# MR01

**MONTHLY REPORT • ECONOMIC AND FINANCIAL MARKET OUTLOOK**

NUMBER 419 | JANUARY 2018

## ECONOMIC & FINANCIAL ENVIRONMENT

FINANCIAL MARKETS
*Mario Draghi and his «parole, parole»*

INTERNATIONAL ECONOMY
*Geopolitics in a globalised world: let the data speak for themselves!*

EUROPEAN UNION
*What will the future EU-UK relationship be like?*

SPANISH ECONOMY
*The complexity of Spanish exports*

## DOSSIER: EMERGING EUROPE

*Analysis of the emerging European economic cycle*

*The dividends of integrating emerging Europe within the EU*

*Political risk in emerging Europe: how much should we be concerned?*

*Emerging Europe: growing with fewer risks*

CaixaBank Research

**MONTHLY REPORT - ECONOMIC AND FINANCIAL MARKET OUTLOOK**
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**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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# Cryptocurrency fever

Between the beginning of 2017 and mid-December, the price of the best-known cryptocurrency, the bitcoin, multiplied twenty-fold from USD 1,000 to 20,000. In the currency's first ever transaction a pizzeria sold two pizzas for 10,000 bitcoins. At the height of the cryptocurrency's appreciation recently, those two pizzas would have cost USD 200 million.

The bitcoin's high price would be reasonable if it became a widely accepted means of payment and/or an asset used as a reserve currency.

But that is not the case at present. The bitcoin is rarely used in e-commerce or other areas of the formal economy, although there are suspicions that it is more widely used in illegal transactions. The bitcoin's anonymity is extremely valuable for such activities. On the other hand, its reputation of being highly volatile prevents it from being seen as a reserve currency, although it does make it phenomenally useful for speculation.

Neither can we be sure how widely the bitcoin will be accepted. Some of its advantages are the privacy offered by its anonymity, the promise that only a fixed number of bitcoins will be produced and low transaction costs. From a social point of view, however, anonymity for large transactions tends to encourage the informal economy (countries usually prohibit cash transactions above a certain amount); freezing the supply of a currency goes against the basic principles of monetary policy because it is deflationary; and bitcoin transaction costs are not so low if we take the energy and computing power consumed by the cryptocurrency into account.

Other features of the bitcoin also play against it. Firstly, no one is forced to accept it (it is not legal tender). Quite the opposite, as countries are very likely to impose restrictions on its use, especially if it starts to be used more widely for illegal activities. The bitcoin will also have to compete with other cryptocurrencies, some of which may be state-supported and legal tender (why not a cryptoeuro issued by the ECB?). And finally, as demonstrated by various attacks on custody and trading platforms, there is a significant risk of fraud or theft for bitcoin holders.

All these uncertainties call the bitcoin boom into question. The current price seems to be based more on speculation and emotion than any rational valuation technique and a bubble may be forming as a result. In fact, the bitcoin trend to date is relatively similar to the initial phases of a bubble identified by Kindleberger and Minsky: the emergence of a new technology, in this case blockchain (which has a great potential that goes far beyond its use in cryptocurrencies); a boom that moves the price away from the asset's fundamental value; and then euphoria, when prices skyrocket. The next phases would involve profit taking by more experienced investors and, finally, panic when the price collapses.

Who knows what the future holds. To paraphrase Isaac Newton, after losing his investment in the South Sea Bubble in 1720, «I can calculate the motion of heavenly bodies but not the madness of people».

**Enric Fernández**
Chief Economist
31 December 2017

# CHRONOLOGY

## DECEMBER 2017

**13** The Fed raises the fed funds rate by 25 bp to a range of 1.25% to 1.50%.
**15** Fitch ratings agency upgrades Portugal's credit rating to investment grade (BBB).
The European Council ratifies the agreement reached with the UK regarding the Brexit terms.
**20** The US passes tax reforms.

## NOVEMBER 2017

**2** The Bank of England raises its benchmark interest rate by 25 bp to 0.50%.
Jerome Powell is appointed the new Chair of the US Federal Reserve, replacing Janet Yellen.
**30** OPEC announces it will extend oil production cuts until the end of 2018, nine months later than initially agreed.

## OCTOBER 2017

**22** Shinzō Abe is confirmed as Japan's Prime Minister.
**24** The 19th National Congress of the Communist Party of China re-elects Xi Jinping as General Secretary for a second five-year mandate.
**26** The ECB announces its plan to reduce the volume of asset purchases (QE). Specifically, from January to September 2018, the ECB will reduce monthly purchases from EUR 60 to 30 billion.

## 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).

# AGENDA

## JANUARY 2018

**3** Registration with Social Security and registered unemployment (January).
**8** Economic sentiment index of the euro area (December).
**11** Industrial production index (November).
**16** Financial accounts (Q3).
**18** Loans, deposits and NPL ratio (November).
**19** Governing Council of the European Central Bank.
**26** Labour force survey (Q4).
**27** US GDP (Q4).
**29** Flash GDP (Q4).
**30** Economic sentiment index of the euro area (January).
**31** Balance of payments (November).
Flash CPI (January).
Fed Open Market Committee.
Euro area GDP (Q4).

## FEBRUARY 2018

**2** Registration with Social Security and registered unemployment (January).
**3** European Council.
**8** Industrial production index (December).
**13** Japan GDP (Q4).
**17** Loans, deposits and NPL ratio (December).
**20** International trade (December).
**27** Flash CPI (February).
Economic sentiment index of the euro area (February).
**28** Balance of payments (December).

# Global economic activity on track

**An optimistic start to 2018 for the world economy**. Indicators point to a 3.6% increase in global economic activity in 2017 as a whole compared with 3.2% in 2016, fulfilling predictions of faster growth made one year ago. Economic activity benefited from improved business and consumer confidence, particularly in the advanced economies. The financial markets also saw considerable gains in stock prices. Investor optimism was especially strong in the US, with the S&P 500 stock market index rising by nearly 20% for the year as a whole (+9.5% in 2016). But it was also notable in Europe, where the Eurostoxx 50 went from a meagre 0.7% rise in 2016 to a significant +6.5% in 2017. The MSCI Emerging Markets index also appreciated by more than 30% with key economies exiting recessions, such as Brazil and Russia, and a recovery in the Chinese stock market after the downturn early in 2016 (Shanghai stock exchange index +6.6% in 2017 compared with –12.3% in 2016).

**Politics and central banks are setting the pace**. However, there are still geopolitical and macrofinancial risks in spite of this favourable macroeconomic situation. One repeated risk among the emerging economies is how China will handle its economic transition as domestic consumption and services become more important to the economy – as well as its financial imbalances. In December, the Communist Party's Politburo made it a priority for 2018 to alleviate financial risks, combat pollution and reduce poverty, suggesting less economic stimulus and environmental measures that will contribute to a moderate slowdown in growth. In advanced economies the focus has shifted towards the maturity of US expansion and the Fed's monetary policy normalisation. In particular, after a hesitant 2016 in which the central bank only carried out one of the three hikes predicted, the Fed eventually carried out three increases in 2017. The latest was in December, raising the fed funds rate to 1.25%-1.50%. Given the strong US labour market and expected upswing in inflation, in December the Fed also repeated that it would carry out three more hikes in 2018. This scenario was reinforced mid-month by the Trump administration's tax reform finally being approved. The reform should provide a moderate boost for growth but, as the US economy is almost at full employment, there is more risk of a greater impact on inflation and therefore more aggressive monetary normalisation. However, financial assets are assuming fewer than three Fed hikes, so any readjustment of financial expectations is another source of risk, especially given the currently booming US stock market.

**Europe is making stronger progress**. Among the advanced economies, the biggest positive surprise of the year came from the euro area. The region has clearly outperformed the forecasts made a year ago, growing by 2.4% in 2017 as a whole. The stronger scenario was reflected in the revised macroeconomic scenario presented by the European Central Bank (ECB) at its December meeting, projecting 2.3% growth in 2018. This better outlook is due to a more even distribution of growth across countries and also in the EU as a whole. In fact, this month's Dossier examines the growing importance of emerging European economies, whose GDP grew by 5.3% in Q3 2017, led by Poland (5.2%), the Czech Republic (5.0%), Hungary (4.1%) and Romania (8.6%). Since joining the EU, these economies have clearly modernised their institutional fabric but populist policies have gained support in recent years. In Poland, for example, in response to controversial reforms of the judicial system carried out by the government, this December the European Commission launched a legal process which could result in it withdrawing the country's EU voting rights.

**Spain stands out among the euro area economies**. Economic activity indicators suggest that growth remained high in the last quarter of the year and the CaixaBank Research forecast model points to + 0.7% quarter-on-quarter, very similar to Q3's 0.8%. The Spanish economy will have therefore enjoyed three exceptionally good years, growing above 3% and creating 1.5 million jobs. Growth is also likely to remain high in 2018, with the main imbalances continuing their correction. As a result of this good economic performance and the low interest rate environment, in 2017 the public deficit will have achieved the 3.1% target agreed with the European Commission and is expected to fall to 2.5% by 2018. However, given the high level of government debt, the deficit's correction should not be left to cyclical growth alone. Measures are still required to ensure a structural improvement in public finances.

# FORECASTS

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

## *International economy*

| | 2016 | 2017 | 2018 | 2019 | Q2 2017 | Q3 2017 | Q4 2017 | Q1 2018 | Q2 2018 | Q3 2018 |
|---|---|---|---|---|---|---|---|---|---|---|
| **GDP GROWTH** | | | | | | | | | | |
| **Global** | 3.2 | 3.6 | 3.8 | 3.8 | 3.6 | 3.8 | 3.7 | 3.9 | 3.8 | 3.7 |
| ***Developed countries*** | *1.7* | *2.2* | *2.2* | *1.9* | *2.2* | *2.3* | *2.4* | *2.4* | *2.2* | *2.1* |
| United States | 1.5 | 2.2 | 2.4 | 2.0 | 2.2 | 2.3 | 2.4 | 2.7 | 2.5 | 2.3 |
| Euro area | 1.8 | 2.4 | 2.2 | 1.7 | 2.4 | 2.6 | 2.6 | 2.5 | 2.3 | 2.1 |
| Germany | 1.9 | 2.6 | 2.3 | 1.8 | 2.3 | 2.8 | 3.0 | 2.7 | 2.5 | 2.2 |
| France | 1.1 | 1.8 | 1.8 | 1.6 | 1.8 | 2.2 | 2.2 | 2.1 | 1.9 | 1.7 |
| Italy | 1.1 | 1.6 | 1.2 | 0.9 | 1.5 | 1.7 | 1.7 | 1.4 | 1.3 | 1.2 |
| Portugal | 1.5 | 2.7 | 2.2 | 2.1 | 3.0 | 2.5 | 2.3 | 1.9 | 2.3 | 2.3 |
| Spain | 3.3 | 3.1 | 2.4 | 2.3 | 3.1 | 3.1 | 3.0 | 2.7 | 2.4 | 2.2 |
| Japan | 0.9 | 1.7 | 1.3 | 1.0 | 1.7 | 2.1 | 1.7 | 1.7 | 1.2 | 0.9 |
| United Kingdom | 1.8 | 1.6 | 1.5 | 1.9 | 1.5 | 1.5 | 1.4 | 1.5 | 1.5 | 1.5 |
| ***Emerging countries*** | *4.3* | *4.6* | *4.9* | *5.0* | *4.6* | *4.8* | *4.7* | *4.9* | *4.9* | *4.9* |
| China | 6.7 | 6.8 | 6.5 | 6.3 | 6.9 | 6.8 | 6.7 | 6.6 | 6.4 | 6.4 |
| India | 7.9 | 6.3 | 7.3 | 7.5 | 5.7 | 6.3 | 7.0 | 7.0 | 7.2 | 7.4 |
| Indonesia | 5.0 | 5.1 | 5.5 | 5.6 | 5.0 | 5.1 | 5.3 | 5.5 | 5.5 | 5.5 |
| Brazil | –3.5 | 0.9 | 2.3 | 2.7 | 0.4 | 1.4 | 1.8 | 1.6 | 2.3 | 2.5 |
| Mexico | 2.9 | 2.1 | 2.2 | 2.6 | 1.9 | 1.5 | 1.7 | 1.9 | 2.2 | 2.3 |
| Chile | 1.6 | 1.4 | 2.6 | 3.0 | 1.0 | 2.2 | 2.2 | 2.5 | 2.6 | 2.6 |
| Russia | –0.3 | 1.7 | 1.8 | 2.4 | 2.5 | 1.8 | 2.0 | 1.9 | 1.8 | 1.6 |
| Turkey | 3.2 | 6.5 | 3.7 | 3.6 | 5.4 | 11.1 | 4.3 | 4.5 | 4.0 | 3.3 |
| Poland | 2.7 | 4.4 | 3.4 | 3.0 | 4.3 | 5.0 | 4.0 | 3.6 | 3.5 | 3.2 |
| South Africa | 0.4 | 0.9 | 1.4 | 1.5 | 0.5 | 1.0 | 1.3 | 1.8 | 1.4 | 1.2 |
| **INFLATION** | | | | | | | | | | |
| **Global** | 2.8 | 3.1 | 3.2 | 3.2 | 3.0 | 3.0 | 3.2 | 3.2 | 3.3 | 3.3 |
| ***Developed countries*** | *0.8* | *1.7* | *1.8* | *1.8* | *1.6* | *1.7* | *1.7* | *1.6* | *1.9* | *2.0* |
| United States | 1.3 | 2.1 | 2.3 | 2.0 | 1.9 | 2.0 | 2.1 | 1.9 | 2.5 | 2.5 |
| Euro area | 0.2 | 1.6 | 1.5 | 1.8 | 1.5 | 1.5 | 1.5 | 1.3 | 1.4 | 1.6 |
| Germany | 0.4 | 1.7 | 1.6 | 1.9 | 1.6 | 1.7 | 1.6 | 1.4 | 1.5 | 1.7 |
| France | 0.3 | 1.2 | 1.4 | 1.8 | 1.0 | 0.9 | 1.3 | 1.2 | 1.3 | 1.4 |
| Italy | 0.0 | 1.4 | 1.3 | 1.6 | 1.6 | 1.3 | 1.2 | 1.2 | 1.2 | 1.3 |
| Portugal | 0.6 | 1.6 | 1.7 | 1.7 | 1.7 | 1.3 | 1.9 | 1.8 | 1.4 | 1.9 |
| Spain | –0.2 | 2.0 | 1.6 | 1.9 | 2.0 | 1.7 | 1.5 | 1.0 | 1.6 | 2.1 |
| Japan | –0.1 | 0.4 | 1.0 | 0.9 | 0.4 | 0.6 | 0.5 | 1.2 | 1.0 | 1.1 |
| United Kingdom | 0.7 | 2.7 | 2.4 | 2.3 | 2.7 | 2.8 | 3.0 | 2.4 | 2.5 | 2.4 |
| ***Emerging countries*** | *4.3* | *4.1* | *4.2* | *4.1* | *3.9* | *4.0* | *4.2* | *4.3* | *4.3* | *4.3* |
| China | 2.0 | 1.6 | 2.1 | 2.3 | 1.4 | 1.6 | 2.1 | 2.4 | 2.4 | 2.2 |
| India | 4.9 | 3.3 | 4.3 | 4.9 | 2.2 | 3.0 | 4.4 | 4.3 | 4.2 | 4.6 |
| Indonesia | 3.5 | 3.8 | 3.8 | 4.6 | 4.3 | 3.8 | 3.3 | 3.1 | 3.6 | 4.0 |
| Brazil | 8.8 | 3.5 | 3.8 | 4.3 | 3.6 | 2.6 | 2.9 | 3.3 | 3.9 | 4.0 |
| Mexico | 2.8 | 5.9 | 3.9 | 3.5 | 6.1 | 6.5 | 6.0 | 4.5 | 3.8 | 3.8 |
| Chile | 3.8 | 2.2 | 2.9 | 3.0 | 2.3 | 1.7 | 2.2 | 2.6 | 3.0 | 3.0 |
| Russia | 7.1 | 3.9 | 3.7 | 4.0 | 4.2 | 3.4 | 3.3 | 3.5 | 3.3 | 4.0 |
| Turkey | 7.8 | 10.6 | 8.2 | 7.5 | 11.5 | 10.6 | 10.3 | 9.0 | 8.5 | 7.7 |
| Poland | –0.2 | 1.6 | 2.2 | 2.5 | 1.5 | 1.5 | 1.7 | 2.0 | 2.3 | 2.3 |
| South Africa | 6.3 | 5.3 | 5.1 | 5.4 | 5.3 | 4.8 | 4.7 | 4.2 | 4.6 | 5.4 |

Forecasts

## *Spanish economy*

| | 2016 | 2017 | 2018 | 2019 | Q2 2017 | Q3 2017 | Q4 2017 | Q1 2018 | Q2 2018 | Q3 2018 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Macroeconomic aggregates** | | | | | | | | | | |
| Household consumption | 2.9 | 2.4 | 2.0 | 1.9 | 2.4 | 2.4 | 2.5 | 2.3 | 2.0 | 1.8 |
| General government consumption | 0.8 | 1.2 | 1.0 | 0.8 | 1.1 | 1.0 | 1.8 | 1.2 | 1.0 | 0.9 |
| Gross fixed capital formation | 3.3 | 4.8 | 3.2 | 3.0 | 3.8 | 5.4 | 5.3 | 3.3 | 3.5 | 2.9 |
| Capital goods | 4.9 | 5.8 | 3.4 | 2.6 | 3.8 | 6.1 | 7.0 | 3.6 | 4.5 | 2.7 |
| Construction | 2.4 | 4.3 | 2.9 | 3.2 | 4.0 | 4.9 | 4.2 | 2.8 | 2.5 | 3.1 |
| Domestic demand (contr. Δ GDP) | 2.6 | 2.5 | 2.0 | 1.9 | 2.3 | 2.7 | 2.8 | 2.2 | 2.1 | 1.8 |
| Exports of goods and services | 4.8 | 5.2 | 4.1 | 4.2 | 4.4 | 4.9 | 5.1 | 2.9 | 3.9 | 5.1 |
| Imports of goods and services | 2.7 | 4.0 | 3.2 | 3.2 | 2.3 | 4.0 | 5.0 | 1.8 | 3.4 | 4.2 |
| **Gross domestic product** | **3.3** | **3.1** | **2.4** | **2.3** | **3.1** | **3.1** | **3.0** | **2.7** | **2.4** | **2.2** |
| **Other variables** | | | | | | | | | | |
| Employment | 3.0 | 2.7 | 2.1 | 2.0 | 2.9 | 2.9 | 3.1 | 2.5 | 2.3 | 1.9 |
| Unemployment rate (% labour force) | 19.6 | 17.1 | 15.4 | 13.7 | 17.2 | 16.4 | 16.2 | 16.7 | 15.5 | 14.8 |
| Consumer price index | –0.2 | 2.0 | 1.6 | 1.9 | 2.0 | 1.7 | 1.5 | 1.0 | 1.6 | 2.1 |
| Unit labour costs | –0.6 | –0.1 | 1.0 | 1.3 | –0.4 | –0.4 | 0.4 | 0.5 | 1.2 | 1.1 |
| Current account balance (cum., % GDP)[1] | 1.9 | 1.8 | 1.7 | 1.7 | 1.8 | 1.8 | 1.8 | 1.8 | 1.7 | 1.7 |
| Net lending or borrowing rest of the world (cum., % GDP)[1] | 2.1 | 2.0 | 1.9 | 1.9 | 2.0 | 2.0 | 2.0 | 2.0 | 1.9 | 1.9 |
| Fiscal balance (cum., % GDP)[2] | –4.3 | –3.1 | –2.5 | –2.1 | | | | | | |

## *Financial markets*

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **INTEREST RATES** | | | | | | | | | | |
| **Dollar** | | | | | | | | | | |
| Fed Funds | 0.51 | 1.10 | 1.75 | 2.52 | 1.05 | 1.25 | 1.30 | 1.50 | 1.58 | 1.83 |
| 3-month Libor | 0.74 | 1.26 | 1.99 | 2.77 | 1.20 | 1.32 | 1.47 | 1.65 | 1.88 | 2.10 |
| 12-month Libor | 1.37 | 1.79 | 2.30 | 2.86 | 1.75 | 1.73 | 1.92 | 2.09 | 2.23 | 2.37 |
| 2-year government bonds | 0.84 | 1.39 | 2.40 | 3.16 | 1.28 | 1.36 | 1.69 | 1.98 | 2.26 | 2.53 |
| 10-year government bonds | 1.84 | 2.33 | 2.86 | 3.52 | 2.26 | 2.24 | 2.38 | 2.54 | 2.75 | 2.97 |
| **Euro** | | | | | | | | | | |
| ECB Refi | 0.01 | 0.00 | 0.00 | 0.08 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| 3-month Euribor | –0.26 | –0.33 | –0.33 | –0.07 | –0.33 | –0.33 | –0.33 | –0.33 | –0.33 | –0.33 |
| 12-month Euribor | –0.03 | –0.15 | –0.17 | 0.22 | –0.13 | –0.16 | –0.19 | –0.18 | –0.18 | –0.18 |
| 2-year government bonds (Germany) | –0.58 | –0.75 | –0.51 | 0.06 | –0.74 | –0.72 | –0.74 | –0.64 | –0.55 | –0.47 |
| 10-year government bonds (Germany) | 0.10 | 0.36 | 0.65 | 1.39 | 0.31 | 0.42 | 0.38 | 0.51 | 0.60 | 0.70 |
| **EXCHANGE RATES** | | | | | | | | | | |
| $/€ | 1.11 | 1.13 | 1.16 | 1.19 | 1.10 | 1.17 | 1.18 | 1.16 | 1.15 | 1.16 |
| ¥/€ | 120.30 | 126.64 | 132.69 | 135.36 | 122.21 | 130.38 | 132.92 | 131.88 | 131.31 | 132.64 |
| £/€ | 0.82 | 0.88 | 0.87 | 0.86 | 0.86 | 0.90 | 0.89 | 0.88 | 0.87 | 0.87 |
| **OIL** | | | | | | | | | | |
| Brent ($/barrel) | 45.04 | 54.80 | 62.00 | 63.75 | 50.92 | 52.18 | 61.43 | 62.00 | 62.00 | 62.00 |
| Brent (€/barrel) | 40.73 | 48.62 | 53.31 | 53.82 | 46.34 | 44.84 | 51.95 | 52.97 | 53.60 | 53.68 |

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

Forecasts

# FINANCIAL OUTLOOK · **A calm finish to the year for international financial markets**

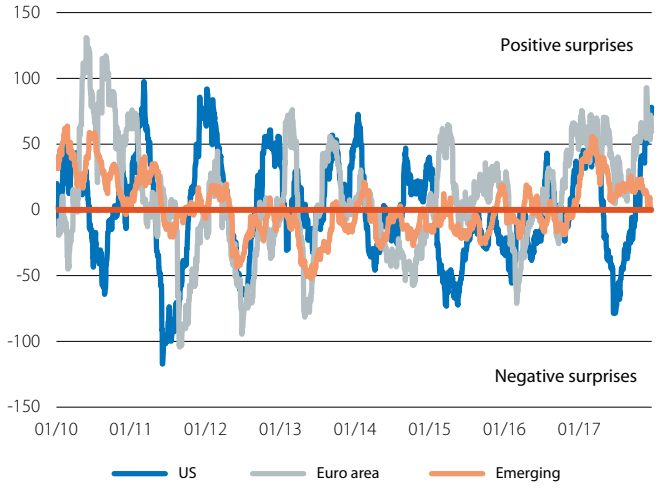
**The markets end a good year with equanimity**. In a positive macroeconomic scenario, which has achieved the acceleration in global growth forecast at the end of 2016, the tone of international financial markets was constructive. Overall, the year saw significant gains in stock prices, moderate increases in interest rates, a general depreciation of the dollar against major international currencies and a gradual rise in the price of oil. The Fed's interest rate strategy is a clear reflection of this positive macrofinancial outlook. 2016 was an uncertain year with just one hike by the Fed. But the institution showed greater confidence in the macrofinancial scenario in 2017 and carried out three interest rate hikes (the last one in December). It also confirmed expectations of three further increases in 2018. At the beginning of 2017 markets were still rather sceptical about the Fed's announced strategy. However, in recent months investors have been adjusting their interest rate expectations upwards. In December, financial markets ended the year with increases in US and German sovereign bond rates and moderate gains were made by advanced stock markets, while the emerging stock markets recorded gains despite some volatility and currencies continued to appreciate slightly against the dollar.

