumption								
Retail sales	3.0	3.6	3.0	0.5	2.5	0.7	1.7	...
Car registrations	21.3	11.4	8.9	7.8	6.3	2.5	13.0	...
Consumer confidence index *(value)*	0.3	–3.8	–3.2	–2.8	1.5	2.0	–0.2	–1.1

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

Employment indicators

	2015	2016	4Q 2016	1Q 2017	2Q 2017	07/17	08/17
Registered as employed with Social Security [1]							
Employment by industry sector							
Manufacturing	2.2	2.8	2.8	3.0	3.1	3.1	3.1
Construction	4.7	2.6	3.3	5.3	6.1	6.3	5.8
Services	3.5	3.2	3.5	3.4	3.8	3.7	3.5
Employment by professional status		3.5					
Employees	3.5	3.5	3.8	4.0	4.4	4.2	4.1
Self-employed and others	1.9	1.0	0.9	0.9	0.9	0.8	0.7
TOTAL	**3.2**	**3.0**	**3.3**	**3.4**	**3.8**	**3.6**	**3.4**
Employment [2]	**3.0**	**2.7**	**2.3**	**2.3**	**2.8**	**–**	**...**
Hiring contracts registered [3]							
Permanent	12.3	14.2	13.3	15.4	10.2	10.6	9.8
Temporary	11.2	7.2	6.6	12.1	9.6	5.8	5.5
TOTAL	**11.3**	**7.8**	**7.1**	**12.4**	**9.6**	**6.2**	**5.8**
Unemployment claimant count [3]							
Under 25	–11.0	–12.6	–13.2	–13.3	–17.3	–11.9	–9.5
All aged 25 and over	–7.2	–8.2	–9.0	–9.2	–10.3	–9.2	–8.4
TOTAL	**–7.5**	**–8.6**	**–9.4**	**–9.6**	**–10.9**	**–9.4**	**–8.5**

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	4Q 2016	1Q 2017	2Q 2017	07/17	08/17	09/17
General	**–0.5**	**–0.2**	**1.0**	**2.7**	**2.0**	**1.5**	**1.6**	**1.8**
Core	0.6	0.8	0.9	1.0	1.1	1.4	1.2	...
Unprocessed foods	1.8	2.3	1.0	4.1	2.5	–1.0	–1.6	...
Energy products	–9.0	–8.4	1.6	15.3	8.0	4.1	6.3	...

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	Q3 2016	Q4 2016	Q1 2017	Q2 2017	06/17	07/17
Trade of goods								
Exports *(year-on-year change)*	4.3	1.7	–1.1	3.2	14.1	6.3	5.7	3.9
Imports *(year-on-year change)*	3.7	–0.4	–3.7	3.0	16.5	7.4	5.0	10.8
Current balance	**12.2**	**21.5**	**19.3**	**21.5**	**21.6**	**21.0**	**21.0**	**20.9**
Goods and services	25.3	33.7	31.9	33.7	32.0	32.3	32.3	31.7
Primary and secondary income	–13.1	–12.2	–12.6	–12.2	–10.4	–11.3	–11.3	–10.8
Net lending (+) / borrowing (–) capacity	**19.2**	**24.2**	**24.4**	**24.2**	**24.1**	**23.1**	**23.1**	**23.0**

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	Q3 2016	Q4 2016	Q1 2017	Q2 2017	07/17
Net lending (+) / borrowing (–) capacity [1]	**–5.3**	**–4.5**	**–2.9**	**–4.5**	**–0.4**	**–2.2**	**–**
Central government	–2.6	–2.7	–2.6	–2.7	–0.5	–1.1	...
Autonomous regions	–1.7	–0.8	–0.1	–0.8	–0.2	–0.7	...
Local government	0.4	0.6	0.5	0.6	0.1	0.2	–
Social Security	–1.2	–1.6	–0.6	–1.6	0.1	–0.5	...
Public debt *(% GDP)*	**99.4**	**99.0**	**100.0**	**99.0**	**100.1**	**100.0**	**–**

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

Credit and deposits in non-financial sectors [1]

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

	2015	2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017	07/17	08/17
Deposits [2]								
Household and company deposits	–0.6	2.5	3.2	3.0	3.2	2.5	1.3	2.1
Sight and savings	14.7	16.0	15.7	16.2	18.6	18.8	16.3	17.2
Term and notice	–16.3	–16.0	–15.1	–17.7	–22.0	–24.9	–25.1	–25.1
General government deposits	6.7	–14.2	–9.4	–29.1	–28.0	–26.7	1.8	8.9
TOTAL	**–0.2**	**1.2**	**2.4**	**0.4**	**1.0**	**0.5**	**1.4**	**2.5**
Outstanding balance of credit [2]								
Private sector	–5.5	–3.6	–3.3	–3.2	–2.7	–2.2	–2.5	–2.4
Non-financial firms	–7.3	–5.3	–5.2	–5.2	–4.3	–3.1	–4.0	–4.0
Households - housing	–4.6	–3.7	–3.3	–3.1	–3.0	–2.8	–2.8	–2.7
Households - other purposes	–2.6	2.0	3.1	2.9	3.6	2.8	2.8	3.2
General government	0.2	–2.9	–2.2	–2.7	–3.2	–12.6	–11.6	–10.8
TOTAL	**–5.2**	**–3.6**	**–3.2**	**–3.2**	**–2.7**	**–2.9**	**–3.2**	**–3.0**
NPL ratio *(%)* [3]	**10.1**	**9.1**	**9.2**	**9.1**	**8.8**	**8.4**	**8.5**	**...**