**The maturity of the economic cycle and geopolitics will affect asset prices in 2018**. At the same time as the macroeconomic scenario improved, 2017 saw an environment of very low financial volatility both in bond and equity markets. There was an episode of risk aversion related to France's presidential elections in the first half of the year. However, after this the climate of low volatility was only disturbed by occasional surges in political uncertainty, especially following diplomatic tensions between the US and North Korea. Although these upswings were brief and contained, increasing geopolitical and commercial risks (the worsening cold war in the Middle East, tensions with North Korea and NAFTA renegotiations) will continue to be a source of potential financial instability. Another downside risk is that the US economy is entering a more mature phase of the cycle. Investors may therefore become more sensitive to the emergence of less favourable economic indicators or higher than expected inflation, especially given the doubts regarding the sustainability of high US stock market valuations.

**Gains subside in developed stock markets**. In December, share prices rose slightly in the main advanced economies, led by the US stock market and investor optimism on the tax reform recently passed by the US Congress (which includes a cut in corporate income tax). The main stock markets of the euro area ended up with losses, however; more moderate in Germany and Portugal, and somewhat more pronounced

### *Index of economic surprises*

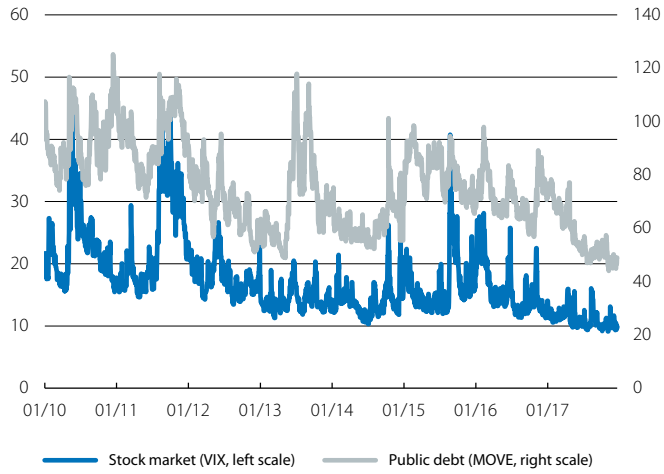
*Level*




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

### *Implied volatility in financial markets*

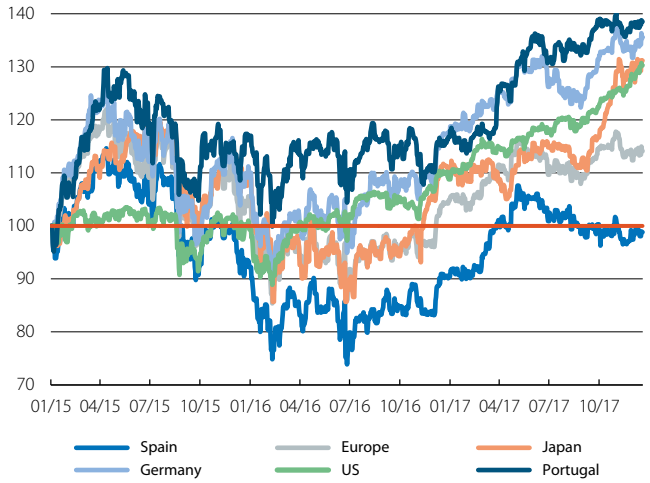
*Index* *Index*




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

### *Main advanced stock markets*

*Index (100 = January 2015)*




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

in the periphery. But advanced stock markets had a very positive year overall. In the US, the S&P 500 index rose by nearly 20% in the year as a whole, outperforming its historical highs month by month (although doubts started to emerge regarding how long this could last). In Europe, the Eurostoxx 50 ended the year with a rise in value of around 6.5%.

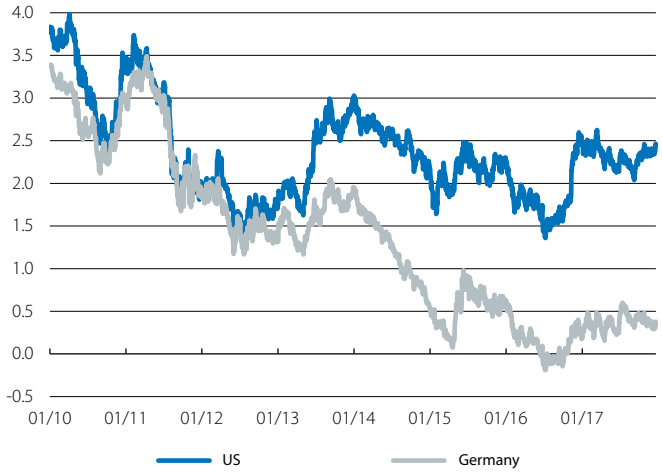
**The Fed ends 2017 with its third interest rate hike of the year**. As expected, at its December meeting the Federal Open Market Committee (FOMC) raised the fed funds rate by 25 bp to 1.25%-1.50%. In contrast to the doubtful climate in 2016, when only one of the three expected hikes was actually carried out, in 2017 the Fed raised the benchmark rate three times (March, June and December), fulfilling the forecasts made in December 2016. The quarterly update of the Fed's macroeconomic outlook also confirmed that the US economy should continue to grow above its potential in the coming years with forecasts that, according to Chair Janet Yellen, include the impact of the Trump administration's tax reform. FOMC members therefore reaffirmed their willingness to continue gradually tightening the Fed's monetary policy stance and repeated their intention to carry out three hikes in 2018 and two more in 2019, in line with the CaixaBank Research scenario. The market reaction to these announcements was relatively subdued although it should be noted that, since September, the number of hikes expected by the market for 2018 has gradually increased from one to two.

**The ECB starts 2018 with a stronger outlook for the euro area**. Following important announcements in October (extension of the asset purchase programme (QE) from January to September 2018 at a monthly rate of EUR 30 billion), the December meeting of the ECB's Governing Council (GC) kept its monetary policy parameters unchanged. The GC concentrated on updating the macroeconomic scenario for 2018-2020 and the ECB upgraded the euro area's growth prospects, as it had already done several times in 2017. In the first half of 2017, these upward revisions led investors to expect the reduction in QE announced last October. The current greater optimism about the new macroeconomic scenario has also boosted expectations that net asset purchases will end in the second half of 2018. However, the updated economic scenario also assumes a very gradual recovery in inflation. The GC therefore repeated principal payment reinvestments mean that the ECB will maintain its market presence for a long time. The ECB's announcements were received without significant gains or losses and sovereign risk premia in the euro area remained relatively stable. The notable exception was Portugal, whose risk premium fell below Italy's (for the first time since January 2010) after Fitch raised its rating from BB+ to BBB.

**The dollar slows down its depreciation against the euro**. Following November's depreciation (2.2%, from USD 1.16 to 1.19 per euro), the euro/dollar exchange rate stabilised in December at around USD 1.18 per euro, supported by investor optimism due to the Trump administration's tax reform and

### *Yield on 10-year public debt*

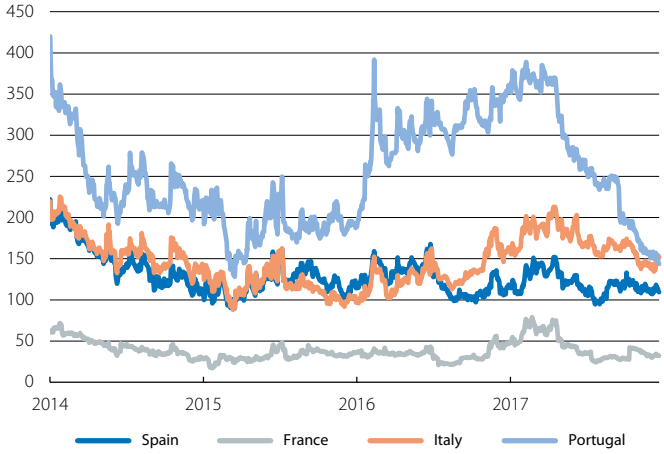
*(%)*




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

### *Euro area: risk premia on 10-year public debt*

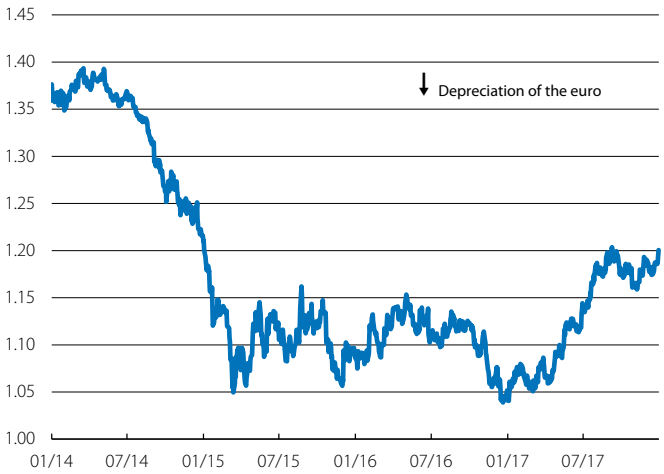
*(bp)*




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

### *Dollar-euro exchange rate*

*(Dollar-euro)*




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

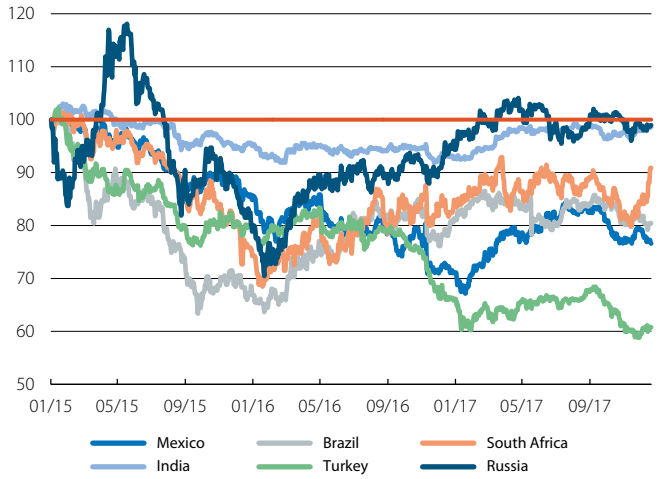
the Fed's commitment to gradually tightening its monetary policy stabce. Nevertheless, the dollar depreciated further in the last week of the month to USD 1.2 per euro. For the year as a whole, the dollar depreciated by more than 12% against the euro. Most of the emerging bloc's currencies also continued to appreciate against the dollar. In December, the most notable example was South Africa, where the rand appreciated by more than 10% against the dollar in response to the election of Cyril Ramaphosa as the new leader of the African National Congress (the candidate who promised to fight corruption the most). At the other extreme, the Mexican peso depreciated again (–5.2% against the dollar) as a result of uncertainty surrounding the NAFTA renegotiations.

**Emerging markets are advancing more moderately**. After a volatile November, emerging stock markets saw more moderate gains in the last month of the year. The MSCI emerging markets index rose to just above 3%. There was a slightly bigger rise in Latin America than in emerging Asian economies (where the stabilisation of the Chinese stock market, falling by –2.2% in November, stood out). Over the year as a whole, however, progress was considerable and clearly greater than in 2016. The MSCI emerging index rose more than 30% (+8.6% in 2016), led by emerging markets in Asia (MSCI regional index +40.1% in 2017, compared with 3.8% in 2016) and, especially, with a better performance by the Chinese stock market (+6.6% in 2017 compared with –12.3% in 2016).

**The price of oil stabilises**. In the first three weeks of December, the price of a Brent quality barrel slowed down the upward trend shown throughout October and November, fluctuating around USD 63, although in the last week it rebounded to over USD 66. This occurred after OPEC announced on 30 November that it would extend its agreement to cut crude oil production until the end of 2018. This agreement, initially announced in November 2016, helped oil prices to recover, finally stabilising, in the first half of 2017, at around USD 50-55 per barrel. Investor credibility was also achieved due to the strong commitment shown by production cuts throughout the year. The renewal of this agreement for 2018 will therefore help oil prices to remain stable around the current level. However, possible increases in US shale production could limit any upward trend in oil prices.

### *Emerging exchange rates against the dollar*

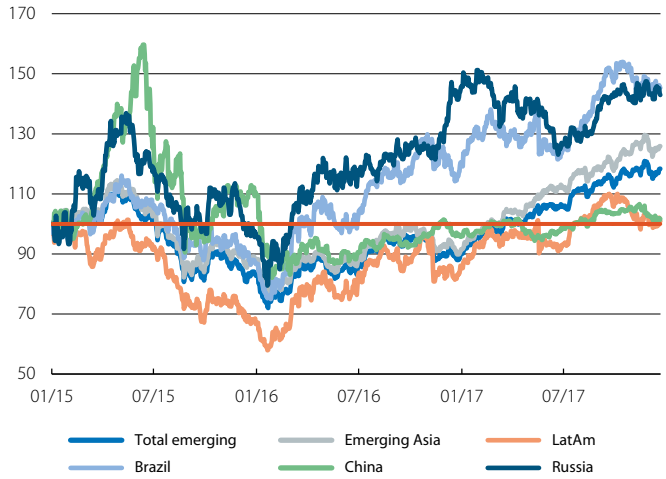
*Index (100 = January 2015)*




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

### *Emerging stock markets by region*

*Index (100 = January 2015)*




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

### *Brent oil price*

*(USD per barrel)*


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

# FOCUS · Mario Draghi and his *«parole, parole»*

The European Central Bank (ECB) has not altered interest rates since 16 March 2016 but that does not mean it has kept itsmonetary policy stance unchanged. The most prominent instrument employed in the past few years is the ECB's asset purchase programme (QE), which has been repeatedly altered both in terms of duration and size. But there is another tool, ostensibly more anodyne and less technically inclined, that might be even more effective: words.

The power inherent in the communication carried out by central banks is well illustrated in the first chart. On 24 July 2012, the euro area's peripheral risk premium reached 605 bp, an all-time high, amid rising concerns on the survival of the euro. Two days later, the ECB President, Mario Draghi, put an end to these fears with a simple sentence: «Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough». From that moment on, risk premia started to fall sharply and Draghi's words went down in monetary policy history as the «whatever it takes» speech.

Communication is powerful because monetary policy is not only passed on via its configuration at the time but also through investors' and savers' expectations of its future configuration. Central banks used to neglect this second mechanism. For instance, before 1994 the Fed provided no information on the decisions taken at its meetings; investors had to infer these by observing the daily transactions carried out by the Fed itself. However, as we can see in the second chart, since the end of the 1990s communication has been increasingly used, not only in public speeches but also by publishing economic forecasts, highly influential among analysts and investors, and academic articles, which also play a part in constructing the narrative (and are particularly important in uncertain times such as the past few years). Inflation targeting also forms part of communication insofar as, since these targets are public, they help to predict how monetary policy will react to different events.

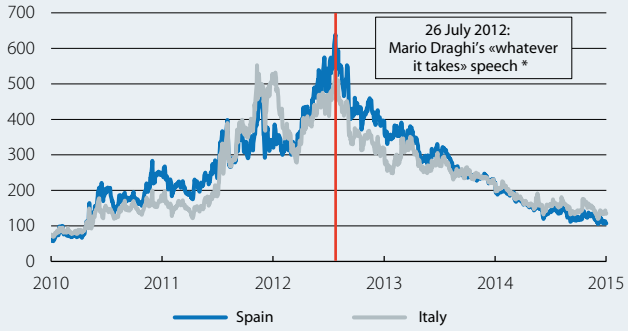
Another macroeconomic element has also emerged over the past few years related to the effects of monetary policy. After reducing benchmark interest rates (typically short-term) to levels close to 0%, central banks have continued to influence medium and long-term interest rates (more relevant for saving and investment decisions) through «forward guidance»; i.e. the probable course of monetary policy. For example, the ECB has stated that it expects to keep interest rates unchanged for a long period of time.

In view of the increasing use of communication, several studies examining its costs and benefits have concluded that, in general, central banks have achieved their aims. First, this increase in communication has been associated with a better understanding, by analysts and consumers, of the theoretical basis of central bank decisions. Dräger *et al.* (2015)[1] show that the Fed's efforts to improve communication have resulted in a larger proportion of consumers and analysts forming expectations regarding inflation, growth and interest rates that are in line with economic theory.

Second, in addition to the effective transmission of expectations and financial asset prices, of which Draghi's «whatever it takes» is a prime example, the evidence also suggests that communication carried out by the Fed and the ECB is a significant predictor of future monetary

### *The ECB President's communication power*

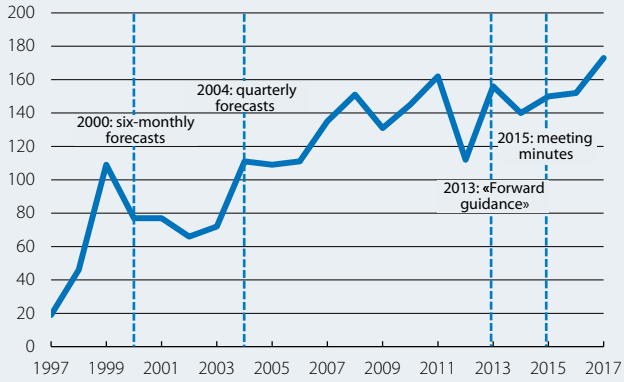
*Risk premia for Spanish and Italian 10-year sovereign debt (bp)*




***Note:*** ** On 26 July 2012, the ECB President, Mario Draghi, stated in London that the central bank would do «whatever it takes» to preserve the single currency.*
***Source:*** *CaixaBank Research, based on data from Bloomberg.*

### *Public presence of the ECB Governing Council*

*Number of speeches and interviews*




***Source:*** *CaixaBank Research, based on information from www.ecb.europa.eu.*

1. Dräger, L. *et al.* (2015), «Are Survey Expectations Theory-Consistent? The Role of Central Bank Communication and News», Finance and Economics Discussion Series, Federal Reserve Board, Washington.

policy decisions and therefore reduce uncertainty regarding the path of monetary policy.[2]

Finally, several studies have shown that the use of communication and particularly «forward guidance» makes financial asset prices less sensitive to the macroeconomic data published.[3] This indicates confidence in the central bank's promises and also reduces financial volatility. In fact, Coenen *et al.* (2017)[4] have shown that, since 2012, on the days when the ECB has given a press conference, financial volatility has been below the (daily) average observed between 1999 and 2011. They have also shown that there have been more episodes of reduced volatility in general.

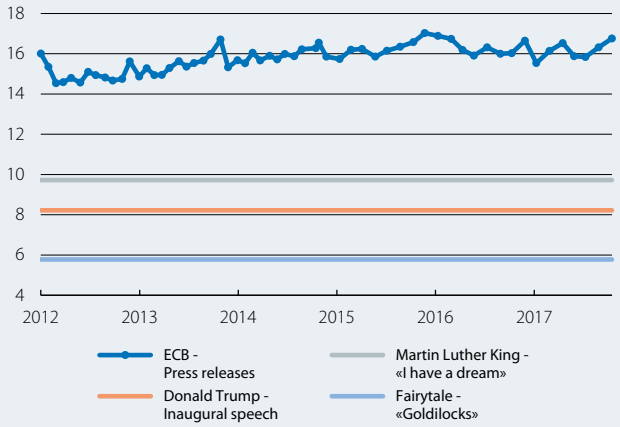
Nevertheless, the findings by Coenen *et al.* (2017) depend on the complexity of the press communication. In fact, the authors have shown that more complicated press communications generate greater financial volatility. This is a particularly important point given the increase in language complexity of central banks (see the third chart), partly an inevitable consequence of the use of complicated unconventional tools such as QE. A more intensive use of communication can therefore cause episodes of higher volatility. For instance, Ehrmann and Talmi (2016)[5] have analysed the case of the Bank of Canada and have shown that, after a series of very similar communications following its monetary policy meetings, the introduction of rather more substantial changes in the next communication increased financial volatility.

Another example where communication can generate volatility is when, due to hints given by a central bank, investors focus on a few economic variables but fail to analyse these in depth. An example in case is that of inflation expectations. Investors realise the ECB may react with a more accommodative monetary stance should inflation expectations fall. Investors also know that one of the indicators used by the ECB to analyse the trend in inflation expectations is a financial instrument called an inflation swap.[6] Investors therefore interpret a fall (rise) in the interest rate for such swaps as a fall (rise) in inflation expectations. However, as argued by Shin

2. Sturm, J. and de Haan, J. (2009), «Does Central Bank Communication really Lead to better Forecasts of Policy Decisions?», CESifo Working Paper Series.
3. Praet (2017), «Communicating the complexity of unconventional monetary policy in EMU» and Blinder *et al.* (2017), «Necessity as the mother of invention: monetary policy after the crisis», ECB Working Papers.
4. Coenen *et al.* (2017), «Communication of monetary policy in unconventional times», ECB Working Paper.
5. Ehrmann, M. and Talmi, J. (2016), «Starting from a blank page? Semantic similarity in central bank communication and market volatility», ECB Working Paper.
6. These consist of a fixed interest rate being traded for a variable rate (in this case, inflation). Given that the fixed rate represents the cost of hedging against inflation, this is normally interpreted as a gauge of inflation expectations.

## *Complexity of the ECB's communication*

*Flesch-Kincaid scale **




***Note:*** ** The Flesch-Kincaid reading ease scale rates the difficulty of understanding a written text according to the length of its sentences and words. Longer words and sentences are associated with more difficult comprehension and higher values on the scale.*
***Source:*** *CaixaBank Research, based on the press releases after ECB monetary policy meetings and www.flesh.sourceforge.net.*

(2017),[7] inflation swap interest rates are also affected by the market's own idiosyncratic factors.[8] Given that these are typically technical and difficult to measure, investors tend to ignore them, leading them to wrongly infer movements in inflation expectations. However, Shin (2017) claims that the current low interest rate environment is partly due to the incorrect interpretation of low swap interest rates, which investors attribute to low inflation expectations when –according to Shin (2017)– they are actually due to market factors.

This review of the role played by central bank communication is particularly relevant at present because the ECB's communication has been and will continue to be of prime importance over the coming quarters. For the moment, the ECB has withdrawn some monetary stimuli without causing any commotion (with an initial announcement that it would reduce its net purchases in December 2016 and another in October 2017). Its «forward guidance» is still highly accommodative. However, with euro area growth accelerating over the past few quarters, the tone is likely to alter in the next few months. This will be the first step taken by the ECB in 2018 to prepare for the end of QE but, as suggested by most of the evidence reviewed above, how this is implemented will be critical.

7. Shin, H. (2017), «Can central banks talk too much?», ECB Conference.
8. Such as a premium for inflation risk. According to Shin (2017), this premium has fallen steadily over the past few years.

# KEY INDICATORS

## Interest rates (%)

| | 29-Dec | 30-Nov | 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 | –1.0 |
| 1-year Euribor | –0.19 | –0.19 | 0 | –10.8 | –10.8 |
| 1-year government bonds (Germany) | –0.64 | –0.72 | 8 | 16.1 | 16.1 |
| 2-year government bonds (Germany) | –0.63 | –0.68 | 5 | 13.6 | 13.6 |
| 10-year government bonds (Germany) | 0.43 | 0.37 | 6 | 22.2 | 22.2 |
| 10-year government bonds (Spain) | 1.57 | 1.45 | 12 | 18.6 | 18.6 |
| 10-year spread (bps) [1] | 114 | 108 | 6 | –3.6 | –3.6 |
| **US** | | | | | |
| Fed funds | 1.50 | 1.25 | 25 | 75.0 | 75.0 |
| 3-month Libor | 1.69 | 1.49 | 20 | 69.2 | 69.2 |
| 12-month Libor | 2.11 | 1.95 | 16 | 42.4 | 42.4 |
| 1-year government bonds | 1.73 | 1.61 | 12 | 91.9 | 91.9 |
| 2-year government bonds | 1.88 | 1.78 | 10 | 69.2 | 69.2 |
| 10-year government bonds | 2.41 | 2.41 | 0 | –3.4 | –3.4 |

## Spreads corporate bonds (bps)

| | 29-Dec | 30-Nov | Monthly change (bp) | Year-to-date (bp) | Year-on-year change (bp) |
|---|---|---|---|---|---|
| Itraxx Corporate | 45 | 48 | –4 | –27.5 | –27.5 |
| Itraxx Financials Senior | 44 | 47 | –3 | –49.5 | –49.5 |
| Itraxx Subordinated Financials | 105 | 111 | –7 | –116.9 | –116.9 |

## Exchange rates

| | 29-Dec | 30-Nov | Monthly change (%) | Year-to-date (%) | Year-on-year change (%) |
|---|---|---|---|---|---|
| $/€ | 1.201 | 1.190 | 0.8 | 14.1 | 14.1 |
| ¥/€ | 135.280 | 133.960 | 1.0 | 10.0 | 10.0 |
| £/€ | 0.888 | 0.880 | 0.9 | 4.1 | 4.1 |
| ¥/$ | 112.690 | 112.540 | 0.1 | –3.7 | –3.7 |

## Commodities

| | 29-Dec | 30-Nov | Monthly change (%) | Year-to-date (%) | Year-on-year change (%) |
|---|---|---|---|---|---|
| CRB Commodity Index | 432.3 | 429.4 | 0.7 | 2.2 | 2.2 |
| Brent ($/barrel) | 66.9 | 63.6 | 5.2 | 17.7 | 17.7 |
| Gold ($/ounce) | 1,303.1 | 1,274.9 | 2.2 | 13.1 | 13.1 |

## Equity

| | 29-Dec | 30-Nov | Monthly change (%) | Year-to-date (%) | Year-on-year change (%) |
|---|---|---|---|---|---|
| S&P 500 (USA) | 2,673.6 | 2,647.6 | 1.0 | 19.4 | 19.4 |
| Eurostoxx 50 (euro area) | 3,504.0 | 3,569.9 | –1.8 | 6.5 | 6.5 |
| Ibex 35 (Spain) | 10,043.9 | 10,211.0 | –1.6 | 7.4 | 7.4 |
| Nikkei 225 (Japan) | 22,764.9 | 22,725.0 | 0.2 | 19.6 | 19.1 |
| MSCI Emerging | 1,158.5 | 1,120.8 | 3.4 | 34.3 | 34.3 |
| Nasdaq (USA) | 6,903.4 | 6,874.0 | 0.4 | 28.2 | 28.2 |

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

# ECONOMIC OUTLOOK · **Good outlook for 2018**

**The global economic momentum improves in Q4 2017 and 2018 starts well**. Overall, at the end of 2017, global economic data were surprisingly good. This endorses the CaixaBank Research scenario which predicts world growth will continue to speed up slightly from 3.2% in 2016 to 3.6% in 2017 and up to 3.8% in 2018. The global composite business sentiment index (PMI) (including both manufacturing and services) stood at 54.0 points for the October and November average, well within the expansionary zone and clearly above the average of 51.9 points recorded in 2016. At a sector level, in November the manufacturing index reached its highest level since March 2011 while the services index continued to point to significant growth in economic activity.

**Macrofinancial risks may cloud these good prospects, however**. Apart from the geopolitical, political and commercial aspects mentioned in last month's *Monthly Report*, macrofinancial risks remain prominent. There are fears that monetary normalisation, which the Fed is likely to continue, will have a greater impact than expected on world growth. One reason is the high level of global debt, which has continued to grow in recent years, as well as the bullish stock markets in some countries. This could be the case, for example, if US inflation increases more than predicted, forcing the Fed to raise interest rates faster than expected. This cannot be ruled out, particularly as global growth will enter the mature phase of the cycle in the coming years (for more details, see the Dossier «Global macrofinancial risks» in MR12/17).

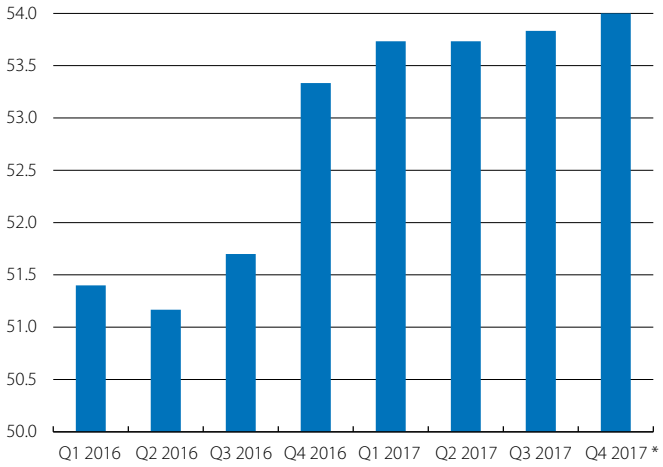
## UNITED STATES

**Good prospects for 2018**. Throughout 2017, analysts of the US economy have steadily improved their GDP growth forecasts for 2018, encouraged by strong economic growth and, more recently, tax reforms. In mid-December, the House of Representatives and the Senate finally approved the tax reform bill. Among many other aspects, this cuts corporate income tax from 35% to 21% and the maximum individual rate from 39.6% to 37%. In general, this reform is expected to provide a moderate boost in 2018 and 2019 of around 0.2 pp. However, there is considerable uncertainty surrounding these estimates. This is partly because the US economy is at a very advanced stage in its economic cycle, potentially limiting growth and, conversely, pushing up inflation higher than expected.

**Sustained growth in economic activity in Q4**. The most recent Q4 economic activity indicators continue to point to solid growth in line with that of Q3. The Atlanta Fed's forecast model (GDP-Now) points to 0.8% growth quarter-on-quarter, matching that of the previous quarter. 228,000 jobs were also

### *Global economic activity indicators: composite PMI*

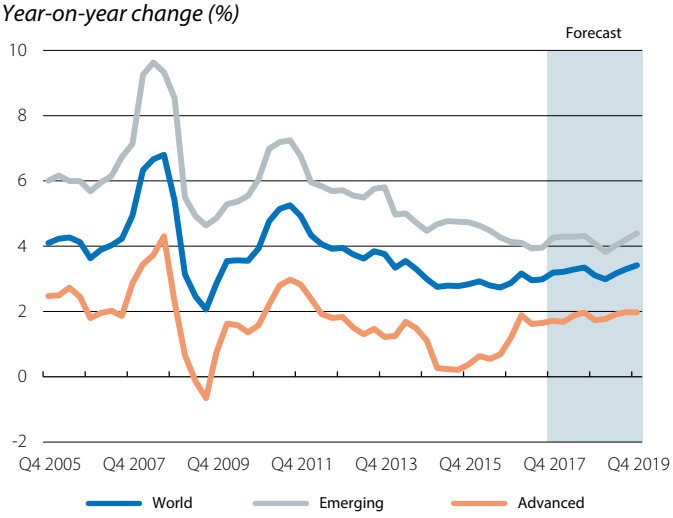
*Level*




***Note:*** ** Q4 2017 only contains data for October and November.*
***Source:*** *CaixaBank Research, based on data from Markit.*

### *World: inflation*

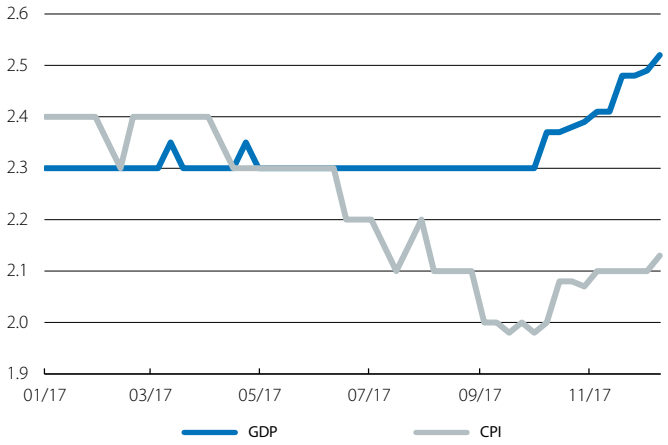
*Year-on-year change (%)*




***Source:*** *CaixaBank Research.*

### *US: trend in GDP and inflation forecasts for 2018*

*Year-on-year change (%)*




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

created in November, a significant figure especially considering the economy is close to full employment. The unemployment rate remained very low at 4.1% while the broader unemployment rate (U6, which takes into account, among other things, discouraged workers and part-time employees who would like to work full-time) stood at 8.0%, in line with pre-crisis levels.

**Inflation remains subdued despite strong growth**. Headline inflation stood at 2.2% in November, 0.2 pp above October's figure while core inflation, less exposed to fluctuations in energy and food prices, stood at 1.7%, 0.1 pp below the previous month's figure. The price index for personal consumption expenditure, the Fed's benchmark, stood at 1.6% in October, well below the institution's target of 2%. However, CaixaBank Research's forecasts predict that inflation will recover over the next few months, reaching just over 2% by the end of 2018. This is due to the maturity of the US economic cycle and the disappearance of various temporary elements that pushed inflation down in mid-2017.

**The Fed boosts confidence in the economy**. In December, given the strong performance by the labour market and expected recovery in inflation, the Fed decided to raise the fed funds rate by 25 bp to 1.25%-1.50%, as implied at previous meetings. The institution also presented its new macroeconomic forecasts, with 2018 growth above the country's potential. This is in line with the estimates by CaixaBank Research, which put annual growth at 2.4% (compared to a potential of 2%).

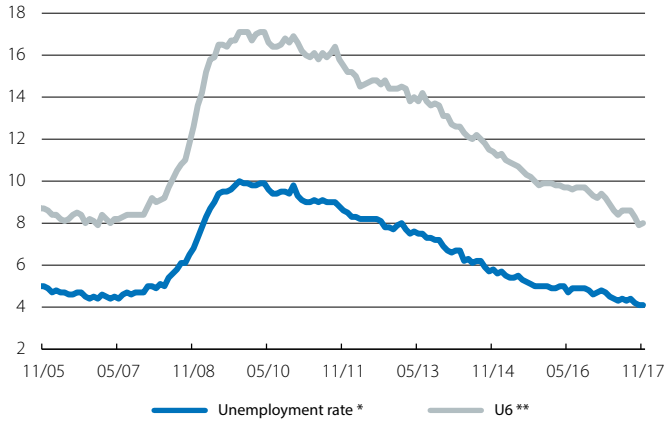
## REST OF THE WORLD

**Japan's Q4 economic activity indicators continue to point to significant growth**. The Q4 business sentiment indicator (Tankan) for large manufacturing companies rose to its highest level since December 2006 (25 points) while the index for large service companies remained stable at a high level. The consumer sentiment index also remained high in November.

**Economic activity indicators remain firm for China although the government's restrictive stance is coming to light**. The most positive notes in November for the largest emerging market were provided by retail sales and exports. The former rose by 10.2% year-on-year, supported by the success of Singles Day on 11 November. On the external front, exports (in nominal terms and in USD) grew by a considerable 12.3% year-on-year and imports by 17.7%. Industrial production was up by 6.1% year-on-year, a positive figure but clearly lower than the average for the first 10 months of the year (6.7%), hampered by far-reaching anti-pollution measures implemented for industries in northern China. Against this backdrop, at its December meeting the Communist Party's Politburo set three economic priorities for 2018: mitigating financial risks, reducing poverty and combating pollution. This suggests that, over the coming

### *US: unemployment rate and U6 rate*

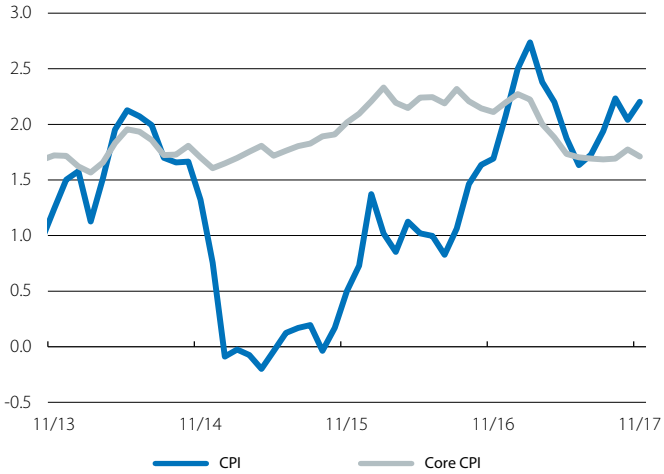
*(%)*




***Notes:*** ** Unemployment rate: unemployed/labour force. ** The U6 unemployment rate includes under-employment (unemployed people who are not looking for employment but have done so in the past 12 months, and employees working part-time involuntarily, for economic reasons).*
***Source:*** *CaixaBank Research, based on data from the Bureau of Labor Statistics.*

### *US: CPI*

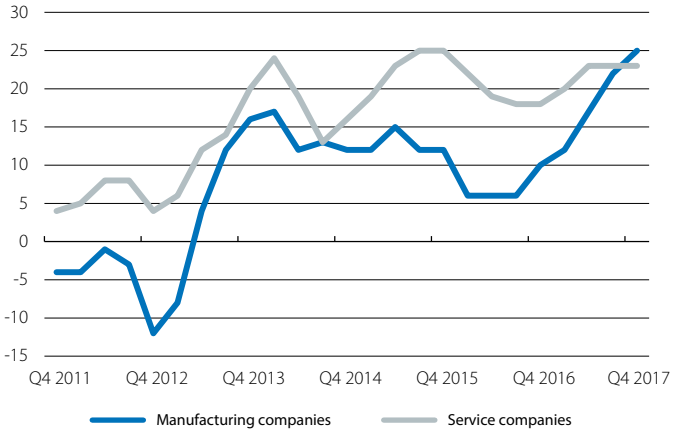
*Year-on-year change (%)*




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

### *Japan: business sentiment index (Tankan*)*

*Level*




***Note:*** **Index for large companies.*
***Source:*** *CaixaBank Research, based on data from the Bank of Japan.*

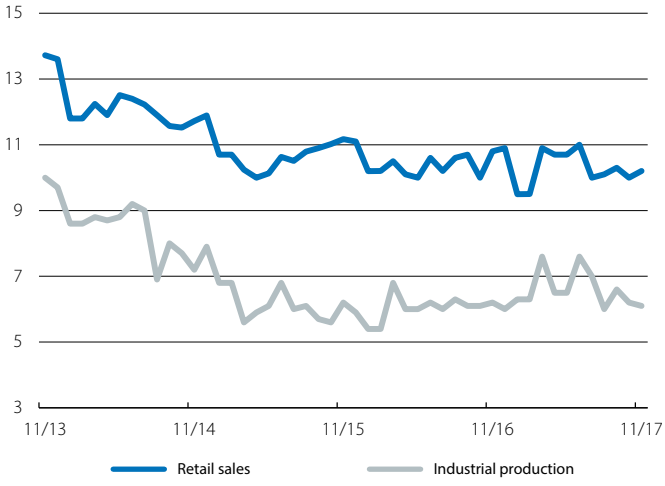
months, vigorous environmental measures will continue and economic stimuli reduced. This more restrictive stance could impact economic growth although we expect the effect to be moderate.

**Brazil, Latin America's leading economy, continues to recover but very slowly, in the face of weak investment and public consumption**. GDP grew by 1.4% year-on-year in Q3, more than the 0.4% growth in Q2 but still 5.5% below the levels of late 2014, before the strong recession. This recovery is likely to continue in the short term. Nevertheless, the political situation (the government's legislature is coming to an end) and uncertainty regarding the important outcome are likely to postpone spending and investment decisions, keeping growth relatively contained.

**Turkey outperforms all expectations**. Turkish GDP grew by 11.1% year-on-year in Q3 2017 (5.4% year-on-year in Q2). Although this figure is altered by a base effect (in Q3 2016 there was a significant drop in GDP after the attempted coup), the economy has undoubtedly been more dynamic than expected. Although the year-on-year growth rate will probably slow down in Q4, 2017 is likely to be the most dynamic year of the past four. However, the outlook for 2018 points to a clear slowdown in growth due to the accumulation of significant macroeconomic imbalances. In November, inflation stood at a high 13% (an all-time high for the series) while the current account balance was –4.7% of GDP in Q3 (compared to –3.7% at the end of 2016).