Notes: *1. Aggregate data from Spain's banks. 2. Residents in Spain. 3. Data up to end of period.*
Source: *CaixaBank Research, based on data from the Bank of Spain.*

CONSUMPTION: NEW TRENDS

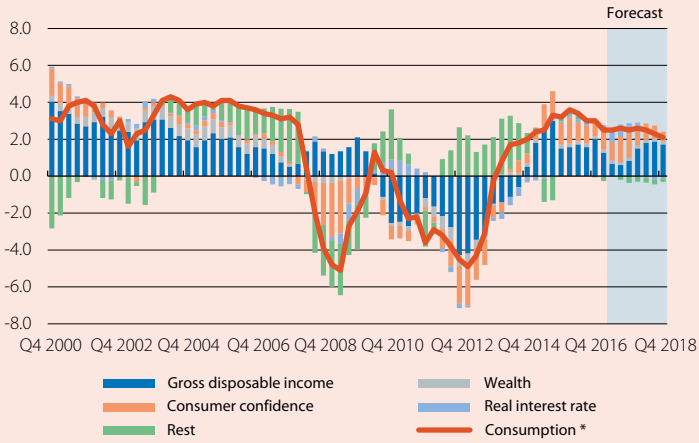
The recovery of consumption in Spain: reasons and outlook

The evolution of consumption of Spanish households, which accounts for almost 60% of GDP, determines the cyclical situation of Spain's economy. That is why we need a close examination of how households spend their money and the key conditioning factors throughout the economic cycle. The first article in this Dossier attempts to achieve precisely that. By way of introduction, job creation, increased confidence and favourable financial conditions are the main factors behind private consumption's dynamic performance in the current recovery. These factors will continue to support consumption, especially of durable goods, over the coming quarters.

Household consumption has been growing non-stop since mid-2013.[1] Its growth rate has been faster than expected, easily outperforming the rate recorded for the euro area as a whole over the same period. However, it is still 3.9% below the peak reached before the crisis due to the huge adjustment carried out during the recession.[2] Two quite different recessionary periods can be observed. Consumption began its first downward phase early in 2008 due to the international financial crisis and the bursting of the real estate bubble, falling by 6.5% in just five quarters. Subsequently, after a year of very slight growth (0.3% quarter-on-quarter on average), in Q3 2010 private consumption declined again, this time for a longer period, falling to its lowest level in Q2 2013 and accumulating a 14.3% drop compared with its pre-crisis figure.

Determining factors of consumption

Contribution to the year-on-year change in real consumption (pp)



Note: ** Year-on-year change (%). Data in real terms.*
Source: *CaixaBank Research, based on data from the INE, the European Commission and the Bank of Spain.*

The underlying factors behind these two recessionary phases for consumption are quite different (see the enclosed chart).[3] In the first phase (2008-2009), the decrease in consumption was not accompanied by a fall in households' gross disposable income (GDI). In fact, GDI continued to increase at a similar rate to the one recorded over the five years prior to the crisis (an annual average of 2.3%). We can therefore conclude that other factors led to the decline in consumption during this period, in particular plummeting consumer confidence, which fell from levels similar to the historical average in 2007 to an all-time low in February 2009. Confidence was lost due to uncertainty, given the worsening economic outlook. Households therefore increased their savings for precautionary reasons,[4] resulting in less consumption.

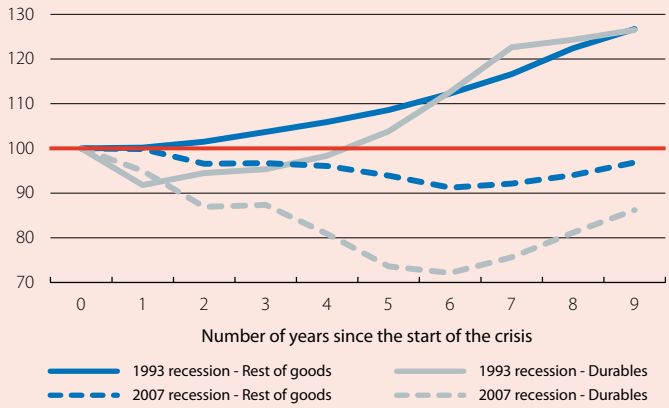
In clear contrast, the second period of sharp falls in consumption (2010-2013) was characterised by a big decrease in GDI, resulting especially from job losses and, to a lesser extent, wage containment. Other factors also played their part, such as the deterioration in consumer confidence, a decline in the net wealth of households, both financial and real estate, and tougher conditions to access credit. All the ingredients for a recessionary cocktail.