### *China: economic activity indicator*

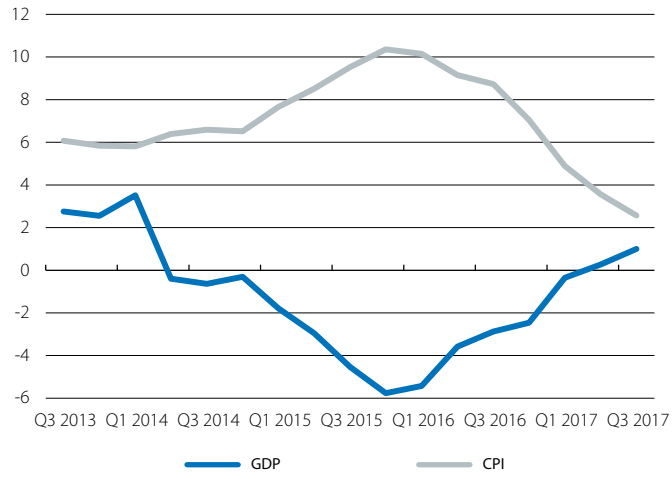
*Year-on-year change (%)*




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

### *Brazil: GDP and CPI*

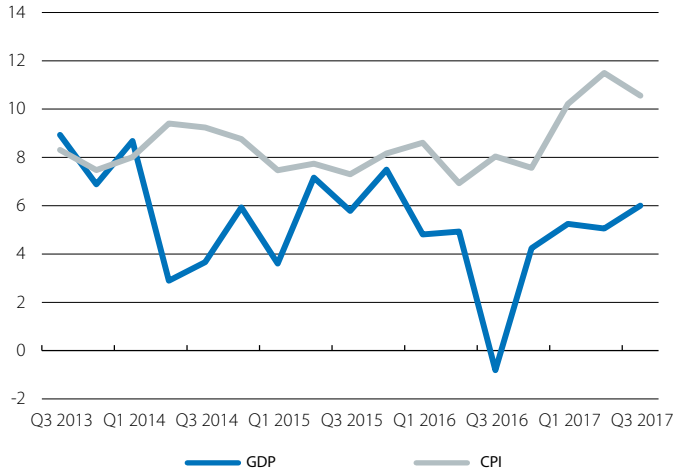
*Year-on-year change (%)*




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

### *Turkey: GDP and CPI*

*Year-on-year change (%)*




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

# FOCUS · CIBI 2017: main findings

Internationalisation has become crucial for many Spanish firms. To help them, CaixaBank has developed the CIBI:[1] an index that assesses the key aspects of internationalisation, providing a comparison of the strong and weak points of each market as well as the underlying trends.[2]

In 2017, countries in Western Europe once again have the most favourable conditions for Spanish companies to internationalise to. This has been the case for several years. In addition to being geographical neighbours, European countries stand out in all the pillars analysed. Their economies are also on the up. The recovery has taken a few years to gain momentum but the main European countries ended 2017 with economic growth clearly outperforming expectations. The outlook for 2018 is also encouraging.

On the Old Continent, it is remarkable that the UK continues to lead the CIBI ranking in spite of Brexit. Uncertainty is still high. However, a preliminary agreement on exit terms was reached at the end of 2017. Both blocs are therefore likely to agree on a transition period from the country's current to its future status. This is vital for the UK's exit from the EU to be orderly and have minimal impact on its economy.[3]

America is still the second region where Spanish companies find it easiest to expand abroad. Mexico ranks relatively high among the Latin American countries although, as with the UK, there is notable uncertainty due to the current NAFTA renegotiations. Given the close ties between the three countries involved, we believe the outcome will be largely constructive and the treaty renewed. Nevertheless, less optimistic scenarios cannot be entirely ruled out. Also remarkable is the fact that Spanish firms have managed to maintain a solid presence in Brazil in spite of the country's severe recession. The CIBI rates this positively, as well as the country's incipient economic recovery.

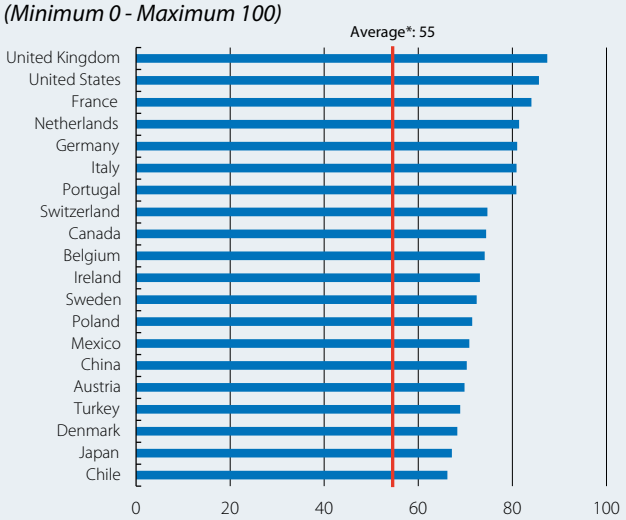
The region of Eastern Europe and Central Asia is the third zone where it is easiest for Spanish companies to internationalize to, almost to the same degree as America. Poland and Turkey head the ranking thanks especially to their commercial attractiveness, reflecting the appeal enjoyed by Spanish goods and services in these countries. Nevertheless, the recent deterioration in Turkey's political situation is already reflected in the CIBI 2017. In particular, the pillar of institutional and macroeconomic stability has fallen significantly in comparison with the previous year.

Southeast Asia and the Pacific constitute the fourth region in terms of ease of internationalisation, further behind the previous two regions. This region's geographical distance is certainly a handicap but so is the low purchasing power of many of its countries, as well as the greater difficulty of doing business. China provides a positive note, however, and occupies a relatively high position in the ranking. Nevertheless, the macroeconomic risks related to China's increasing corporate debt should be taken into account, although the country's medium and long-term growth potential is clearly attractive for Spanish firms.

Arab and African countries have a lower ranking for ease of internationalisation overall. However, some specific countries in these regions could be very attractive for Spanish firms, particularly in sectors with presumably high growth rates, such as infrastructures, natural resources and telecommunications.

### *CIBI 2017: Top 20 countries*

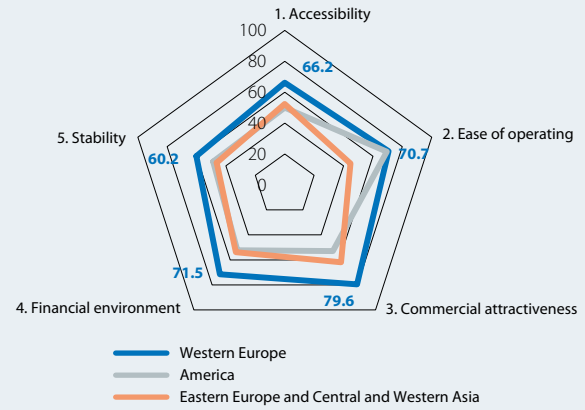
*(Minimum 0 - Maximum 100)*




***Note:*** ** Average for all 67 countries.*
***Source:*** *CaixaBank Research (CIBI 2017).*

### *CIBI 2017: internationalisation pillars*

*(Minimum 0 - Maximum 100)*




***Source:*** *CaixaBank Research (CIBI 2017).*

1. CaixaBank Index for Business Internationalisation.
2. For a detailed description of the index, see the Focus «Deciding where to internationalise your business: CIBI 2017» in MR12/2017, as well as the website: http://www.caixabankresearch.com/en/index-business-internationalisation.
3. For a more detailed analysis of the Brexit negotiations, see the Focus «What will the future EU-UK relationship be like?» in this *Monthly Report.*

# FOCUS · Geopolitics in a globalised world: let the data speak for themselves!

Geopolitics is currently very much in vogue. However, the views provided by most analysts in the media are limited, a mixture of data and opinion. This article looks at how both the current state and trends in geopolitical relations can be measured objectively.

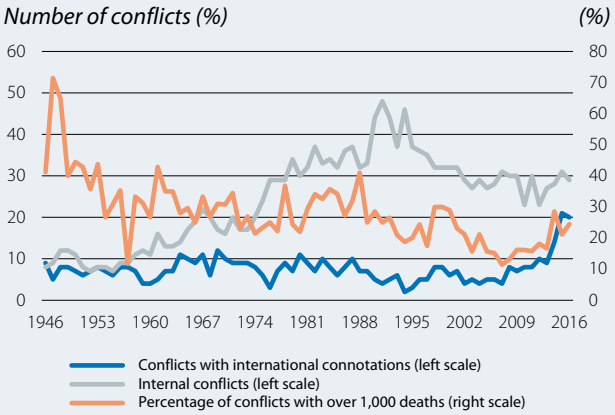
The term «geopolitics» was coined by the Swedish political scientist Rudolf Kjellén early in the 20th century. It was initially defined as the study of geography's influence on international relations. This definition has gradually evolved, and geopolitics currently refers to any event associated with international relations and the political power interactions between different states and territories.

One way to characterise the state of global geopolitics is by examining the trends in armed conflicts.[1] The first chart shows that conflicts with international connotations have tended to increase in the last decade while purely internal conflicts have been in decline since the early 1990s. The percentage share of conflicts with over 1,000 deaths has also decreased notably since the 1950s.

The GDELT database is a source of more detailed information on conflicts. This uses cutting-edge algorithms to obtain real-time data on geopolitical events from the news items produced by a large number of media, including Google News. Based on these data, we have produced a conflict index[2] (the percentage of conflicts out of the total number of events). This variable covers not only material but also verbal conflicts. The second chart reveals three distinct periods. The 1980s were a period with high geopolitical tensions; the 90s were relatively calm while the percentage of conflicts has risen again in the period 2000-2017. However, it should be noted that there was a significant drop in the relative number of conflicts between 2016 and 2017. This suggests that, contrary to what might be expected, geopolitical tensions did not increase at a global level in 2017.

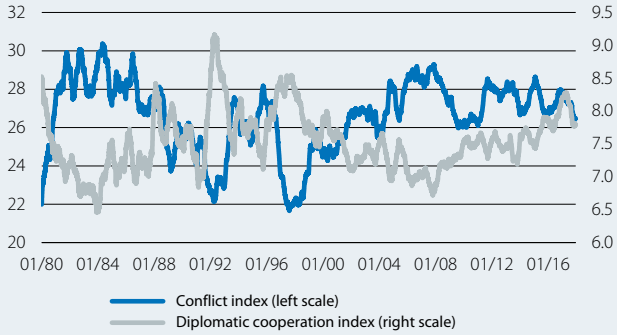
Finally, we have created an index that measures the percentage of diplomatic cooperation initiatives out of the total events. The second chart also reveals a clear pattern. The '80s saw very little cooperation while substantial progress was made in the '90s, followed by a decline early in the 21st century. As from 2008 this trend reversed there have been more diplomatic cooperation initiatives. The most recent data are less encouraging, however, and since April 2017 there has been a decrease in cooperative initiatives. This should come as no surprise considering the rise in protectionist policies endorsed by populist movements. Given the close negative relationship between conflicts and diplomatic cooperation,[3] there could be an upswing in conflicts in the next few years should the diplomatic cooperation index continue to fall. We must hope this does not come to pass.

### Armed conflicts *




***Note:*** ** An armed conflict is defined as a contested incompatibility that results in at least 25 victims per year and where one of the parties is a central government.*
***Source:*** *CaixaBank Research, based on data from the Uppsala Conflict Data Program.*

### Conflicts and diplomatic cooperation




***Note:*** *Conflicts are classified as any event involving disagreement that cannot be related to cooperation or peace initiatives. Six-month moving average.*
***Source:*** *CaixaBank Research, based on data from the GDELT Project.*

1. See the note for the first chart for more details regarding the definition of armed conflict.
2. See the note for the second chart for more details regarding the methodology used to produce the index.
3. The lineal correlation coefficient between the two indices is –0.72.

# KEY INDICATORS

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

## UNITED STATES

| | 2015 | 2016 | Q4 2016 | Q1 2017 | Q2 2017 | Q3 2017 | 10/17 | 11/17 | 12/17 |
|---|---|---|---|---|---|---|---|---|---|
| **Activity** | | | | | | | | | |
| Real GDP | 2.9 | 1.5 | 1.8 | 2.0 | 2.2 | 2.3 | – | ... | – |
| Retail sales (excluding cars and petrol) | 4.3 | 3.8 | 3.4 | 4.0 | 2.9 | 2.8 | 4.2 | 5.0 | ... |
| Consumer confidence *(value)* | 98.0 | 99.8 | 107.8 | 117.5 | 118.1 | 120.3 | 126.2 | 128.6 | 122.1 |
| Industrial production | –0.7 | –1.2 | –0.1 | 0.6 | 2.1 | 1.7 | 2.9 | 3.4 | ... |
| Manufacturing activity index (ISM) *(value)* | 51.4 | 51.5 | 53.3 | 57.0 | 55.8 | 58.6 | 58.7 | 58.2 | ... |
| Housing starts *(thousands)* | 1,107 | 1,177 | 1,248 | 1,238 | 1,167 | 1,172 | 1,256 | 1,297 | ... |
| Case-Shiller home price index *(value)* | 179 | 189 | 192 | 197 | 199 | 200 | 203 | ... | ... |
| Unemployment rate *(% lab. force)* | 5.3 | 4.9 | 4.7 | 4.7 | 4.4 | 4.3 | 4.1 | 4.1 | ... |
| Employment-population ratio *(% pop. > 16 years)* | 59.4 | 59.7 | 59.7 | 60.0 | 60.1 | 60.2 | 60.2 | 60.1 | ... |
| Trade balance [1] *(% GDP)* | –2.8 | –2.7 | –2.7 | –2.8 | –2.8 | –2.9 | –2.9 | ... | ... |
| **Prices** | | | | | | | | | |
| Consumer prices | 0.1 | 1.3 | 1.8 | 2.5 | 1.9 | 2.0 | 2.0 | 2.2 | ... |
| Core consumer prices | 1.8 | 2.2 | 2.2 | 2.2 | 1.8 | 1.7 | 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 | Q4 2016 | Q1 2017 | Q2 2017 | Q3 2017 | 10/17 | 11/17 |
|---|---|---|---|---|---|---|---|---|
| **Activity** | | | | | | | | |
| Real GDP | 1.4 | 0.9 | 1.5 | 1.3 | 1.7 | 2.1 | – | ... |
| Consumer confidence *(value)* | 41.3 | 41.7 | 42.2 | 43.4 | 43.4 | 43.7 | 44.5 | 44.9 |
| Industrial production | –1.2 | –0.2 | 2.8 | 3.9 | 5.8 | 4.6 | 4.1 | 3.7 |
| Business activity index (Tankan) *(value)* | 12.8 | 7.0 | 10.0 | 12.0 | 17.0 | 22.0 | – | 25.0 |
| Unemployment rate *(% lab. force)* | 3.4 | 3.1 | 3.1 | 2.9 | 2.9 | 2.8 | 2.8 | 2.7 |
| Trade balance [1] *(% GDP)* | –0.5 | 0.7 | 0.7 | 0.7 | 0.6 | 0.6 | 0.8 | 0.8 |
| **Prices** | | | | | | | | |
| Consumer prices | 0.8 | –0.1 | 0.3 | 0.3 | 0.4 | 0.6 | 0.2 | 0.5 |
| Core consumer prices | 1.4 | 0.6 | 0.2 | 0.1 | 0.0 | 0.2 | 0.2 | 0.3 |

***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 | Q4 2016 | Q1 2017 | Q2 2017 | Q3 2017 | 10/17 | 11/17 |
|---|---|---|---|---|---|---|---|---|
| **Activity** | | | | | | | | |
| Real GDP | 6.9 | 6.7 | 6.8 | 6.9 | 6.9 | 6.8 | – | ... |
| Retail sales | 10.7 | 10.4 | 10.6 | 10.0 | 10.8 | 10.3 | 10.0 | 10.2 |
| Industrial production | 6.1 | 6.0 | 6.1 | 6.8 | 6.9 | 6.3 | 6.2 | 6.1 |
| PMI manufacturing *(value)* | 49.9 | 50.3 | 51.4 | 51.6 | 51.4 | 51.8 | 51.6 | 51.8 |
| **Foreign sector** | | | | | | | | |
| Trade balance [1] *(value)* | 608 | 512 | 512 | 466 | 458 | 435 | 425 | 421 |
| Exports | –2.3 | –8.4 | –5.3 | 7.8 | 9.0 | 6.9 | 6.9 | 12.3 |
| Imports | –14.2 | –5.7 | 2.1 | 23.9 | 14.3 | 14.7 | 17.4 | 18.7 |
| **Prices** | | | | | | | | |
| Consumer prices | 1.4 | 2.0 | 2.2 | 1.4 | 1.4 | 1.6 | 1.9 | 1.7 |
| Official interest rate [2] *(value)* | 4.35 | 4.35 | 4.35 | 4.35 | 4.35 | 4.35 | 4.35 | 4.35 |
| Renminbi per dollar *(value)* | 6.3 | 6.6 | 6.8 | 6.9 | 6.9 | 6.7 | 6.6 | 6.6 |

***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 · **Another good year ahead for the euro area economy**

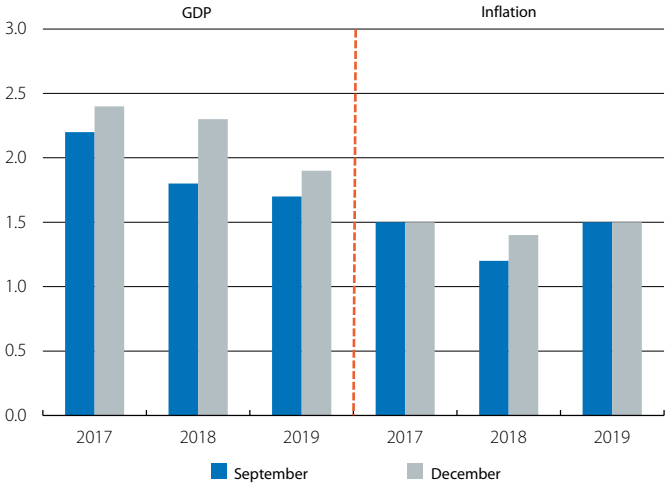
**The pace of euro area economic activity remains firm**. The euro area's economy expanded much faster than expected in 2017. According to the CaixaBank Research scenario, the region will have grown by 2.4% in 2017, while at the beginning of the year the GDP growth forecast was 1.7%. In 2018, we expect GDP growth to remain robust, at 2.2%, above potential, supported by favourable financial conditions, improvements in the labour market and the global economic recovery. The ECB's view is very similar, and in its latest quarterly macroeconomic update it highlighted the euro area's strong performance in recent quarters and revised its 2017 growth forecast upwards to 2.4% (+0.2 pp) and to 2.3% (+0.5 pp) for 2018. Despite the strong recovery in activity, inflation will lag behind, as prices are forecast to increase by 1.5% in 2018 and 1.8% in 2019. The ECB also revised its 2018 inflation forecast slightly upwards to 1.4% (+0.2 pp) while keeping its 2019 forecast at 1.5%, below the central bank's target (below but close to 2%). On the political front, the first phase of Brexit negotiations has successfully concluded with a pre-agreement between the EU and UK on the terms of separation. The UK's Brexit financial bill is estimated to be between EUR 40 and 45 billion. This breakthrough heralds the second phase of negotiations on the future trade agreement, discussed at length in the Focus: «What will the future EU-UK relationship be like?» in this *Monthly Report*.

**Domestic demand drives euro area growth**. Eurostat confirmed that euro area GDP growth in Q3 2017 was 0.6% quarter-on-quarter (2.6% year-on-year). Domestic demand contributed significantly to quarterly growth (0.5 pp), mainly supported by private consumption and investment. Foreign demand also contributed positively to growth (0.1 pp). Over the next quarters, we expect domestic demand to continue to drive euro area growth, partly supported by favourable credit conditions, although external demand will also play a part.

**The European Commission proposes new measures to advance towards further European integration**. The EC recently published a strategic plan with concrete measures to promote further economic and monetary integration. These include proposals such as transforming the European Stability Mechanism (ESM) into a European Monetary Fund (which would be responsible for any bail-out programme); the creation of a euro area budget (which would have a stabilising role); and setting up a European Ministry of Economy and Finance. In this context, it is worth highlighting that the European project is in good shape, even though Eurosceptic voices have come to the fore in recent years. In particular, according to the October 2017 Eurobarometer, support for the euro remains high: the percentage of respondents who

### *Euro area: ECB GDP and inflation forecasts*

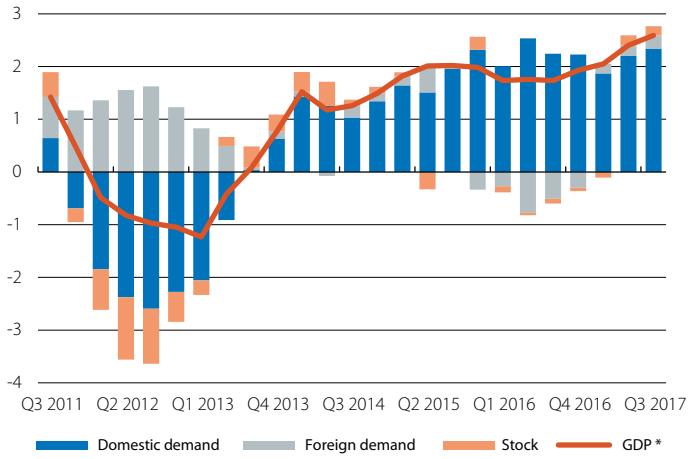
*Annual rate of change (%)*




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

### *Euro area: GDP*

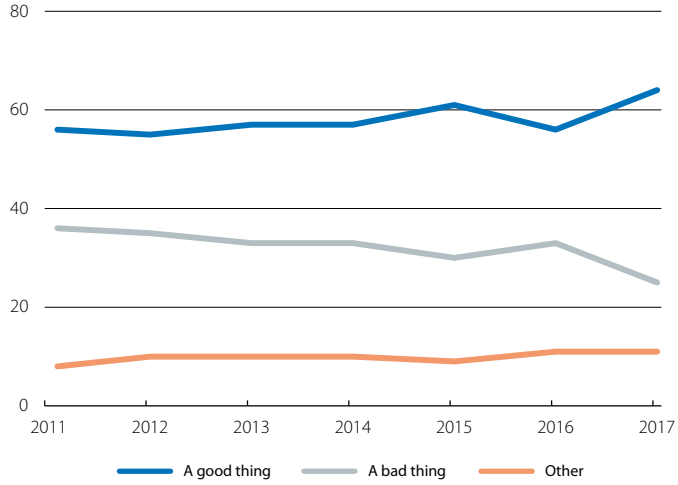
*Contribution to year-on-year growth (pp)*




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

### *Eurobarometer: opinion on the euro*

*(%)*




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

believe that having the euro is a good thing for their country increased by 8 pp when compared to the 2016 survey, and reached 64%, the highest level since it was first published (2002).

**Business sentiment indicators point to strong growth in Q4**. In particular, the composite PMI index for the euro area stood at 57.2 points in Q4, above the previous quarter's figure (56.0) and in the expansionary zone (above 50 points). Across countries the acceleration was led by France, whose composite PMI reached 59.2 points (56.0 in Q3). Germany also performed well, with a PMI that increased to 57.5 points (56.1 in Q3). All this points to stronger economic growth in the last quarter of 2017.

**Private consumption slows down temporarily**. October's retail sales rose by 0.7% year-on-year, way below the figure of the previous month (3.7%) and the year average (2.6%), but the slowdown is due to temporary factors. In particular, sales of clothing and footwear were negatively affected by unseasonably warm weather. However, the rise in the consumer confidence index to its highest levels since 2001 (+0.1 pp in November and +0.5 in December) suggests that retail sales picked up again in November and December. By 2018, we expect household consumption to remain sound, supported by the improved economic outlook and labour market prospects and low interest rates.

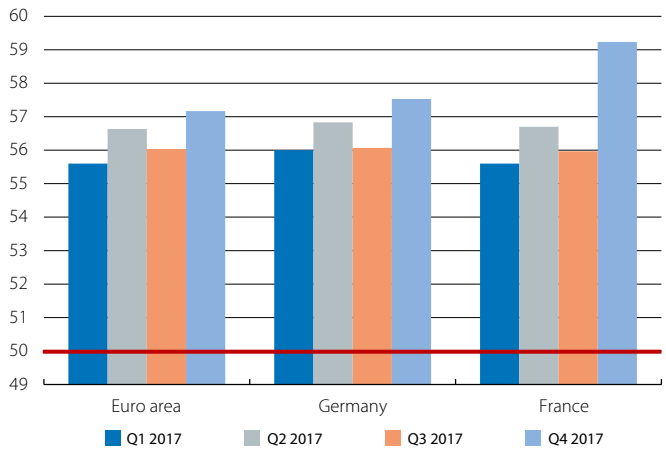
**The labour market benefits from the dynamism of economic activity**. Euro area employment increased by 0.4% quarter-on-quarter in Q3 2017, and the total number of employees increased to 156.3 million, an all-time high. Employment growth was widespread across countries, particularly in Spain (0.7%) and Portugal (0.6%) while in Germany, France and Italy employment growth was slightly lower (0.3% on average). This improvement in employment is gradually pushing up wages. In Q3 2017, hourly wage costs for the euro area as a whole rose by 1.6% year-on-year, a similar increase as the one in H1 (1.8%). Across countries, wage costs rose sharply in Germany (2.2% year-on-year) and France (2.1%) while in Italy and Spain wage growth was weak (0.3% and 0.1% year-on-year, respectively). In Portugal, hourly wage costs fell (–1.2% year-on-year) due to a change in the distribution of supplementary payments for public sector workers.

## PORTUGAL

**Growth remains steady**. After closing 2017 with an estimated GDP growth above 2.5%, analysts and major international institutions forecast a slight slowdown in the growth rate in 2018. According to CaixaBank Research forecasts, GDP growth will remain at high levels, at 2.2%, supported by a favourable external environment (particularly in the euro area, where Portugal's main trading partners are located), accommodative financial conditions and improved confidence. Banco de Portugal's forecasts in its December economic bulletin are very

### *Euro area: composite PMI economic activity indicator*

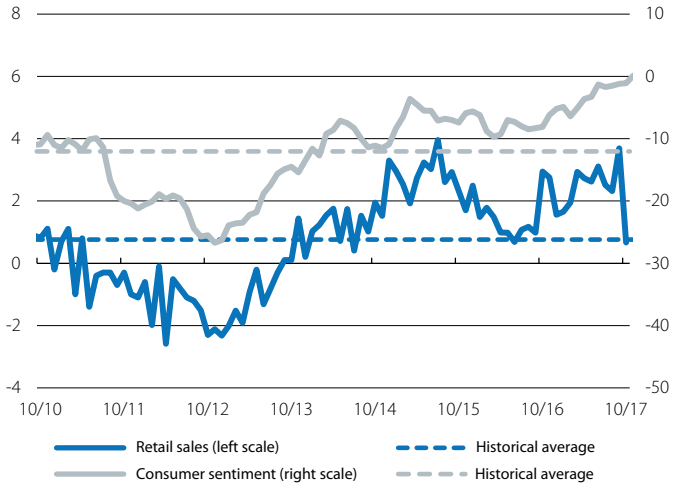
*Level*




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

### *Euro area: consumption indicators*

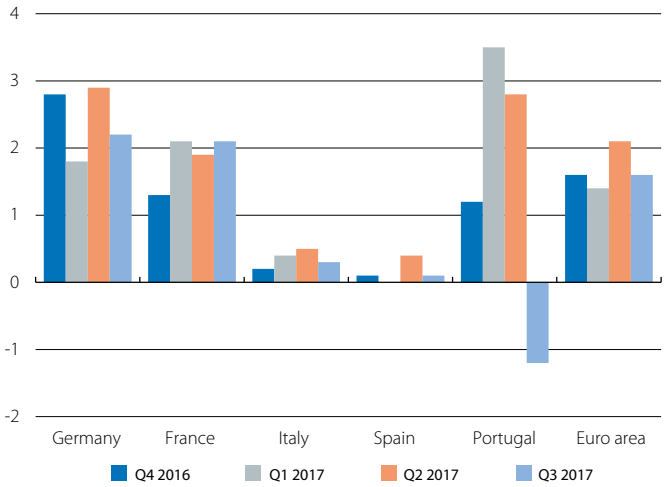
*Year-on-year change (%)* *Level*




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

### *Euro area: wage costs*

*Year-on-year change (%)*




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

similar, as they expect GDP growth to remain above potential over the forecast period, albeit at a slightly slower pace than in 2017 (2.3% in 2018 and 1.8% in 2019).

**Public finances benefit from the favourable economic outlook**. Public deficit stood at 0.1% of GDP (12-month cumulative) in Q3, which implies a significant correction with respect to the figure of Q3 2016 (3.7%). This improvement was due to both higher revenue growth (+2.7% year-on-year) and a reduction in expenditure (+0.1%). This positive development should enable the 2017 deficit to be below the government's target (1.4% of GDP). The lower public deficit, together with sustained GDP growth will continue to support a gradual decline in the government debt ratio, which we estimate reached 127.3% of GDP at the end of 2017. Against this backdrop of improving public finances and positive growth prospects, Fitch revised Portugal's sovereign rating from BB+ to BBB, taking it back to investment grade. This announcement, in the wake of S&P's announcement in September, was widely expected, as reflected by the fall in the country's sovereign risk premium since late October to 150 bp.

**The current account balance remains positive**. The current account surplus (12-month cumulative) reached EUR 457.6 million in October (or 0.2% of GDP), below the EUR 1,359 million of October 2016. In terms of composition, this deterioration was caused by a larger deficit in the goods balance, despite the larger surplus in services and the smaller deficit in the income balance. The deterioration of the trade balance has been due to the sharp rise in imports, as a result of higher oil prices and the recovery in investment, even though exports have remained very dynamic.

## Portugal: forecasts by Banco de Portugal

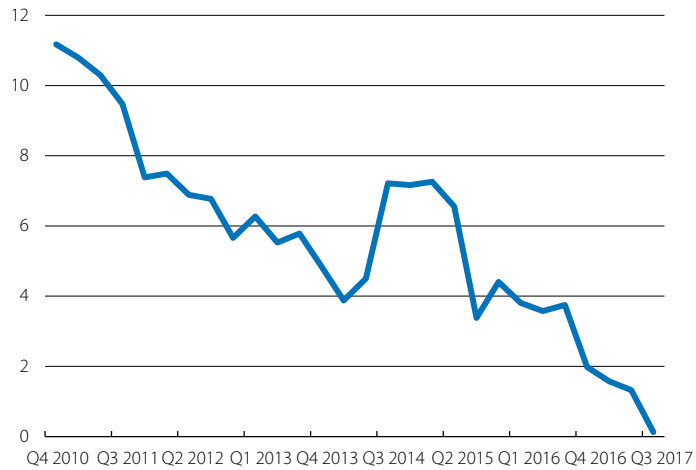
*Year-on-year change (%)*

| | | Forecasts | | |
|---|---|---|---|---|
| | 2017 | 2018 | 2019 | 2020 |
| GDP | 2.6 | 2.3 | 1.9 | 1.7 |
| Private consumption | 2.2 | 2.1 | 1.8 | 1.7 |
| Public consumption | 0.1 | 0.6 | 0.4 | 0.2 |
| Gross fixed capital formation | 8.3 | 6.1 | 5.9 | 5.4 |
| Exports | 7.7 | 6.5 | 5.0 | 4.1 |
| Imports | 7.5 | 6.7 | 5.5 | 4.8 |
| Employment | 3.1 | 1.6 | 1.3 | 0.9 |
| Unemployment rate * | 8.9 | 7.8 | 6.7 | 6.1 |
| Inflation (HICP) | 1.6 | 1.5 | 1.4 | 1.6 |

***Note:*** ** By percentage of the labour force.*
***Source:*** *CaixaBank Research, based on data from Banco de Portugal.*

## Portugal: general government deficit

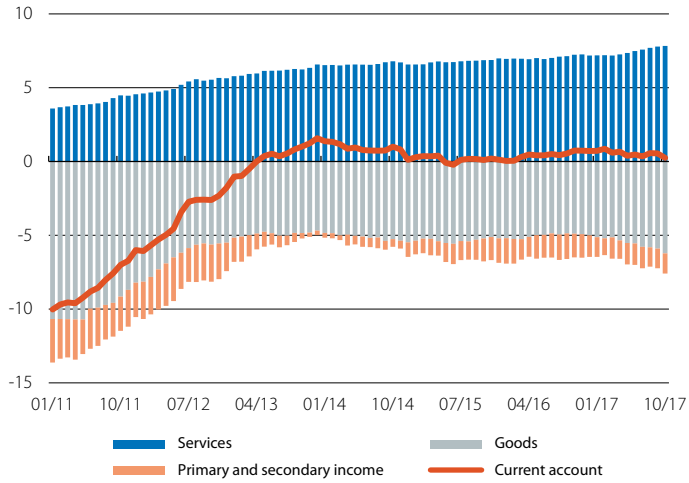
*(% of GDP)*




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

## Portugal: current account

*(% of GDP)*




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

# FOCUS · What will the future EU-UK relationship be like?

After six months of negotiations, the United Kingdom and European Union have reached a preliminary agreement on the terms of their separation.[1] This has been possible thanks to the UK accepting most of the demands initially presented by the EU. At its December meeting, the European Council therefore gave the go-ahead for the second phase of negotiations, tackling the transition agreement and future framework of UK-EU relations. This Focus examines the main aspects of this stage of the negotiations to determine the possible outcomes.[2]

To date, the effort made by the UK to move negotiations forward has been largely related to its interest in achieving a transition period. The aim is to reduce the Brexit-related uncertainty hovering over the British economy. If the UK could remain in the single market for longer and have more time to negotiate future trade relations, this would reduce the likelihood of a disorderly withdrawal from the EU and would help all economic agents to prepare for the new scenario. In principle, the UK would be the biggest loser should an agreement not be reached on the transition period. The EU therefore has bargaining power, although both blocs should be able to come to some kind of agreement on this issue.

Beyond the transition period, the UK and the EU must also negotiate their future trade relationship. It is useful to review the current treaties between the EU and Norway and the EU and Canada to understand the agreement that might potentially be reached for the UK. These models represent the two extremes between which the UK agreement is most likely to fall.

Norway is a member of the European Economic Area (EEA). This means that it forms part of the Single Market; i.e. it enjoys freedom of movement of people, goods, services and capital with the EU. But it does not form part of the Customs Union. Norway can therefore sign trade treaties with other countries independently from the EU but there are customs controls. Customs duties are not levied on products or product components originating in Norway but they are on those from other non-EU countries. Another condition is that Norway must adopt a large amount of EU legislation although, since it is outside the EU, it is not directly involved in the legislative process. The country also makes a significant contribution to the EU budget.[3]

The Canadian model represents the other extreme. The EU and Canada recently signed a significant free trade agreement. Most importantly, this eliminates a very large proportion of trade tariffs (more than 97.5% of all customs duties). The aim is also to harmonise key aspects that should boost trade in some services, such as telecommunications, energy and shipping.

In the case of the UK, the Norwegian model is clearly a poor substitute for EU membership. However, the problem with the Canadian model is that it is not ambitious enough. The UK economy is most competitive in services, especially in areas where the Canadian model would offer much less access to the European market than currently enjoyed by the British. It could even be argued that the Canadian model would benefit the EU more than the UK. It would maintain extensive access to the goods market, in which the EU has a trade surplus with the UK, while restricting trade in services, a sector where the UK is more competitive.

Consequently, the UK will probably attempt to negotiate a Canadian-type deal but with greater access to the services market. In exchange, the EU is likely to ask for a considerable contribution to its budget, as well as sovereignty concessions in areas such as the free movement of people. The final agreement between both blocs is therefore likely to be somewhere between the Norwegian and Canadian models.

There are obviously risk factors that could push the final agreement away from these two positions. One possibility is that the Brexit process might actually end up with the UK remaining in the EU, although this is unlikely. Nevertheless, such an outcome could arise, for example, should the public believe the economic cost of Brexit is too high. On the other hand, the current weak position of the UK government could jeopardise the negotiations and result in a disorderly exit for the UK. However, both these risks are considerably smaller now that an agreement on the terms of separation has been reached.

1. See the Focus «Brexit: the road ahead» in MR10/2017 for a more detailed explanation of this stage.
2. Although this Focus looks at trade-related aspects, the agreement will also tackle areas such as the degree of cooperation in security and nuclear energy, among others.
3. Norway pays around EUR 150 per inhabitant per year, a similar figure to the UK's net contribution.

# FOCUS · Minimum-income benefits in a changing labour market

One of the principles established by the European Pillar of Social Rights approved by the European Commission in November 2017 is the right to an adequate minimum-income benefit. As a general rule, social transfers should help to reach this goal. However, this is now more complicated to achieve, due to the changes currently occurring in the labour markets of advanced economies. As a result of this transformation, there is an increasing number of employment relations that provide less social coverage, such as freelancing, part-time and temporary contracts and other atypical labour relations produced by the so-called gig economy.[1] Together with a long-term unemployment rate that has remained abnormally high over the past few years, this situation highlights the need to redesign the social transfer system.

In European countries, minimum-income benefit schemes have been set up as last-resort safety nets, once the primary income replacement benefit schemes have been exhausted, such as contributory unemployment benefit. Minimum-income benefit schemes aim to provide an acceptable income for those people who cannot earn, reducing income inequality between households and helping to level out an individual's income over their lifetime when different contingencies occur, such as temporary incapacity. Individuals usually have to be actively seeking employment and/or training and meet minimum income requirements to receive such transfers. Minimum-income benefit schemes include a wide range of programmes, such as non-contributory unemployment benefit, subsidies for single parent families, housing benefits and other programmes with a variety of eligibilities and conditions.

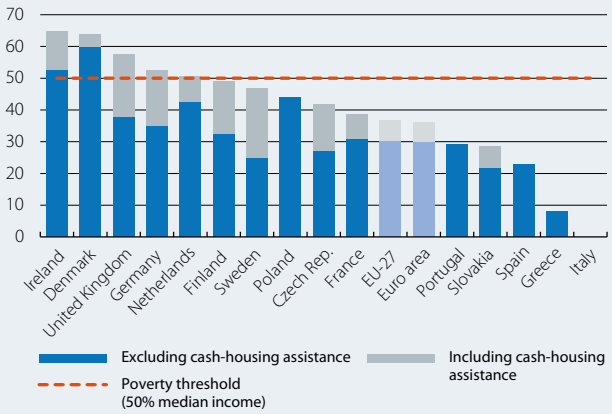
Given this wide range of minimum-income benefit schemes and the increasing share of jobs with less social coverage, an alternative proposal which has recently come to the fore is the basic income. Although they may have similar goals, conceptually basic income proposals are very different. A basic income would be universal, received by everyone irrespective of their income. It would also be unconditional; i.e. not requiring anything in exchange, such as looking for employment. Moreover, basic income schemes often aim to replace all other social redistribution programmes and not merely complement them. Such proposals face two considerable obstacles, however. First, they can encourage people not to work and, second, they are very expensive to fund.[2]

Minimum-income benefit schemes also face several challenges, both in terms of their design and also implementation. Regarding design, the conditions demanded by each scheme might exclude low-income individuals who do not meet the requirements (such as family type). Or, conversely, high-income individuals may be included, a situation which occurs in Mediterranean countries (see the second chart). The fact that the benefit is lost when a job offer is accepted could also discourage potential workers and should be taken into account. To reduce this effect, the benefit could be withdrawn gradually as employment income rises (similar to introducing a negative tax).[3]

Regarding implementation, one of the current problems is access to such transfers since a significant number of individuals who are entitled do not claim them (over 50% in some European countries)[4] while others receive them although they are not entitled. Neither can we be certain whether many of the current programmes are actually achieving their goal. The first step to improving minimum-income benefit schemes is therefore to thoroughly assess their effectiveness.

### *Minimum-income benefit transfers **

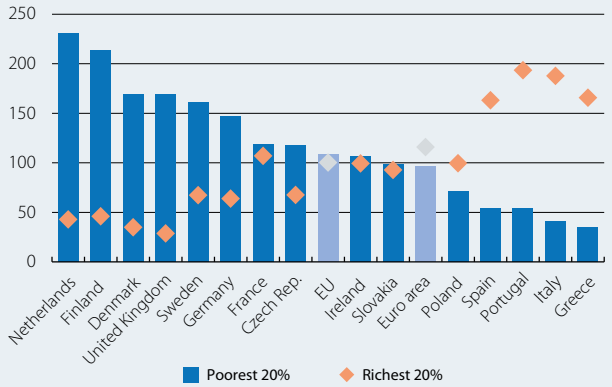
*(% of median net household income)*




***Note:*** ** Maximum level of minimum-income benefit transfers to which a family is entitled made up of a couple and two children.*
***Source:*** *CaixaBank Research, based on data from the OECD (OECD income distribution database and tax-benefit models).*

### *Transfers received by the richest and poorest quintiles **

*(% of average transfer)*




***Note:*** ** Social transfers received by working-age individuals (including contributory benefits).*
***Source:*** *CaixaBank Research, based on data from the OECD (OECD income distribution database).*

1. The gig economy refers to workers using online apps created by intermediary firms to find clients for whom they carry out separate pieces of work.
2. OECD (2017), «Basic Income as a policy option: Can it add up?», Els Policy Brief on the Future of Work.
3. IMF (2017), «Fiscal Monitor: Tackling Inequality», October.
4. Atkinson, A. B. (2015), «Inequality. What can be done?», Harvard University Press.

# KEY INDICATORS

## Activity and employment indicators

*Values, unless otherwise specified*

| | 2015 | 2016 | Q1 2017 | Q2 2017 | 10/17 | 11/17 | 12/17 |
|---|---|---|---|---|---|---|---|
| Retail sales *(year-on-year change)* | 2.7 | 1.5 | 2.2 | 2.9 | 0.4 | ... | ... |
| Industrial production *(year-on-year change)* | 2.1 | 1.5 | 1.3 | 2.7 | 3.7 | ... | ... |
| Consumer confidence | –6.1 | –7.7 | –5.5 | –2.7 | –1.1 | 0.1 | 0.5 |
| Economic sentiment | 104.2 | 104.8 | 108.0 | 110.0 | 114.1 | 114.6 | ... |
| Manufacturing PMI | 52.2 | 52.5 | 55.6 | 57.0 | 58.5 | 60.1 | 60.6 |
| Services PMI | 54.0 | 53.1 | 55.1 | 56.0 | 55.0 | 56.2 | 56.5 |
| **Labour market** | | | | | | | |
| Employment (people) *(year-on-year change)* | 1.0 | 1.3 | 1.6 | 1.6 | – | ... | – |
| **Unemployment rate: euro area** *(% labour force)* | 10.9 | 10.0 | 9.5 | 9.1 | 8.8 | ... | ... |
| Germany *(% labour force)* | 4.6 | 4.2 | 3.9 | 3.8 | 3.6 | ... | ... |
| France *(% labour force)* | 10.4 | 10.0 | 9.6 | 9.5 | 9.4 | ... | ... |
| Italy *(% labour force)* | 11.9 | 11.7 | 11.6 | 11.2 | 11.1 | ... | ... |
| Spain *(% labour force)* | 22.1 | 19.6 | 18.2 | 17.3 | 16.7 | ... | ... |

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

## Foreign sector

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

| | 2015 | 2016 | Q1 2017 | Q2 2017 | 10/17 | 11/17 |
|---|---|---|---|---|---|---|
| **Current balance: euro area** | **3.4** | **3.6** | **3.5** | **3.2** | **3.4** | **...** |
| Germany | 8.5 | 8.3 | 8.3 | 7.7 | 7.8 | ... |
| France | –0.4 | –0.9 | –1.1 | –1.2 | –1.1 | ... |
| Italy | 1.5 | 2.7 | 2.9 | 2.8 | 2.8 | ... |
| Spain | 1.1 | 1.9 | 1.9 | 1.9 | 1.8 | ... |
| **Nominal effective exchange rate**[1] *(value)* | **91.7** | **94.3** | **93.7** | **95.2** | **98.6** | **98.5** |

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

## Financing and deposits of non-financial sectors

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

| | 2015 | 2016 | Q1 2017 | Q2 2017 | 10/17 | 11/17 |
|---|---|---|---|---|---|---|
| **Private sector financing** | | | | | | |
| Credit to non-financial firms[1] | –0.3 | 1.8 | 2.2 | 2.3 | 2.9 | 3.1 |
| Credit to households[1, 2] | 0.8 | 1.7 | 2.3 | 2.6 | 2.7 | 2.8 |
| Interest rate on loans to non-financial firms[3] *(%)* | 1.6 | 1.4 | 1.3 | 1.3 | 1.3 | ... |
| Interest rate on loans to households for house purchases[4] *(%)* | 2.1 | 1.8 | 1.8 | 1.7 | 1.7 | ... |
| **Deposits** | | | | | | |
| On demand deposits | 11.1 | 10.0 | 9.4 | 10.2 | 10.4 | 10.1 |
| Other short-term deposits | –3.8 | –1.9 | –2.3 | –2.9 | –2.7 | –2.5 |
| Marketable instruments | 2.6 | 2.7 | 5.7 | 0.6 | –0.8 | –0.4 |
| Interest rate on deposits up to 1 year from households *(%)* | 0.8 | 0.5 | 0.4 | 0.4 | 0.4 | ... |

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

# ECONOMIC OUTLOOK · **2018: Strong growth expectations**

**The outlook for the Spanish economy is favourable**. Spain's economy has enjoyed three exceptionally good years, growing at rates above 3%. This growth rate will probably ease in 2018 although it will still be one of the highest in the advanced economies according to all analysts' forecasts. The CaixaBank Research GDP growth forecast of 2.4% assumes sustained growth in domestic demand, albeit slightly lower than in recent years. The competitiveness gains achieved in recent years, together with the projected positive developments in the global economy, will support the strong performance by exports, at least partially offsetting the expected slowdown in domestic demand.