The turning point for the consumption trend came in the second half of 2013, when it started to recover and gradually picked up momentum, reaching a growth rate close to 3% between 2015 and Q2 2017, on average. This exceptional performance by consumption is due to the aforementioned factors starting to have a positive effect. Firstly, the economic recovery is substantially boosting job creation, resulting in growth in GDI even though the still necessary wage containment is acting as a lid on this growth. Improved expectations regarding the labour market trend are also having a positive effect on consumption. Specifically, the better economic conditions are not only encouraging consumption among those directly benefitting (such as people finding employment) but are also boosting consumption among other households. For instance, those who already had a job but are now less afraid of losing it. This confidence effect is the reason why savings are currently a significantly below their historical average.

1. Specifically, in real terms, 10.5% cumulative growth between Q3 2013 and Q2 2017, an annual average of 2.5%. In nominal terms, cumulative growth was 9.3%, an annual average of 2.2%.
2. In this article the data are in real terms, unless otherwise specified.
3. Contributions to the variation in consumption are based on an estimate in two steps. In the first step, a univariate regression of consumption and GDI has been estimated (year-on-year change). The residuals from this first stage are used as a dependent variable for a second regression, in which the explanatory factors included are consumer confidence (lag), household net wealth and the real interest rate.
4. The savings rate rose from 5.9% in 2007 to 13.4% in 2009, significantly higher than the historical average of 9.6%.

Consumption of durables and the rest of goods in recessions

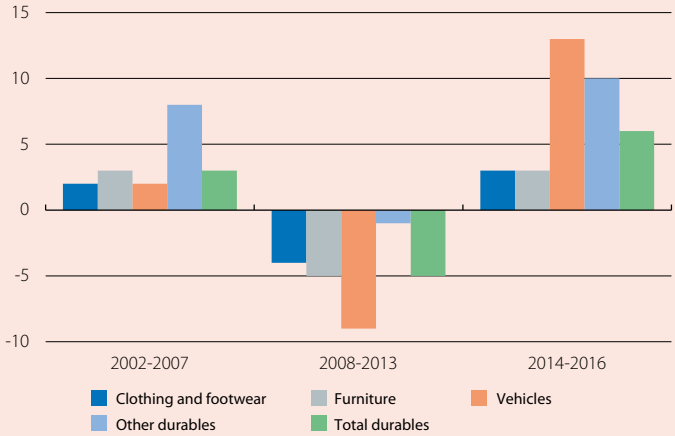
Index (100 = year the crisis started)



Note: *Data in real terms.*
Source: *CaixaBank Research, based on data from the INE.*

Consumption of durables in different periods

Average annual change (%)



Note: *Data in real terms.*
Source: *CaixaBank Research, based on data from the INE.*

Another reason for the recovery in consumption is the improved wealth of all households, both financial and real estate. That is, the recovery in the real estate market and in financial asset prices is supporting growth in net household wealth. This is very important in our current situation since household deleveraging is now at a very advanced stage, greatly improving their capacity to access credit. Financial conditions for consumer loans have also improved considerably thanks to the ECB's accommodative monetary policy and the fact that banks' solvency and liquidity ratios are now much improved (see the article «Situation and outlook for consumer financing» in this Dossier).

Given this highly favourable environment, CaixaBank Research expects the positive trend in the main determining factors for consumption to continue, resulting in solid growth, namely 2.6% in 2017 and 2.4% in 2018. Although job creation is expected to slow down slightly over the next few quarters, moderate wage rises and the continuing low level of inflation will support GDI growth in real terms. These forecasts also assume the savings rate will remain at around its current level of 6.5%. In any case, a 1pp increase in the savings rate from its current level, a rate more in line with that recorded in the period 2015-2016, would also be compatible with notable growth in consumption (around 2% in 2018).

There is, however, significant variation between different goods and services which is not revealed by the overall trend for spending. One especially relevant aspect that illustrates the particular features of the consumption trend in Spanish households over the last economic cycle is the pattern of adjustment in consumer durables. In broad terms, spending on durables, such as vehicles, furniture and domestic appliances, is very sensitive to the economic cycle since households tend to delay buying such goods during economic recessions (as shown by the second chart).[5] However, on this occasion there was also a marked adjustment in the consumption of other goods, unlike the consumption pattern observed in the less severe recession of 1993.

Another especially important observation is the time required for the consumption of durables to get back to its pre-crisis level. It took five years after the 1993 recession to return to the pre-crisis level of durable goods consumption, while this was still 14% below its pre-crisis level nine years after the 2007 recession. The cycle has been even more marked in the particular case of vehicle purchases. Although sales rose strongly in the period 2014-2016 (13.4% on average, see the third chart), the current number of registrations is only 72% of the figure reached at the pre-crisis peak (2005).

In short, the outlook for household spending and particularly on consumer durables is promising. As we have seen, all the underlying factors are encouraging: job creation is performing well, moderate wage rises are expected in a context of still low inflation, confidence is at an all-time high and financial conditions are favourable.