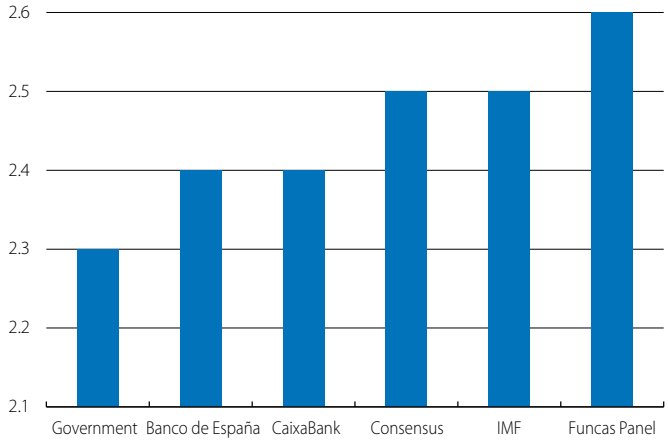
**Growth remains high in the last quarter of the year**. The CaixaBank Research GDP forecast predicts 0.7% growth quarter-on-quarter in Q4, very similar to Q3 (0.8% quarter-on-quarter). Overall, the various indicators published over the past month point to a strong growth rate. Supply indicators suggest the economy is still comfortably in the expansionary zone although service sector activity was somewhat weaker at the end of the year. In contrast, manufacturing showed some signs of improvement. Specifically, the services PMI in November stood at 54.4 points, its lowest since January, while manufacturing advanced to 56.1 points and industrial production grew solidly by 4.1% year-on-year in October.

**The positive trend in economic activity is reflected in the labour market**. This good performance by the Spanish economy has had a very positive impact on the labour market. In the past three years 1.5 million jobs have been created, half those lost during the crisis. The most recent data point to this expansion continuing. In November, the number of workers affiliated to Social Security increased by 3.6% year-on-year. Compared with October, the number fell by 12,773 in November. This tends to happen due to loss of tourism jobs. However, seasonally adjusted data confirm the dynamism of the labour market (+43,437). Looking ahead to 2018, lower GDP growth is expected to reduce the job creation rate slightly. 2.1% growth is forecast (in terms of full-time equivalent jobs), an additional 350,000 jobs. This positive employment trend will also help the unemployment rate to continue falling, down to 15.4% this year and far from the 26% posted in 2013.

**Competitiveness, essential for sustained growth**. The gains in competitiveness achieved in recent years have considerably boosted economic growth, encouraging the export boom and resulting current account surpluses. Contained production costs are helping to maintain the competitiveness gained in recent years. Hourly labour costs fell by 0.3% in Q3 compared to Q2 (–0.1% year-on-year) while core inflation remained subdued (0.8% in November), below the euro area figure

### *2018 GDP growth forecasts*

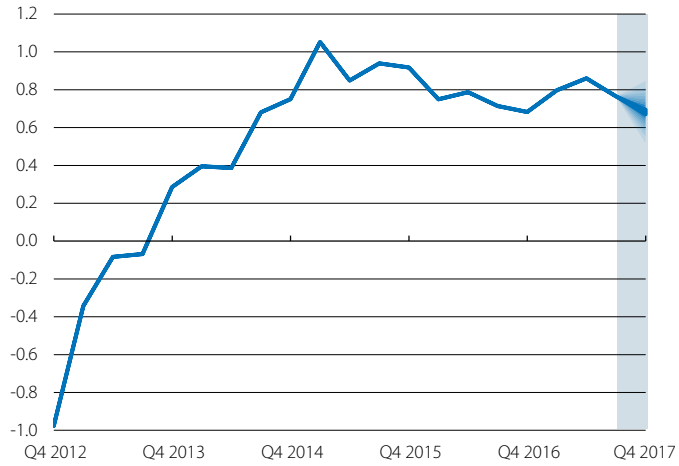
*Annual rate of change (%)*




***Note:*** *Forecasts at December 2017.*
***Source:*** *CaixaBank Research, based on data from the Banco de España, Ministry of Finance, Consensus Economics, Funcas and IMF.*

### *GDP*

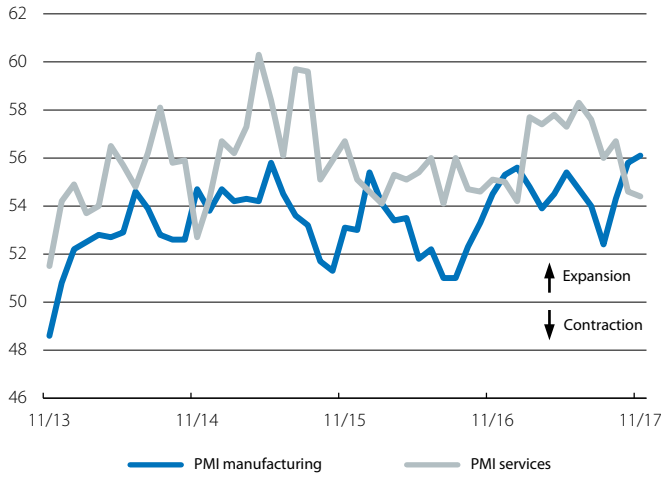
*Quarter-on-quarter change (%)*




***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.*

(1.1%). Headline inflation eased by 0.5 pp in December to 1.2% as oil prices decelerated. In 2018 inflation is expected to moderate to 1.6%, 0.4 pp below 2017's increase (2% on average). This slowdown, which has been observed since March 2017, is expected to last throughout Q1 as a result of energy base effects. Core inflation, unaffected by energy fluctuations, is expected to rise gradually as the economy uses more of its production resources.

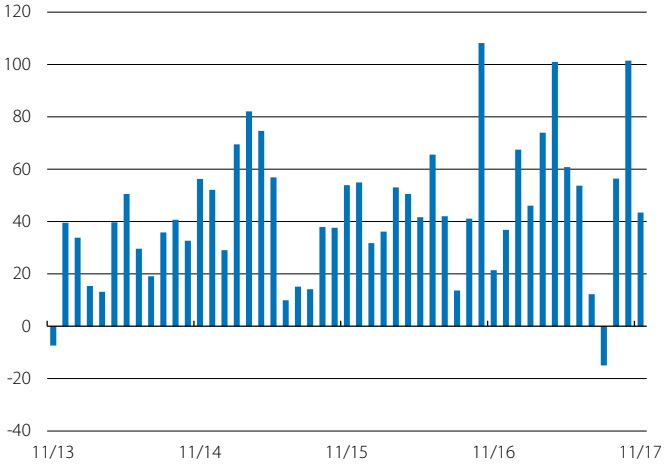
**Adjustment continues in the external imbalance**. Booming exports have led to substantial improvements in the current account balance. This has now been in surplus for five years and is key to correcting the country's high debt position with respect to the rest of the world, one of its weak points. Spain's net international investment position fell to –83.2% of GDP in Q3 2017 (–86.5% of GDP in Q2), although still well above the benchmark of –35% established in the European Commission's Macroeconomic Imbalance Procedure. Good foreign trade figures have undoubtedly contributed to this improvement. In 2017 up to October, exports increased by a remarkable 8.7% year-on-year (12-month cumulative). Imports also increased sharply (10.3% year-on-year), largely as a result of higher oil prices. The increase in oil prices, which will continue in 2018, will result in a slight deterioration in the current account, which is expected to post a surplus of around 1.7% of GDP.

**Good economic performance and low interest rates are driving the reduction of the government deficit**. The total government deficit in September reached 1.5% of GDP in Q3, making it likely that the 3.1% deficit target agreed with the European Commission for 2017 will be met. Looking ahead, the favourable economic cycle coupled with lower interest pressure will continue to support the correction of the deficit, with Spain exiting the excessive deficit procedure in 2018. In the absence of more budget details, the deficit is expected to reach 2.5% of GDP in 2018, a decrease of 0.6 pp of GDP on year-end 2016. This reduction would bring the deficit close to the 2018 target of 2.2%. However, given that government debt is still at a high 98.7% of GDP, the correction of the deficit should not be left to cyclical improvements alone. Measures are required to ensure long-term structural improvements in the public accounts.

**The real estate sector is on track to consolidate its expansion in 2018**. House price trends are a good example of this. Q3 growth in house prices based on sales accelerated to 6.6% year-on-year (5.6% in Q2), more than the Q3 index based on appraised values (2.7% year-on-year). Given their very nature, appraised values fell less during the crisis and are therefore expected to rise more gradually during the expansionary phase of the cycle. Nevertheless, there is every indication that the upward trend in house prices will continue in the coming quarters. For instance, land prices rose by 7.4% in Q3, a typical early indicator of the house price trend in a year's time. Demand and supply indicators also point to a dynamic trend, reflecting the sector's strong recovery. In

### *Registered workers affiliated to Social Security **

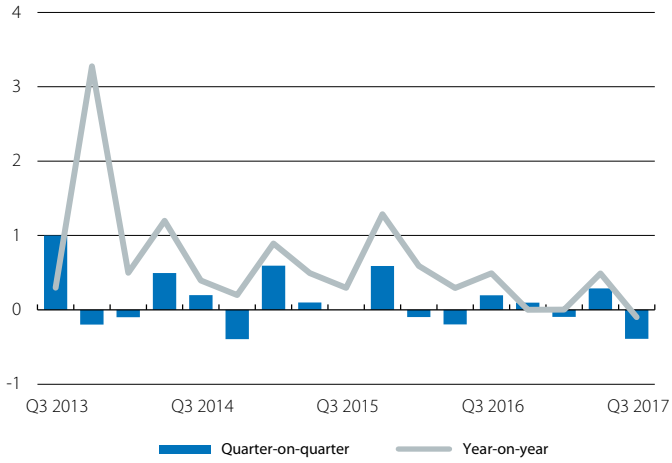
*Month-on-month change (thousands of people)*




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

### *Labour cost per hour **

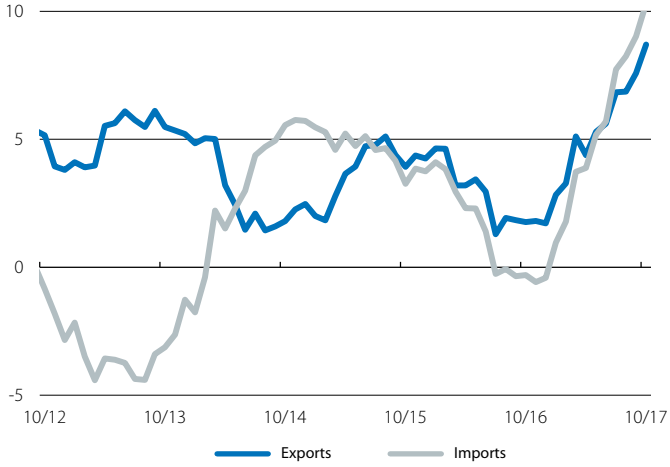
*Change (%)*




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

### *Exports and imports of goods **

*Year-on-year change (%)*



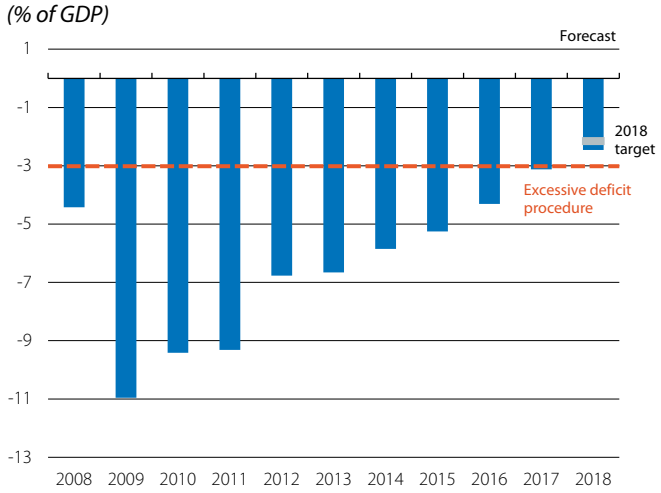

***Note:*** ** Cumulative over 12 months.*
***Source:*** *CaixaBank Research, based on data from the Customs Department.*

particular, new building permits grew by 25% in September (12-month cumulative). Nonetheless, the number of permits is still historically low and a lack of supply is already beginning to be felt in some areas.

**Good outlook for bank credit**, supported by the recovery in economic activity, continued accommodative monetary conditions and the boom in real estate. The breakdown of credit in Q3 2017 shows that consumer credit grew at a good rate (14.4% year-on-year) while loans to other segments still declined, albeit at a slower pace. The NPL ratio continued to fall in all segments. There has been a particularly positive 0.5 pp fall in the NPL ratio for developer loans over the past year, although this was still high at 20.8% in Q3 2017. The NPL ratio will continue to fall in 2018, supported by improvements in economic activity and the labour market, as well as sales of non-performing asset portfolios.

## Public sector borrowing needs

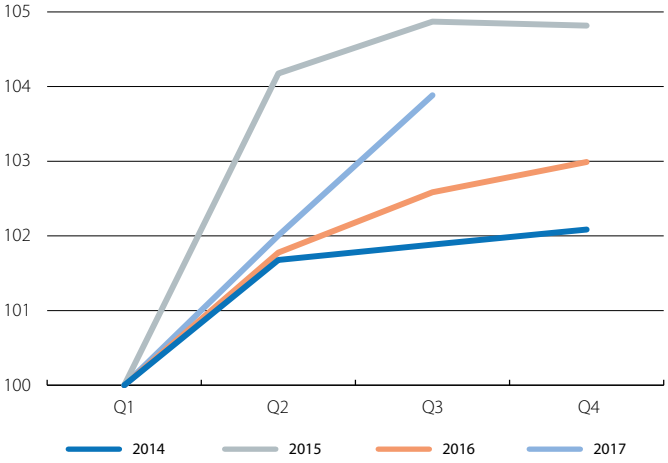
*(% of GDP)*




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

## House prices based on sales

*Index (100 = Q1)*




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

## Gross credit and NPL ratio in Q3 2017

| | Balance (EUR billion) | Year-on-year change (%) | NPL ratio (%) |
|---|---|---|---|
| Loans to households | 698 | –1.0% | – |
| House purchases | 526 | –2.7% | 4.7% |
| Other purposes | 172 | 4.4% | 8.7% |
| Consumption | 76 | 14.4% | – |
| Loans to enterprises | 476 | –3.7% | – |
| Non-developers | 366 | –1.2% | 10.8% |
| Developers | 110 | –11.0% | 20.8% |
| Loans to private sector * | 1,174 | –2.1% | 8.3% |

***Note:*** ** The total balance does not include loans to financial services.*
***Source:*** *CaixaBank Research, based on data from the Banco de España (chapter 8).*

# FOCUS · The complexity of Spanish exports

Spain's exports have seen solid growth over the past few years. Moreover the range of destinations has broadened and the products exported diversified. But there is still one important issue to resolve: the complexity of exports. What is this complexity and why is it so important? The prestigious Harvard economists Ricardo Hausmann and César Hidalgo produce an Economic Complexity Index (ECI) which, broadly speaking, classes an economy as complex when it can export a diverse range of products which very few other countries can produce.[1] An economy's complexity matters because, as shown by the authors themselves, it is closely linked to long-term growth in per capita income.

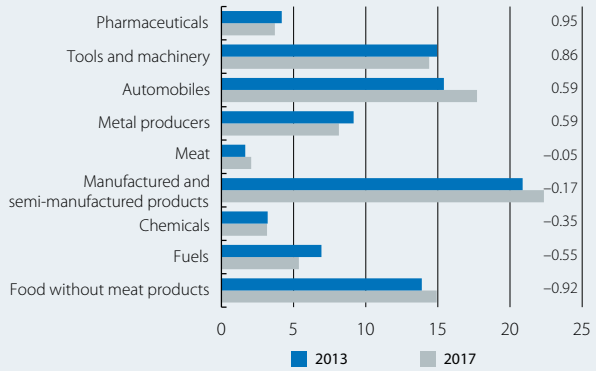
According to the ECI, the growth in Spain's exports since 2010 has been accompanied by a decline in the country's position in the export complexity ranking, going from 23rd in 2010 to 33rd in 2015 and 2016 (out of 124 countries). Why has Spain lost ranking in complexity terms? One initial explanation is that weak demand during the Great Recession forced a large number of firms to start exporting to offset the slump in domestic sales. Consequently, a lot of relatively small companies became exporters. Such firms tend to have lower productivity and the goods they produce are usually not very sophisticated. Secondly, economic complexity is a relative concept. An economy becomes less complex if there are increasingly more countries capable of producing what it sells. The rise in the emerging economies over the past few years has therefore reduced the complexity of most advanced economies, such as Portugal, France and the UK. The exceptions are Germany and Japan, strong exporters which have remained at the top of the ranking.

Nevertheless, a product-based analysis reveals some positive points. First, the complexity of Spanish exports is dominated by the car industry (passenger vehicles and components, and accessories). This sector is highly complex and has a large spillover capacity (thereby boosting other industries). During the Great Recession, the emergence of new exporters in other industries pushed the car industry's share of all exports from 17.4% in 2010 to 14.6% in 2012. This was therefore a major reason for Spain's lower complexity rating. The positive aspect is that, since 2013, the car industry's share has increased again (reaching a cumulative figure of 17.7% up to September 2017), as well as its complexity. Another sector growing in complexity, albeit to a lesser extent than automobiles, is metal production and its products, especially iron and steel. This has an 8.1% share of all exports and an above-average complexity. The pharmaceutical industry (3.7% share) and tools and machinery (14.4% of all exports) also have a positive effect on Spain's export complexity, although their contribution has fallen in the past few years. At the other end of the scale we find food products (17.0% of all exports), whose increasing share has reduced overall complexity, with the notable exception of the meat industry (2.1% share of exports) which has a high and growing complexity.

1. See the Observatory of Economic Complexity at https://atlas.media.mit.edu/en/.

### Exports by product and their complexity *

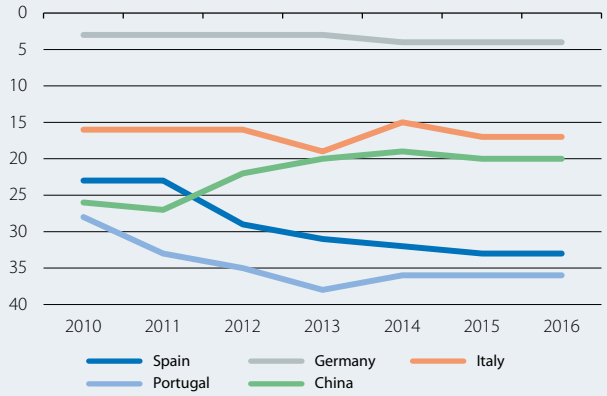
*(% of all exports)* *Complexity*




***Note:*** ** Product groups ordered by complexity (maximum 2.3 and minimum –3.3).*
***Source:*** *CaixaBank Research, based on data from the Dept. of Trade and the Atlas of Economic Complexity (MIT).*

### Export complexity

*World ranking **




***Note:*** ** Ranking on the Economic Complexity Index (ECI) out of 124 countries.*
***Source:*** *CaixaBank Research, based on data from the Atlas of Economic Complexity (MIT).*

# FOCUS · The impact of monetary policy on house prices

A new bullish cycle is taking hold of the real estate sector and the house price trend is a good example. This has been growing for two and a half years and cumulative growth has reached double digit figures in some areas. The sector's recovery is solid, supported by a strong upswing in economic activity and a rise in demand driven by a dynamic labour market and improved financial conditions. The Focus examines this last point.

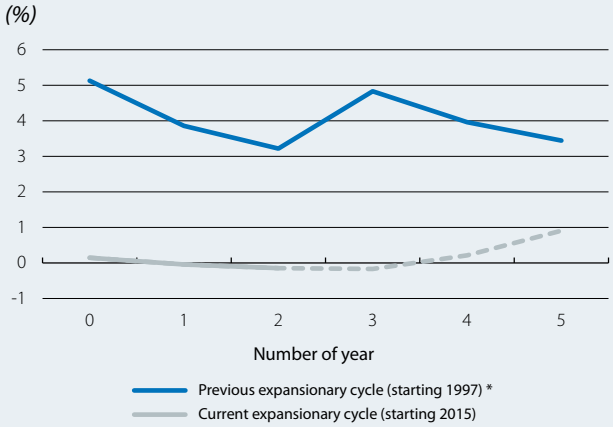
The importance of the ECB's monetary policy in supporting those households most affected by the crisis can be illustrated by a simple example. A 1 pp reduction in mortgage interest rates offsets an 8% fall in a household's gross income and keeps its affordability ratio unchanged.[1] For instance, between 2012 and 2016 household income fell by 6.3% on average in cumulative terms while the ECB's accommodative monetary policy helped to reduce mortgage interest rates by 1.3 pp.

There is every indication that the interest rate environment will remain favourable. Although the ECB has started to alter its tone, interest rate hikes are not expected until mid-2019. Moreover, any such hikes are very likely to be gradual. We expect the average interest rate on the outstanding mortgage balance to remain below 2.5% over the next two years, well below the 5.0% average recorded in the previous cycle.[2] Consequently, those households hardest hit by the economic crisis are very likely to continue benefitting from ultra-low interest rates.

However, this low interest rate environment is also pushing up house prices. It encourages investment in property by lowering returns on financial savings and also makes it easier to buy more expensive housing. An example illustrates this very well: a 1 pp reduction in mortgage rates means that a 10% more expensive property can be afforded.[1] Shifting this example to the current interest rate environment we can see that, with a monthly mortgage payment of EUR 550 over 20 years, a 3.2% interest rate[3] allows us to finance a house purchase valued at EUR 120,943, 18% higher than if interest rates were 5%, as in the previous cycle.

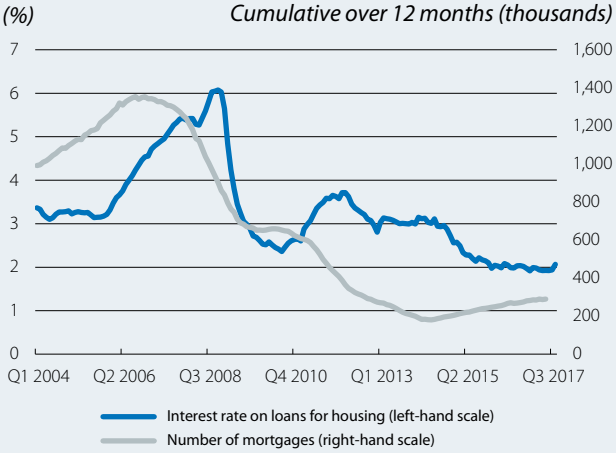
These examples for households with particular characteristics are illustrative. However, the overall impact of monetary policy on house prices has been shown to be considerable by academic articles attempting to isolate this effect more systematically. In developed countries in particular, a 1 pp drop in the real interest rate may push up house prices by as much as 1 pp.[4]

### 12-month Euribor




***Note:*** ** For years prior to 1999 the MIBOR is reported, the most widely used mortgage benchmark rate in that period.*
***Source:*** *CaixaBank Research, based on data from the Banco de España.*

### Interest rate and number of mortgages




***Source:*** *CaixaBank Research, based on data from the Banco de España and the INE.*

1. An interest rate drop of 3% to 2% is assumed for a 20-year mortgage.
2. Real interest rate differences are unlikely to be as wide because inflation is expected to remain lower than in the previous cycle.
3. Assuming a mortgage for 80% of the property's value. The average monthly mortgage payment currently stands at EUR 549, the average maturity is 23.4 years and the interest rate for fixed-rate mortgages is 3.16% (Q3 2017).
4. See Kuttner, K. (2012), «Lower Interest Rates and Housing Bubbles: Still No Smoking Gun» and Jarociński, M. and Smets, F.R. (2008), «House Prices and the Stance of Monetary Policy», Federal Reserve Bank of St. Louis Review, 90.

# FOCUS · How diversified are Spain's sources of business financing?

Historically, Spanish and European companies in general have tended to look to banks for their financing more than other advanced economies such as the US.[1] However, this new expansionary cycle has seen a significant change in both the sources of financing used and the providers of such financing.

The main source of financing for SMEs is bank credit. Given that Spanish business is dominated by SMEs, it comes as no surprise that this is the main source of financing in the country. Small businesses cannot afford the costs of accessing capital markets. Among others, these include the costs of producing and reporting the necessary information. It is therefore essential for SMEs to maintain a close and stable relationship with their bank. In this way, bank managers are better able to gauge each company's credit risk. Larger companies, on the other hand, tend to provide more frequent and detailed financial information, usually audited, or even have an independent rating. This means they can complement bank credit with alternative sources of financing such as corporate bonds, issued directly on the financial markets.

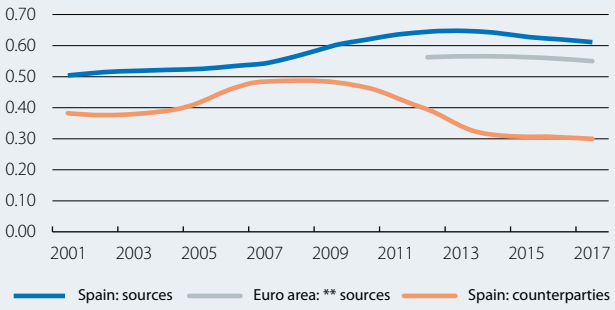
One of the fundamental issues is the optimal mix of financing for companies, both for banks and entrepreneurs and, more generally, from a macroeconomic point of view. For large firms, a greater variety of sources of finance gives them access to a larger number of investors and usually more favourable financial conditions. This is often accompanied by access to international finance markets, allowing more bank resources to be allocated to small businesses, which benefit more from banking activity. On the downside, capital market assets are highly volatile as liquidity is often drained in episodes of financial instability. Bank financing, on the other hand, tends to be less volatile.

Moving from theory to practice, there has been a decline in the relative weight of bank loans in Spain over the past five years while commercial credit and corporate bonds (the latter boosted by the ECB's corporate bond purchase programme) have become more prominent. This has reduced the concentration of financing sources, in line with the trend for the euro area as a whole although still at somewhat higher levels.

A similar pattern can be observed in the diversification of external financing providers. Looking at the counterparties of corporate loans and bonds (i.e. corporate debt holders), we can see a decline in monetary financial institutions, partly offset by a rise in the rest of the world; i.e. increased access to international finance. This demonstrates the confidence of international investors in Spanish companies and reveals an opportunity for the latter to diversify their sources of financing.

### *Concentration of sources of financing and its counterparties*

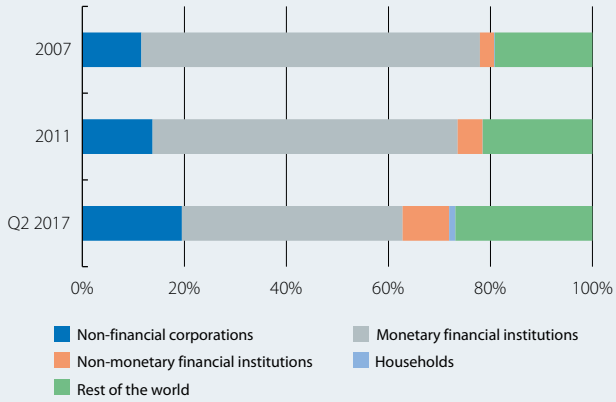
*Herfindahl index **




***Notes:*** ** The Herfindahl index for sources of financing is calculated by squaring the share of each source and then summing the resulting numbers. The Herfindahl index for the counterparties is calculated based on holders of corporate debt (corporate loans and bonds). A higher index indicates a greater concentration. ** Euro area data available only since 2012.*
***Source:*** *CaixaBank Research, based on data from the Banco de España and the European Central Bank.*

### *Counterparties of non-financial corporate debt*

*(%)*




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

1. See the Focus «Capital market union: a first step» in MR04/2015.

# KEY INDICATORS

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

## Activity indicators

| | 2015 | 2016 | Q4 2016 | Q1 2017 | Q2 2017 | Q3 2017 | 10/17 | 11/17 |
|---|---|---|---|---|---|---|---|---|
| **Industry** | | | | | | | | |
| Electricity consumption | 1.7 | 0.0 | –0.1 | 1.6 | 1.2 | 0.2 | 0.2 | 2.9 |
| Industrial production index | 3.3 | 1.9 | 1.9 | 1.9 | 2.1 | 2.5 | 4.2 | ... |
| Indicator of confidence in industry *(value)* | –0.3 | –2.3 | –0.6 | 0.3 | –0.5 | –0.1 | 2.5 | 5.5 |
| Manufacturing PMI *(value)* | 53.6 | 53.2 | 54.4 | 54.8 | 54.9 | 53.6 | 55.8 | 56.1 |
| **Construction** | | | | | | | | |
| Building permits *(cumulative over 12 months)* | 20.0 | 43.7 | 36.9 | 24.5 | 18.4 | 23.5 | 25.3 | ... |
| House sales *(cumulative over 12 months)* | 10.9 | 13.1 | 13.9 | 15.2 | 12.2 | 13.3 | 14.4 | ... |
| House prices | 1.1 | 1.9 | 1.5 | 2.2 | 1.6 | 2.7 | – | ... |
| **Services** | | | | | | | | |
| Foreign tourists *(cumulative over 12 months)* | 5.6 | 8.2 | 10.1 | 10.0 | 10.2 | 10.3 | 9.4 | 9.3 |
| Services PMI *(value)* | 57.3 | 55.0 | 54.9 | 56.4 | 57.8 | 56.8 | 54.6 | 54.4 |
| **Consumption** | | | | | | | | |
| Retail sales | 3.0 | 3.6 | 3.0 | 0.6 | 2.5 | 1.8 | –1.5 | 3.3 |
| Car registrations | 21.3 | 11.4 | 8.9 | 7.8 | 6.3 | 6.7 | 13.7 | 12.4 |
| Consumer confidence index *(value)* | 0.3 | –3.8 | –3.2 | –2.8 | 1.5 | 0.2 | –1.4 | –1.7 |

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

## Employment indicators

| | 2015 | 2016 | Q4 2016 | Q1 2017 | Q2 2017 | Q3 2017 | 10/17 | 11/17 |
|---|---|---|---|---|---|---|---|---|
| **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 | 3.2 |
| Construction | 4.7 | 2.6 | 3.3 | 5.3 | 6.1 | 6.1 | 6.8 | 7.1 |
| Services | 3.5 | 3.2 | 3.5 | 3.4 | 3.8 | 3.6 | 3.7 | 3.6 |
| Employment by professional status | | 3.5 | | | | | | |
| Employees | 3.5 | 3.5 | 3.8 | 4.0 | 4.4 | 4.1 | 4.1 | 4.3 |
| Self-employed and others | 1.9 | 1.0 | 0.9 | 0.9 | 0.9 | 0.7 | 0.7 | 0.5 |
| **TOTAL** | **3.2** | **3.0** | **3.3** | **3.4** | **3.8** | **3.5** | **3.5** | **3.6** |
| **Employment** [2] | **3.0** | **2.7** | **2.3** | **2.3** | **2.8** | **2.8** | **–** | **...** |
| **Hiring contracts registered** [3] | | | | | | | | |
| Permanent | 12.3 | 14.2 | 13.3 | 15.4 | 10.2 | 11.0 | 21.4 | 10.3 |
| Temporary | 11.2 | 7.2 | 6.6 | 12.1 | 9.6 | 5.0 | 7.6 | 3.7 |
| **TOTAL** | **11.3** | **7.8** | **7.1** | **12.4** | **9.6** | **5.5** | **8.8** | **4.3** |
| **Unemployment claimant count** [3] | | | | | | | | |
| Under 25 | –11.0 | –12.6 | –13.2 | –13.3 | –17.3 | –9.4 | –6.9 | –10.5 |
| All aged 25 and over | –7.2 | –8.2 | –9.0 | –9.2 | –10.3 | –8.7 | –8.0 | –8.1 |
| **TOTAL** | **–7.5** | **–8.6** | **–9.4** | **–9.6** | **–10.9** | **–8.8** | **–7.9** | **–8.3** |

***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 | Q4 2016 | Q1 2017 | Q2 2017 | Q3 2017 | 10/17 | 11/17 | 12/17 |
|---|---|---|---|---|---|---|---|---|---|
| **General** | **–0.5** | **–0.2** | **1.0** | **2.7** | **2.0** | **1.7** | **1.6** | **1.7** | **1.2** |
| Core | 0.6 | 0.8 | 0.9 | 1.0 | 1.1 | 1.3 | 0.9 | 0.8 | ... |
| Unprocessed foods | 1.8 | 2.3 | 1.0 | 4.1 | 2.5 | –0.2 | 4.9 | 4.3 | ... |
| Energy products | –9.0 | –8.4 | 1.6 | 15.3 | 8.0 | 5.4 | 3.9 | 5.9 | ... |

***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 | Q4 2016 | Q1 2017 | Q2 2017 | Q3 2017 | 08/17 | 09/17 | 10/17 |
|---|---|---|---|---|---|---|---|---|---|
| **Trade of goods** | | | | | | | | | |
| Exports *(year-on-year change, cumulative over 12 months)* | 4.3 | 1.7 | 1.7 | 5.1 | 5.6 | 7.6 | 6.9 | 7.6 | 8.7 |
| Imports *(year-on-year change, cumulative over 12 months)* | 3.7 | –0.4 | –0.4 | 3.7 | 5.7 | 9.0 | 8.2 | 9.0 | 10.3 |
| **Current balance** | **12.2** | **21.5** | **21.5** | **21.6** | **21.2** | **20.6** | **20.7** | **20.6** | **20.4** |
| Goods and services | 25.3 | 33.7 | 33.7 | 32.0 | 32.6 | 31.9 | 32.2 | 31.9 | 31.4 |
| Primary and secondary income | –13.1 | –12.2 | –12.2 | –10.4 | –11.4 | –11.3 | –11.5 | –11.3 | –11.0 |
| **Net lending (+) / borrowing (–) capacity** | **19.2** | **24.2** | **24.2** | **24.1** | **23.4** | **22.6** | **22.8** | **22.6** | **22.5** |

***Source:*** *CaixaBank Research, based on data from the Department of Customs and Special Taxes and Banco de España.*

## Public sector

*Percentage GDP, cumulative in the year, unless otherwise specified*

| | 2015 | 2016 | Q4 2016 | Q1 2017 | Q2 2017 | 07/17 | 08/17 | 09/17 | 10/17 |
|---|---|---|---|---|---|---|---|---|---|
| **Net lending (+) / borrowing (–) capacity** [1] | **–5.3** | **–4.5** | **–4.5** | **–0.4** | **–2.2** | **–** | **–** | **–1.5** | **–** |
| Central government | –2.6 | –2.7 | –2.7 | –0.4 | –1.1 | –1.8 | –1.9 | –1.5 | –1.1 |
| Autonomous regions | –1.7 | –0.8 | –0.8 | –0.2 | –0.7 | 0.0 | 0.1 | 0.1 | 0.1 |
| Local government | 0.4 | 0.6 | 0.6 | 0.1 | 0.1 | – | – | 0.5 | – |
| Social Security | –1.2 | –1.6 | –1.6 | 0.1 | –0.5 | –0.5 | –0.6 | –0.6 | –0.6 |
| **Public debt** *(% GDP)* | **99.4** | **99.0** | **99.0** | **100.0** | **99.8** | **–** | **–** | **98.7** | **–** |

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

## Credit and deposits in non-financial sectors [1]

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

| | 2015 | 2016 | Q4 2016 | Q1 2017 | Q2 2017 | Q3 2017 | 08/17 | 09/17 | 10/17 |
|---|---|---|---|---|---|---|---|---|---|
| **Deposits** [2] | | | | | | | | | |
| Household and company deposits | –0.6 | 2.5 | 3.0 | 3.2 | 2.5 | 2.3 | 2.3 | 2.9 | 2.7 |
| Sight and savings | 14.7 | 16.0 | 16.2 | 18.6 | 18.8 | 17.2 | 17.3 | 17.3 | 16.7 |
| Term and notice | –16.3 | –16.0 | –17.7 | –22.0 | –24.9 | –25.1 | –25.1 | –25.1 | –25.5 |
| General government deposits | 6.7 | –14.2 | –29.1 | –28.0 | –26.7 | 6.8 | 9.0 | 9.5 | 7.0 |
| **TOTAL** | **–0.2** | **1.2** | **0.4** | **1.0** | **0.5** | **2.6** | **2.6** | **3.2** | **2.9** |
| **Outstanding balance of credit** [2] | | | | | | | | | |
| Private sector | –5.5 | –3.6 | –3.2 | –2.7 | –2.1 | –2.3 | –2.4 | –2.1 | –2.0 |
| Non-financial firms | –7.3 | –5.3 | –5.2 | –4.3 | –3.0 | –3.9 | –4.0 | –3.7 | –3.3 |
| Households - housing | –4.6 | –3.7 | –3.1 | –3.0 | –2.8 | –2.7 | –2.7 | –2.7 | –2.7 |
| Households - other purposes | –2.6 | 2.0 | 2.9 | 3.6 | 3.2 | 3.6 | 3.5 | 4.4 | 4.0 |
| General government | 0.2 | –2.9 | –2.7 | –3.2 | –12.6 | –11.6 | –10.9 | –12.2 | –11.6 |
| **TOTAL** | **–5.2** | **–3.6** | **–3.2** | **–2.7** | **–2.9** | **–3.0** | **–3.0** | **–2.8** | **–2.7** |
| **NPL ratio** *(%)* [3] | **10.1** | **9.1** | **9.1** | **8.8** | **8.4** | **8.3** | **8.5** | **8.3** | **8.2** |

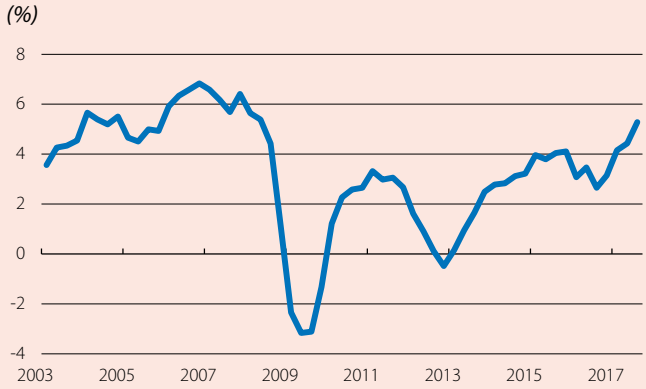
***Notes:*** *1. Aggregate data from Spain's banks. 2. Residents in Spain. 3. Data up to end of period.*
***Source:*** *CaixaBank Research, based on data from the Banco de España.*

EMERGING EUROPE

# Analysis of the emerging European economic cycle

Eastern Europe (EE) is growing strongly. Latest GDP growth figures have not been seen in these countries for years (see the first chart). This has raised some eyebrows. Is such a high rate of growth sustainable? This article examines the factors behind the economic upswing in emerging Europe. We will see that, although the economic boom is closely linked to the strong EU economy, idiosyncratic factors have also come into play.

**Emerging Europe: weighted GDP growth ***



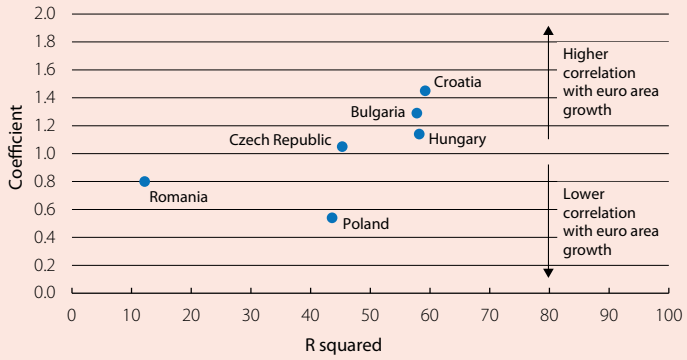

***Note:*** ** Emerging Europe includes Poland, Hungary, Czech Republic, Romania, Bulgaria and Slovakia. Weighted by each country's GDP.*
***Source:*** *CaixaBank Research, based on data from Eurostat.*

An analysis of the current cycle of the EE economies can be divided into two parts. On the one hand, EE is a very open economy with its main trading partner, the EU, taking around 75% of its total exports.[1] As economic activity in the EU has gained momentum, it has boosted EE exports. Another key factor contributing to higher growth in EE is the fact that it has received EU structural funds.[2]

However, the EU does not explain by itself the entirety of the economic cycle of emerging Europe. Proof of this is the relationship between GDP growth in each of the EE economies and the euro area.[3] As can be seen in the second chart, although the ratio between the GDP of each EE economy and that of the euro area is generally one to one (1 pp more GDP growth in the euro area is associated with 1 pp more growth in each EE country[4]), the variance due to the euro area's GDP barely reaches an average of 50% of the total variance.

So what other factors explain the EE cycle? At present there are two particularly important ones: fiscal policy and monetary policy. EE governments have taken a clearly expansionary stance since 2015 (see the third chart). As discussed in more detail in the article «Political risk in emerging Europe: how much should we be concerned?» in this Dossier, this stance is at least partly due to the rise of populist policies that are being implemented mainly in Poland and Hungary. The plans announced by the respective governments so far suggest this trend will continue in the coming years.

**Degree of association between Emerging Europe and euro area growth ***




***Note:*** *For each EE country, the following equation is estimated by the ordinary least squared: $\gamma_{EE} = \alpha + \beta\gamma_{EA}$, where $\gamma_{EE}$ is the GDP growth of each EE country and $\gamma_{EA}$ the GDP growth of the euro area. The vertical axis shows the estimated β coefficients and the horizontal axis the R squared. The R squared measures the percentage of total variance observed that is due to the explanatory variable; i.e. GDP growth of the euro area.*
***Source:*** *CaixaBank Research, based on data from Eurostat.*

Regarding monetary policy, the benchmark interest rate in most EE countries is at an all-time low, thereby supporting growth in demand.[5] However, inflation is likely to rise faster than expected, even though it is still around the monetary authorities' target at present. This is because of the strong growth recorded in economic activity and wages and the expansionary tone of fiscal policy.[6] Soaring inflation could force monetary authorities to raise interest rates faster than previously announced in order to stop their economies from overheating. This suggests that monetary policy can be too accommodative in the current context. It is therefore

1. In 2016, in a GDP-weighted average, the economies of Poland, Hungary, the Czech Republic, Romania, Bulgaria and Slovakia had a ratio of total imports and exports to GDP that was 34.4 pp higher than the euro area.
2. For more details on the issue of the Structural Funds allocated to EE, see the article «The dividends of integrating emerging Europe within the EU» in this *Monthly Report*.
3. The euro-area aggregate is used instead of the EU aggregate since the EU includes EE countries.
4. Poland is the main exception, which is to be expected given the relative weight of its domestic market.
5. The central banks of Poland, the Czech Republic and Hungary allow their exchange rate to fluctuate freely in the market. In particular, between 2013 and April 2017 the Czech Republic maintained its commitment to keep the koruna at a minimum exchange rate of CZK 27 per euro. Such a measure became effective in combating the risk of deflation and was abandoned once the central bank deemed the risks had disappeared.
6. In Q3 2017, wages grew 5% year-on-year in Poland, 7% in the Czech Republic, 12.5% in Hungary and 15.6% in Romania.