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

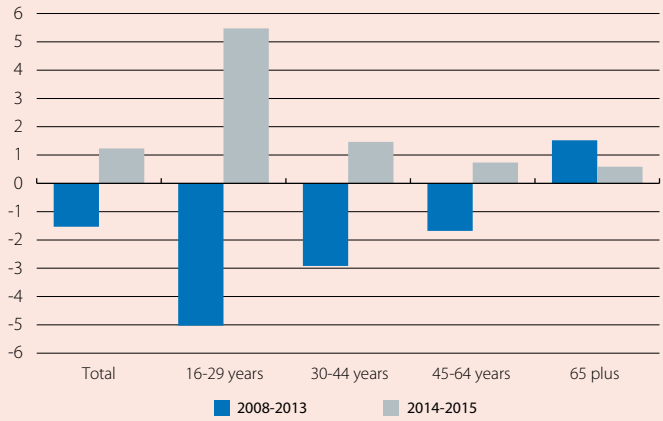
5. Based on the final consumption expenditure of households according to national account data (two-digit COICOP classification), the different products have been grouped into two categories: durables (codes 3, 5, 7.1, 8.2, 9.1, 9.2 and 9.3) and the rest of goods and services. See «La recuperación del consumo privado en España por tipo de producto y hogar», Bank of Spain, June 2017.

Consumption: who, how much and of what?

One of the economic recovery's main features is dynamic household consumption. But this brilliant performance by consumption in general hides very different patterns depending on households' sociodemographic characteristics. Not everyone was hit as hard by the economic crisis nor are they all experiencing the recovery similarly.

*Household consumption by age range **

Annualised average change (%)



Note: ** Mean consumption per person in households whose head is within this age range. Data in nominal terms.*
Source: *CaixaBank Research, based on data from the INE* (Encuesta de Presupuestos Familiares).

The last recession cost over 3.5 million jobs in Spain. Directly or indirectly, more or less close to home, we all noticed the impact of the crisis. But one group of people felt it especially keenly: young people. This can clearly be seen by the unemployment trend for those aged from 16 to 29, which reached 44% in 2013 and was around 20 pp higher than the unemployment rate for the population as a whole. The consumption trend was also clear, falling by 5% annually among younger households between 2008 and 2013, three times the rate of the average household.[1]

Fortunately such patterns have reversed during the recovery. Consumption is now increasing more intensively among young households. In 2014 and 2015 (the last years with information available), growth exceeded 5% year-on-year and tripled the overall growth for households (see the chart). The increase in spending by young people is particularly strong for eating out, clothing and automobiles, up by 17.5%, 10.2% and 37.3% respectively in the annual average for 2014 and 2015. Moreover, young households tend to consume these three groups more than the average for Spanish households (see the table).

This rapid recovery in spending among young people is partly due to the stronger labour market (youth unemployment has fallen by 14 pp since 2013). This is also helping to form new households, a key factor in dynamic consumption since it tends to boost young people's spending on consumer durables, the segment of the population that forms most new households. 68,200 households were created in 2016. Although this number is still relatively small, it is 45% up on 2015.[2] All the evidence points to both factors, the improved labour market and household formation, continuing over the coming years, which should support the recovery in consumption among young households.

There are some reservations to this optimistic outlook for younger households, however. Firstly, the extremely temporary nature of youth employment is still an obstacle to consumption's recovery since temporary contracts tend to be associated with lower wages. Moreover, households whose members are employed on temporary contracts tend to save more for precautionary reasons. Spain's temporary employment rate stands at 27%, double the average for large European countries, rising to 53% among young adults under 29 years of age. Secondly, the emergence of new technologies and especially the growing importance of e-commerce and the sharing economy, especially among the young, represent a paradigmatic change for consumption habits that is difficult to predict (for more details, see the article «Consumption in the digital era» in this Dossier).

Continuing with our detailed analysis in sociodemographic terms, another important aspect to examine is the different effect of the crisis on household consumption depending on income level. Consumption data in nominal terms show that lower income Spanish households were hardest hit by the crisis, with year-on-year falls close to 6% (compared with 1.5% for households as a whole). Consumption by these households has also failed to increase as quickly during the first few years of the recovery. In absolute terms, this has placed them in a worse situation in consumption terms than the one they were in before the crisis. It is also in relative terms since the gap has widened between them and higher income households.

1. Based on data from the *Encuesta de Presupuestos Familiares*, the average expenditure is analysed per person in nominal terms in the type of household whose main member's characteristics are specified.
2. For more information, see the Focus «Leaving home: a dream or reality for young adults?» in this *Monthly Report*.

This increase in the consumption gap actually forms part of a much wider and controversial debate; whether the greater inequality in income levels occurring over the past decade in most advanced economies, and also in Spain,[3] has led to greater inequality in consumption. And whether the crisis actually aggravated this inequality. The data for Spain do seem to point to an increase in inequality in consumption terms during the crisis.

However, the economic literature offers important information on the consumption trend in low income households. This notes that real consumption (a more accurate measurement of well-being) has fallen much less than suggested by the data in nominal terms. As a result, the increase in consumption inequality by income level may not have been as acute.[4]

Several academic articles suggest that the prices paid by low income households for the goods and services they consume have risen less than indicated by the general price index. This is largely due to the capacity of households to replace products with similar but cheaper ones when there is a negative and unexpected shock in their income. This situation is not clearly indicated by the consumer price index (CPI), however. The emergence of new establishments offering products more cheaply, such as large commercial centres or online stores, is not accurately reflected by the CPI either. And it is precisely low income households that tend to take most advantage of such opportunities.[5]

*Household consumption by type of good or service **

	All ages		16-29 years	
	Mean spend per person (euros) *	Annualised average change 2014 and 2015 (%)	Mean spend per person (euros) *	Annualised average change 2014 and 2015 (%)
Meals and drinks outside the home	947	7.3%	1,332	17.5%
Clothing	415	1.7%	483	10.2%
Vehicle purchases	336	13.7%	565	37.3%
Furniture	80	–3.3%	115	3.8%
Total	**10,960**	**1.2%**	**10,637**	**5.5%**

Note: ** Mean consumption per person in households whose head is within this age range; 2015. Data in nominal terms.*
Source: *CaixaBank Research, based on data from the INE* (Encuesta de Presupuestos Familiares).

In short, the recovery in consumption is widespread but also varies depending on the sociodemographic characteristics of households. The trend in the labour market, its temporary bias and household formation will affect the continuity of this recovery. However, the role of technologies and the sharing economy are creating a new panorama for consumption trends, especially among the young.

Anna Campos and Clàudia Canals
Macroeconomics Unit, Strategic Planning and Research Department, CaixaBank

3. See OECD (2016), «Income inequality remains high in the face of weak recovery», Income Inequality Update; and the Dossier «The consequences of inequality» in MR01/2017.
4. See Sacerdote, B. (2017), «Fifty Years of Growth in American Consumption, Income, and Wages», NBER Working Paper no. 23292, for the US case.
5. See Campos, R. and Reggio, I. (2017), «Do the Unemployed Pay Lower Prices? A Reassessment of the Value of Unemployment Insurance», Working Paper 08/06. For Spain, the authors conclude that the unemployed pay prices that are around 1.5% lower than those paid by employed people, which could account for approximately one sixth of the gap in consumption.

Consumption in the digital era

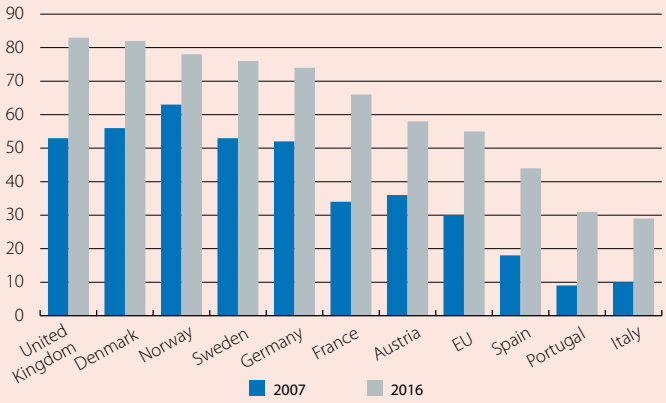
The proliferation of department stores, supermarkets and then shopping malls in the 20th century significantly changed how we shop. Instead of asking an assistant for what we wanted, who then fetched it from the back of the store, consumers had several products of different categories within reach, all displayed with their respective prices, making their choice much simpler. Thanks to the internet, in the 21st century we are now witnessing a new «revolution» in consumption. Today consumers can shop anywhere and anytime. They can also have their purchase delivered or sent to a nearby pick-up point. This article analyses the current impact of new digital technologies on consumption, consumers and how companies operate.

Widespread internet and smartphone use, faster internet connection speeds and the development of new online payment methods are boosting growth in e-commerce. Some figures help to highlight this. In China, the largest e-commerce market in the world, 17% of retail sales are already carried out online while, in the US, internet sales account for almost 9% of the total.[1]

Online shopping has also become very popular in Europe. In 2016, 55% of Europeans bought online compared with 30% in 2007. In some EU countries e-commerce is even more widespread (see the first chart). For instance, over 70% of people shop online in the United Kingdom, Scandinavia and Germany. In other countries, such as Spain, the percentage is below the European average[2] although the trend is clearly upward and growth is generalised across age groups (see the second chart).[3] Since younger generations (16-44 years) are the most «digitalised», we are likely to see exponential growth in e-commerce in the future.

People who purchased online within the last 12 months

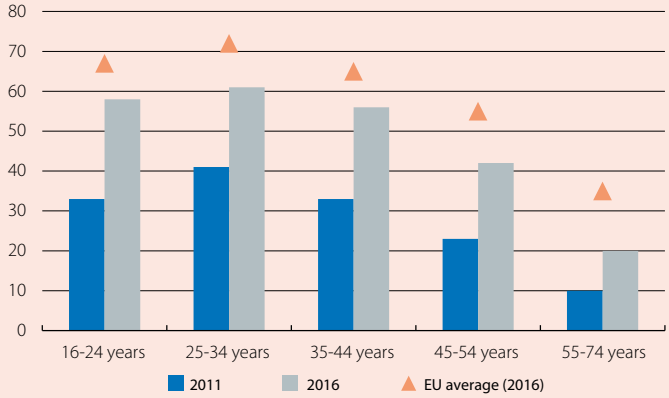
(%)



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

Spain: people who purchased online within the last 12 months by age group

(%)



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

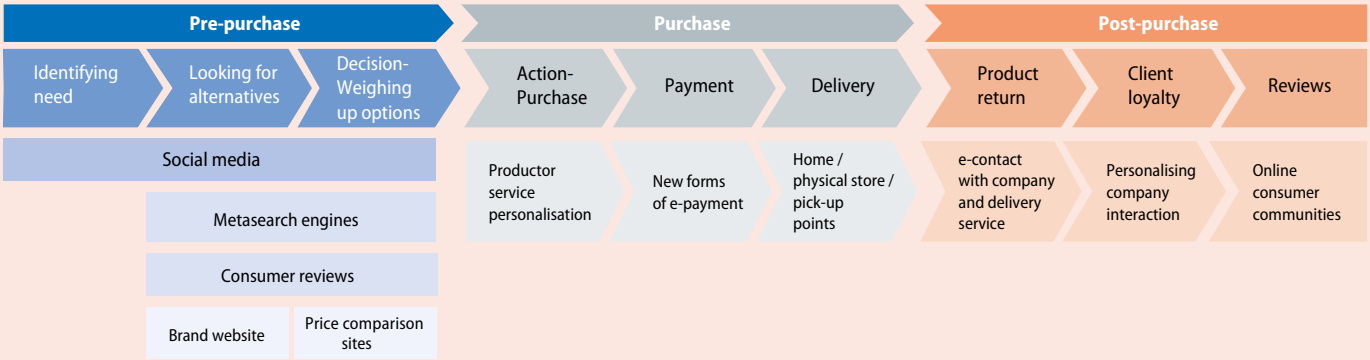
This fast «consumer digitalisation» is transforming all the stages in the traditional buying process (see the diagram). Firstly, because consumers are being given an increasingly bigger role, particularly in the initial purchase stage. Today, consumers have a wider variety of products and services in all categories available to them, offered at different prices. As consumers become more connected, they enjoy greater decision-making power as they can easily compare prices and features offered by suppliers worldwide, know more about the manufacturer or product in question and check the opinion of other consumers before choosing a particular product or service. e-commerce platforms are becoming increasingly important in this context. Through these, consumers can shop anytime and anywhere. Consumers now expect this greater convenience, demanding to be able to buy all the products and services they consume, both online and offline, equally quickly and efficiently. Consumers also increasingly expect to personalise more products and services, and their interactions with the brand to be more relevant.[4]

But changes are also occurring in the post-purchase stage. There are now more options open to consumers to return products they do not want and to be attended at all times (via several channels) when they have a problem or their expectations have not been met. They can also share their experiences regarding a product or service on social media and review platforms, producing content for the initial stage of other consumers.

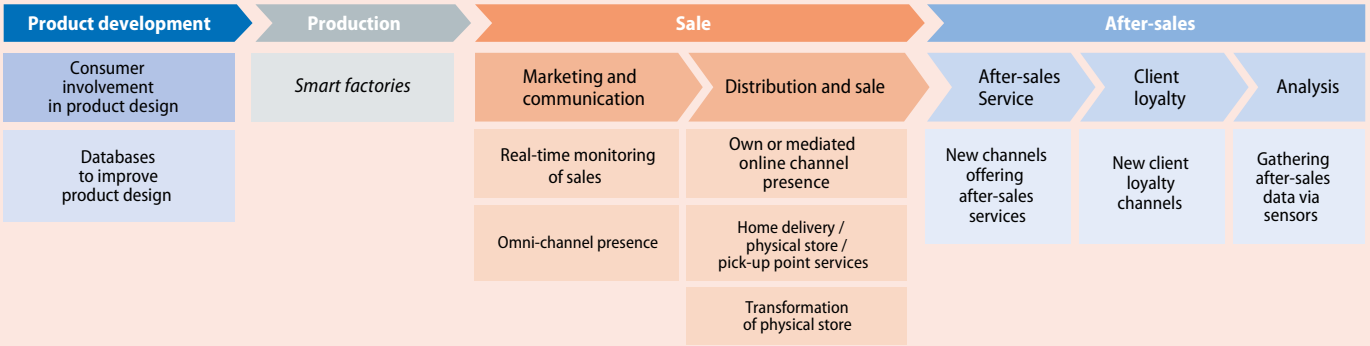
Besides changes in the different purchasing stages, digitalisation has also led to new consumption patterns becoming popular, such as the growing preference for «accessing goods» instead of «owning them». The development of digital platforms that connect individuals and assets have helped to create online markets for the temporary use of goods and the peer-to-peer provision of services and on-demand services, known as the sharing economy, which undoubtedly represents a new paradigm for consumption.[5]

1. PwC, Total Retail 2017 Survey, «e-Commerce in China - the future is already here» and US Department of Commerce, «Quarterly Retail *e-commerce* sales, 2nd quarter 2017», Eurostat.
2. The main negative aspects of online shopping cited by Spanish consumers are their preference to see and feel the product first, delivery costs, problems with returning orders and the time taken to deliver a product. See Observatorio Cetelem e-Commerce 2016.
3. World Economic Forum White Paper (2016), «Digital Transformation of Industries (in collaboration with Accenture): Digital consumption».
4. In the US alone, it is estimated that 110 million people (34% of the total population) already take part in the sharing economy (WEF, 2016).
5. World Economic Forum and Accenture, 2017. «Shaping the future of retail for consumer industries».

Impact of digitalisation on the purchasing cycle stages



Impact of digitalisation on the production process stages



Source: *CaixaBank Research.*

New digital technologies are also radically transforming the business environment from a company point of view (supply). Digitalisation has already considerably lowered the barriers to entry in many economic sectors, with a considerable increase in competition. The internet has also encouraged new purely digital companies offering new ways to serve clients and pushing out more traditional business models. Given such changes, established companies have been forced to rethink how they operate and alter their production process to adapt to this new digital environment in order to remain competitive.

For example, in the initial stage of the production process, the consumer is becoming increasingly involved in product design, usually via digital platforms or by sending in suggestions. This helps to differentiate the product and also provides the company with greater insight regarding consumer preferences. Product development is also improved via big data, as it helps companies to detect new market segments and decide their pricing strategy. New digital technologies are also being used to improve production efficiency. For instance, smart factories can adapt the production strategy in real time using information from different points of sale (see the Dossier «Industry 4.0» in MR11/2016).

Client communication strategies have also altered considerably. Nowadays any marketing campaign needs to use communication tools on several channels (particularly online). Moreover, this strategy must be implemented on all channels, for instance by using online channels to attract clients to the physical store (and vice versa). Data analysis can also help companies to differentiate between consumer profiles and adapt advertising to the client's particular interests.

Digitalisation's impact is perhaps even more evident in the sale stage, with traditional firms now offering their products and services also on e-commerce platforms, both their own and intermediaries'. As a result, they constantly need to improve the client experience and make the buying process as user-friendly as possible, offering different payment and delivery options. This represents a huge logistics challenge. Consumers demand faster deliveries and more options to collect and return their orders. Meeting such expectations is increasingly important to keep up with the growing competition. Companies are also working hard to revitalise and improve the buying process in physical stores, especially for products requiring greater interaction and personalisation. They are starting to focus on transforming physical stores from a traditional distribution channel to a place of consumer discovery, experience and interaction. Another strategy employed is to create a shopping experience that unites both online and offline channels. For instance, by giving clients the option to buy online but pick up their purchase at the physical store (click and collect).

In short, new digital technologies are radically changing how we consume. Proof of this is the rapid spread of e-commerce but their impact goes much further. Whether this digital transformation achieves its full potential will depend on how certain challenges are handled, such as the implementation of strategies to guarantee consumers' online security and privacy , adapting the legal framework to a rapidly changing environment and managing the impact of new technologies on employment.

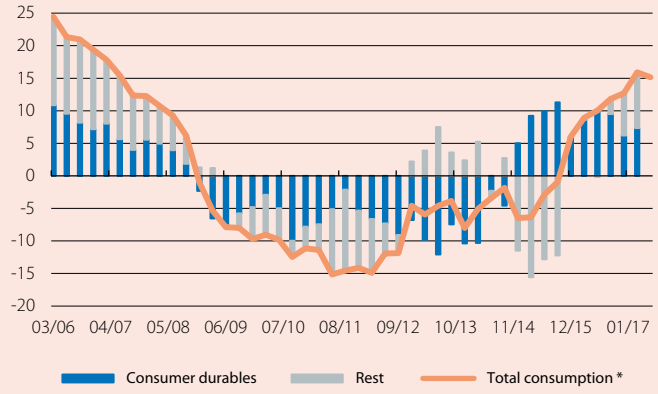
Roser Ferrer
Macroeconomics Unit, Strategic Planning and Research Department, CaixaBank

Situation and outlook for consumer financing

Household purchase decisions are largely determined by their level of income and wealth, as well as their future economic expectations (for more details on the impact of such factors see the article «The recovery of consumption in Spain: reasons and outlook» in this Dossier). But there is another important factor which families also take into account when deciding how much to spend and on what: their borrowing capacity and the availability of financing. Access to financing allows households to meet their consumption requirements throughout life, smooth consumption and deal with unexpected shocks.

Consumer lending stock of Spanish banks

Contribution to year-on-year growth (pp)



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

Many of the goods we consume with a long product life cycle require a large initial outlay. By financing their purchase, payment is spread throughout the product life cycle and is therefore more in line with how it is used. Consumer durables fall within this category, such as furniture, household equipment and vehicles, among others. This kind of good accounts for 53% of bank-financed consumption but only represents 14% of the basket of goods consumed by households. The rest of financed consumption ranges from deferred payment by credit card to non-durable goods and services such as medical services and travel expenses.[1]

Consumer financing currently totals EUR 75,000 million in Spain, accounting for approximately 10% of all credit granted to households. Deposit institutions are key to granting consumer loans although credit institutions are becoming increasingly important, providing 16% of this kind of financing. Credit institutions specialise in granting loans, very often linked to retail consumption, but cannot hold customer deposits. Some credit institutions are bank subsidiaries.

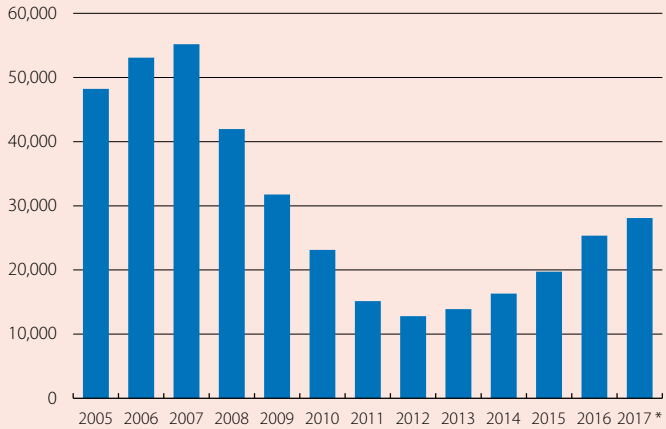
The improved economic situation of Spanish households has boosted consumer financing. New loans have posted double digit growth since their recovery began at the end of 2013. The consumer credit stock has consequently grown by 30% since its all-time low reached in 2014.

Consumer credit is also performing well in 2017: both stock and new lending are growing at a rate close to 15% year-on-year. But in spite of this growth, households' financial burden due to consumer credit in Q1 2017 was still 5.7% of their gross disposable income (GDI), remaining stable since 2013 and far from the peak of 9% of GDI reached in 2007. There has been a slight upturn in the NPL ratio for this segment, however, in one year up by almost 1 pp to 8.9%.[2] This rise has placed it almost at the same level as the overall NPL rate.

We expect consumer loans to keep growing over the next few years, albeit at an ever-slower rate. This is because, after a strong recovery, their share of Spain's GDP is now approaching what might be considered a normal level (6.3% at present and 7.4% for the historical average since 2005).

Consumer new lending

EUR million



Note: ** According to CaixaBank Research forecasts.*
Source: *CaixaBank Research, based on data from the Bank of Spain.*

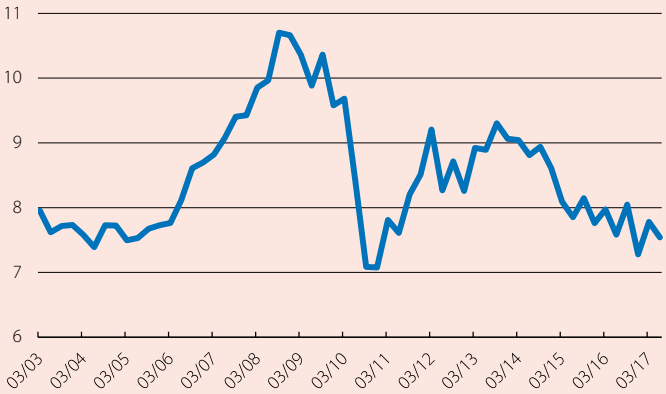
1. According to a survey carried out in 2016 by Cetelem, 24% of respondents would finance medical or dental treatments with a loan, while 15% would finance travel. Observatorio Cetelem, 2016, «Análisis del consumo en España».
2. Data in March 2017, regarding household loans for purposes other than housing.

Banks will also continue to focus on consumer financing due to the good risk/reward ratio it offers, especially in the low interest rate environment over the medium term. In fact, in the past few years consumer credit interest rates have remained at around 8%, below the historical average for this kind of credit but much higher than the average return achieved by other products. Consumer financing is therefore one of the ways open to Spanish financial institutions to continue improving their profitability.

Higher demand for consumer credit will also support growth in this kind of financing. On the one hand, the labour market's recovery will boost household income expectations. They will therefore be more willing to borrow funds to advance part of their future consumption. Their stronger financial position thanks to the economic recovery and the deleveraging carried out will also result in a more solvent demand for credit to meet future payment obligations.

Interest rates for consumer new lending

*NDER * (%)*



Note: ** Narrowly defined effective rate equivalent to the APR but without commission or rebates.*
Source: *CaixaBank Research, based on data from the Bank of Spain.*

The future trend for consumer financing will also be closely linked to digitalisation and technological innovations, phenomena which are transforming the banking industry and particularly the consumer credit business. New technologies are changing how consumers behave. They are increasingly connected and demand greater availability, immediacy, simplicity and personalisation in each of the stages of the purchasing cycle (see the article «Consumption in the digital era» in this Dossier). In this cycle, financial institutions (traditional or fintech) play an important role in the payment stage and in financing transactions.

New technologies are therefore helping to improve customers' experience on digital channels using fast, user-friendly apps that make it easier to take out financing. Digitalisation and big data also offer greater insight into consumer needs and thereby improve the services being offered. For instance, pre-approved loans mean that clients can quickly cover their financial needs. Big data also improve management tools in areas as important as risk analysis and price fixing. This means that financing can be offered at a price that is much more in line with each consumer's risk profile.

In summary, the recovery in consumer credit that began in 2013 has supported the economic recovery of Spanish households over the past few years. This situation looks like continuing, albeit growing more in line with the long-term potential, which may not differ greatly from the nominal growth of the economy. The future trend also depends partly on how quickly banks can adapt to technological changes and the digital era to be able to offer the services demanded by new consumers.

Ariadna Vidal and Pau Labró
Macroeconomics Unit, Strategic Planning and Research Department, CaixaBank

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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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