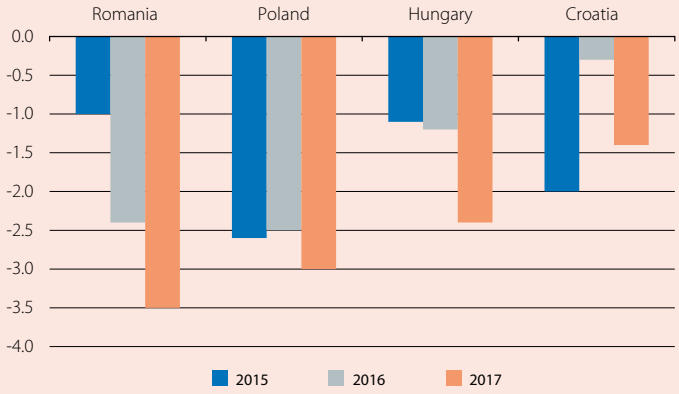
illustrative to compare the benchmark interest rate for each country with the rate predicted by a simple Taylor rule. As can be seen in the fourth chart, in all cases the predicted rate is higher than the real rate.[7]

Strong growth is therefore expected to continue in EE over the coming quarters as the abovementioned factors will boost economic activity. Nonetheless, growth will ease slightly should the monetary authorities begin to withdraw the current stimuli.

Beyond a short-term analysis, it is also revealing to examine whether the region's good momentum can be sustained in the medium and long term. An initial analysis of how the current expansionary phase is developing is encouraging since, as discussed in the article «Emerging Europe: growth with fewer risks» in this Dossier, EE countries are managing to maintain a high growth without accumulating macroeconomic imbalances.

### *Cycle-adjusted deficit **

*(% of potential GDP)*

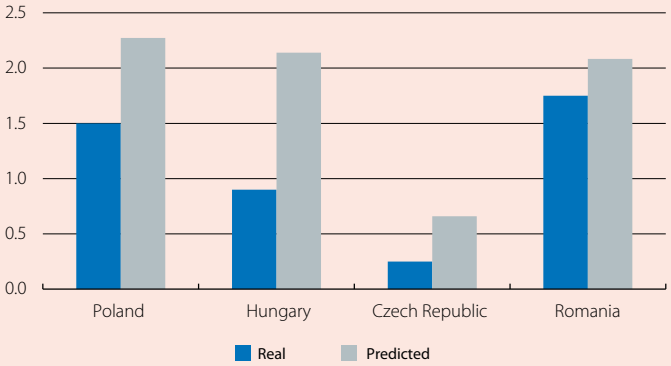



***Note:*** ** The cycle-adjusted deficit is a measure that eliminates cyclical factors from the deficit's calculation (e.g. corrected for the fact that expenditure on unemployment benefit is higher in a recession than during expansion).*
***Source:*** *CaixaBank Research, based on data from the IMF.*

However, the region still faces considerable challenges, particularly how EE might fit into the EU. This issue is tackled in the article «The dividends of integrating emerging Europe within the EU» in this Dossier. The main claim by this article is that EE has benefited greatly from its integration within the EU, although this boost has begun to wane. Reversing this trend will depend to no small extent on the degree of commitment of EE countries to supporting the construction of Europe. Otherwise there is a risk of countries such as Poland and Hungary becoming more populist, potentially resulting in a less favourable investment climate, both domestically and internationally. However, as discussed in the aforementioned article «Political risk in emerging Europe: how much should we be concerned?», the risks associated with a rise in illiberal democracies remain contained, at least for the time being.

### *Benchmark interest rate: real and predicted **

*(%)*




***Note:*** ** The predicted interest rate is calculated using a benchmark interest rate regression of the same interest rate a period before, the difference between GDP growth and its historical average and the same difference for inflation. The regression is estimated based on data up to 2016. The comparison is with the value in Q3 2017.*
***Source:*** *CaixaBank Research, based on data from Datastream.*

The biggest challenge comes from the EE's production model. Leading up to the financial crisis, a significant percentage of economic growth was due to improvements in total factor productivity (TFP), largely because of the region's integration within the global economy and, in particular, in euro area countries. Unfortunately this source of growth will gradually diminish. In fact, since 2009 TFP's contribution to growth has decreased markedly while the contribution made by capital accumulation has grown.[8] Since growth based on the accumulation of production factors is limited in scope, the pressure for EE to alter its production model is likely to increase, moving from a model still highly dependent on cheap labour to one based on higher value added. This challenge may not be new – but is there an emerging region better prepared to tackle it?

*Oriol Carreras Baquer*
*Macroeconomics Unit, Strategic Planning and Research Department, CaixaBank*

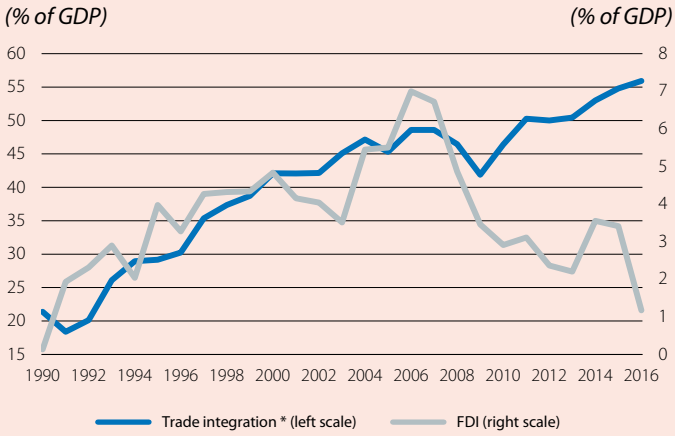
7. The Taylor rule used in this article relates the benchmark interest rate to its own lag, the difference between inflation and the historical average of inflation, and the difference between GDP growth and its historical average.
8. The TFP has gone from representing approximately 60% of growth over the period 1998-2008 to just under 40% between 2009 and 2016. For these calculations, a production function has been assumed with two factors of production: capital and labour. In addition, contributions have been calculated assuming the share of return on capital out of the countries' total income is 40%.

# The dividends of integrating emerging Europe within the EU

Meeting in Copenhagen in 2002, the heads of government of the 15 EU states and 10 candidate countries agreed that EU enlargement would become a reality on 1 May 2004.[1] This was a time of celebration and maxims of supposedly great import on the part of all those attending. But perhaps Siim Kallas, the Estonian Prime Minister, best expressed the aspirations of emerging Europe. He said that Europe was a new place of opportunity for future member states because it would help them to attract investment, sell their products and travel and work in Europe. The pragmatic nature of his words may lack ambition (Kallas was essentially satisfied with access to a large domestic market). Nevertheless, a quick glimpse at history shows quite the opposite: joining the EU offered something that, for much of the 20th century, had been out of reach for the eastern half of the European continent.

There are four key moments in the history of this region. In 1937, Czechoslovakia's per capita income was 72% that of Western Europe, Hungary 63%, Poland 48%, Bulgaria 39% and Romania 28%. 1992: shortly after the collapse of the USSR and the fall of the Berlin Wall. After nearly five decades of a planned economy, the region's ranking in wealth terms had not altered. In fact, it had moved even further away from the continent's advanced states. 2004: after a decade of transition to a market economy, enlargement took place. The situation? The same ranking and almost identical levels of relative wealth as in 1937. And finally, 2016. After a calamitous century, the longed-for real convergence has finally begun to appear. Since joining the EU, the abovementioned countries have been able to cut their income gap by between 9 and 24 pp, depending on the case.

***Emerging Europe: trade integration and foreign direct investment***




***Note:*** ** Trade integration is calculated as the sum of exports and imports with the euro area divided by the nominal GDP of the region.*
***Source:*** *CaixaBank Research, based on data from the IMF and Oxford Economics.*

This success (greater in some countries than in others) is mainly due to a combination of two factors: the connection of these economies to the EU's solid core and the modernisation of their institutions. The effect of economic integration is clearly positive. Since 1995, when preparations to join the EU began, the ratio of exports plus imports with the euro area as a percentage of GDP has risen from 29.2% to 55.9% today. Poland, Hungary, the Czech Republic and Slovakia have been particularly successful, more than doubling the intensity of their trade with the euro area. Another key area is foreign direct investment (FDI). In the aforementioned period, emerging Europe received the equivalent of 4% of GDP annually, a significant figure considering that, between 1986 and 1997 (the same length of time since it joined the EU), Spain's inflows of FDI were equivalent to 2.2% of GDP. The rate has diminished since 2007 but we will discuss this trend later on. A third aspect that reveals the high degree of integration is the flow of people. In a demographically static region, gross emigration has been considerable. Poland has contributed the most to this trend, with 1.8% of its population emigrating between 1995 and 2015.

The second key to success for emerging Europe is institutional modernisation. This can be gauged using the World Bank's Indicators of Regulatory Governance, which measure whether regulation and government policies are conducive to private business. According to this index, whereas in 1996 the region's regulatory quality was similar to that of Argentina at the time, in 2016 it was equivalent to Portugal's current status. This is a markedly positive development. But it is also true that progress has been slow since the mid-2000s. Going back to the aforementioned issue of foreign investment, although inflows have continued their rate is now slower. There are many different reasons for this and not all of them can be put down to the idiosyncrasy of the emerging countries, but the lack of institutional improvement is nevertheless a burden.

It is therefore reasonable to conclude that emerging Europe has benefitted from joining the EU. The evidence confirms this but it also confirms that this beneficial effect is fading and the growth pattern changing. As pointed out in the article «Analysis of the emerging European economic cycle» in this Dossier, since 2009 the region has been moving towards what is sometimes called an

1. In this article, emerging Europe refers to the following countries: Poland, Czech Republic, Slovakia, Slovenia, Hungary, Latvia, Lithuania, Estonia, Romania, Bulgaria and Croatia. The first eight joined the EU in 2004, Romania and Bulgaria in 2007 and Croatia in 2013.

extensive growth model; i.e. more focused on accumulating factors of production than increasing productivity. To move back towards a model of intensive growth, the countries of emerging Europe will have to rethink their expectations of the EU and what they can contribute to its construction. They will also have to improve their infrastructures and embark once more on institutional improvements. The relationship between the EU and emerging Europe will be decisive in both cases, although here we will focus more on the former.

Emerging Europe is relatively less wealthy than the EU average. It has therefore tended to receive various EU funds and transfers to finance structural change. This change has essentially taken place by developing regions, providing infrastructures and modernising agriculture. As an annual average, since 2004 emerging Europe has received net transfers from the EU budget equivalent to 2.2% of GDP (in the same period Spain has received the equivalent to 0.3% of GDP). Irrespective of whether this EU aid has been used efficiently, such a large amount suggests the region's transformation has been greater thanks to these funds.

There is, however, a paradox. Due to the eligibility conditions for such funds, the more prosperous a country is, the fewer funds it receives. Emerging Europe therefore needs to discuss, and in depth, how to adjust regional policy and other structure-related funds as from 2020, when the current financial programming period comes to an end. But its influence on this discussion will also depend on whether its EU partners believe emerging Europe is helping to construct the European project. Recent relations between some emerging European countries and the EU are not very encouraging. In addition to the misunderstandings discussed in the article «Political risk in emerging Europe: how much should we be concerned?» in this Dossier, there are other indications of estrangement, such as the lukewarm response by some countries to them theoretically joining the euro. There is currently a window of opportunity (and certainly a need) to rekindle European integration, especially in the area of monetary integration. Such an attitude may therefore be a strategic error.[2] Emerging Europe should realise that the EU still offers considerable opportunities for the eastern half of the continent.

We have already mentioned a second aspect that needs to be changed in the region's growth model; namely institutional improvement, sometimes referred to as second-generation reforms. If joining the EU can act as an incentive to create a modern institutional framework, then surely we can find ways to ensure the progress of the EU and of emerging Europe's institutions goes hand in hand. In short, emerging Europe's hard work allowed it to benefit from an obvious economic dividend from integration over the past 20 years. Surely countries that are no longer the same as they were decades ago should now invest decisively in political capital and obtain, in fair exchange, the political benefits of integration. Or, to paraphrase John F. Kennedy, they should not ask what the EU can do for them but what they can do for the EU.

*Àlex Ruiz*
*Macroeconomics Unit, Strategic Planning and Research Department, CaixaBank*

2. On this issue, see Mestres, J. and Ruiz, À. (2017), «The European Union: the keys to a rebirth», in MR09/2017.

# Political risk in emerging Europe: how much should we be concerned?

Recently, the main emerging European countries have been in the spotlight of the European because of disagreements with the EU regarding refugee quotas. However, such disagreements have not arisen spontaneously. Behind this situation lie far-reaching political changes taking place in the region since the 2008 economic crisis. An examination of the region reveals that some governments now contain political parties in favour of heterodox policies that break away from the patterns set by Western democracies. These political parties are primarily Fidesz in Hungary, led by Viktor Orbán, in government since 2010, and Law and Justice in Poland (in power since 2015). There is also the ANO11 movement of billionaire Andrej Babiš in the Czech Republic, which has formed a minority government following election victory this autumn, and the Bulgarian far right, which participates in its country's coalition government. But to what extent does this new political scenario in emerging Europe increase political risk?

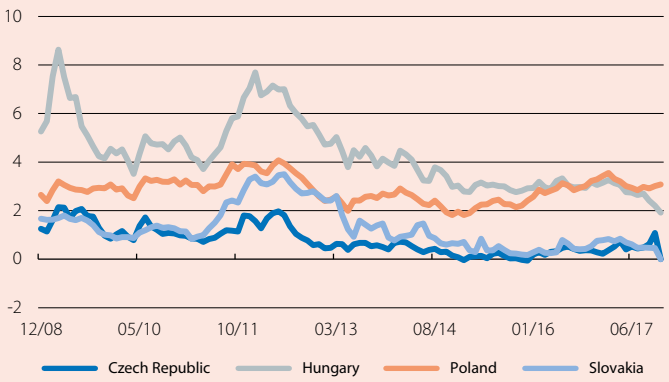
To begin with, several democratic quality indexes point to a relatively moderate and recent decline in this variable in emerging Europe. The aggregate index created by the Economist Intelligence Unit, which goes from 0-10 on a scale of less to more democratic, decreased from 6.83 in 2015 to 6.68 in 2016. Poland has particularly declined, due to a low score in functioning of government and political culture. Hungary has also deteriorated notably, albeit to a lesser extent, with a relative negative assessment of political participation. The decline reflects the nature of «illiberal democracies» in Hungary and Poland: greater governmental power, increasing economic interventionism and more control over some of the checks and balances that act as counterweights to the executive branch (courts, media, etc.).

The deterioration in these indexes may be a cause for concern but they should be interpreted with caution. These countries governments combine a populist rhetoric to boost support with a pragmatic stance that tends to prevail or at least temper the scope of the policies implemented. In Hungary, the protectionist measures implemented ownership (higher taxes in telecommunications, banking and energy) have significantly hurt certain strategic sectors with a high percentage of foreign. However, in recent years this trend has been offset by measures such as the 2015 Reconstruction and Development agreement with the European Bank, which includes a reduction in bank taxes in 2016-2019 and less public sector involvement in banking. Poland is currently the main focus of risk in the region. To date, the government is imposing similar fiscalmeasures to Hungary and is involved in a bitter dispute with the EU a over judicial reform which would undermine the independence of judges. However, pragmatism may still prevail. One sign pointing to the pragmatic avenue is that the initial plan to convert mortgages in Swiss francs into the local currency[1] appears to have been reconsidered, easing the fears of the banking sector. Another fact reinforces this pragmatic hypothesis: Fidesz and Law and Justice are not newcomers (the first was created in 1988 and the second in 2001) but have shifted from traditional conservative positions to more heterodox positions to broaden their base of support.

So far, financial markets have not severely penalised emerging European countries. Long-term sovereign bonds spreads of emerging European countries with the Germand bund have remained contained, despite some sporadic upswings in Hungary. Here the financial markets have been quite benevolent, believing in the ultimate pragmatic approach. For instance, Hungarian public debt held by foreigners grew significantly between 2010 and 2014, although the proportion has decreased in recent years. The responsible fiscal policies and reduction in the deficit carried out by Orbán's government during this time have certainly

***Sovereign risk: spread between the 10-year sovereign bond and the German bund***

*(pp)*




***Long-term debt of the Hungarian government held by foreigners***

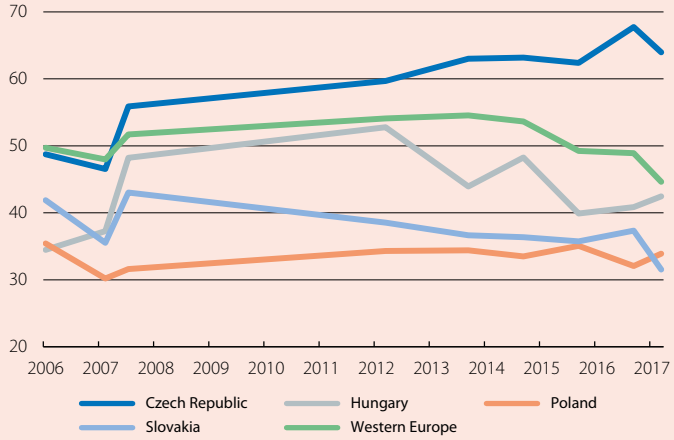
*(% of total debt)*


***Note:*** *Long-term debt is debt with a maturity longer than one year.*
***Source:*** *CaixaBank Research, based on data from Hungary's Government Debt Management Agency (AKK) and the OECD.*

1. More than 500,000 mortgages denominated in foreign currency, mostly in Swiss francs, were taken out by Polish citizens before 2008. The initial plan meant that foreign currency loans had to be converted into zlotys at a historical exchange rate, with banks having to absorbing the resulting losses.

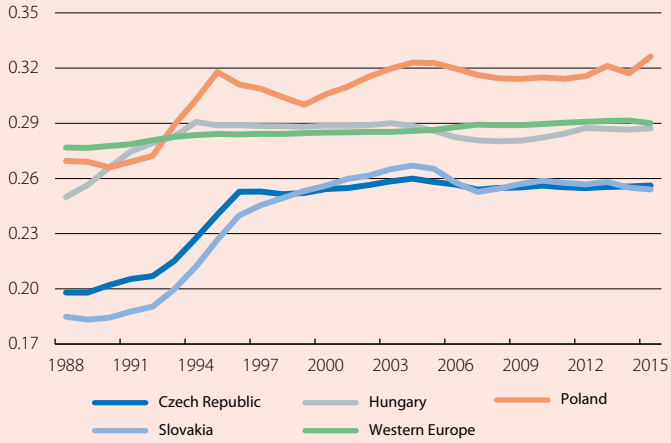
### *Citizens dissatisfied with the EU*

*(%)*




### *Economic inequality*

*Gini index **




***Note:*** ** The Gini index ranges from 0 (maximum equality) and 1 (maximum inequality).*
***Source:*** *CaixaBank Research, based on data from the Eurobarometer and The Standardised World Income Database.*

helped Hungary to maintain good access to the financial markets despite its various clashes with the IMF and EU. The scenario is somewhat more disturbing in Poland. Nevertheless any precise diagnosis seems premature after only two years of Law and Justice in government. One of the main focuses of attention in the markets is the impact on public finances of the expansionary fiscal policies undertaken, as it is feared these may lead to an excessive increase of public deficit. S&P has internalised such concerns and, as a result, downgraded the country's sovereign debt rating from A– to BBB+.

But why is there so much support for non-conventional parties?[2] Using data from the European Social Survey of 2012, 2014, and 2016 in Poland, Hungary and the Czech Republic, we note that 47.6% of the explained variance in the vote for these parties is related to cultural and demographic issues, 21.3% to indicators of confidence in institutions and 18.2% to economic reasons. Factors such as religious beliefs, age and concern about inequality emerge as key for voters of these parties. In fact, the increasing inequality in these countries since the break-up of the USSR may have created support for these parties' policies, which stressed economic and social protection in their political platforms. On the other hand, Europe does not seem to be a predominant factor: only a trivial 3% of the explained variance of the vote for these parties is explained by concerns about the EU. Moreover, the people of Poland and Hungary feel more attached to the EU than the average for Western Europe. However, the importance attached by these societies to cultural factors has led to a considerable degree of opposition to the EU migration policy. As a result, the current pragmatism could mutate into a more belligerent position should these countries feel their cultural identity is under threat due to further migratory pressures not properly managed by the EU.

Finally, we should also look briefly at the geopolitical relations of emerging Europe and the complex balancing act the region must achieve. The Polish and Hungarian governments realise that, although their citizens are relatively pro-Europe, there are issues such as monetary union or the aforementioned migration policy that do arouse considerable opposition.[3] These governments have taken advantage of this situation to adopt Eurosceptic positions on these issues and strengthen themselves internally and gain more support. In fact, opposition to refugee quotas in these countries may provide a boost to the Visegrad group, the regional alliance formed by Hungary, the Czech Republic, Poland and Slovakia. Lastly, it is difficult to achieve a rapprochement with Russia that goes much beyond mere strategic interests, as the scars left by the USSR are too recent. Orbán's approach once again leans towards pragmatism: cooperation with Russia has focused on strategic issues such as the energy industry (emerging Europe is highly dependent on Russia for energy) and trade relations, but has not pursued issues of a more political or territorial nature.[4]

In short, emerging Europe has undergone some far-reaching political transformations but the political risk is still moderate. It is important not to lose our sense of perspective. To use a weather analogy: there have certainly been some strong gusts of wind but we have not suffered the populist gale predicted by some forecasters. However, the importance attached by these societies to cultural and demographic factors could tempt their rulers to step up the tone and abandon pragmatism, which would intensify frictions within the EU. Let us hope, however, that good judgement and *fineza* will prevail.

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

2. We include other parties such as Jobbik (Hungary) and SPD (Freedom and Direct Democracy) (Czech Republic).
3. According to the November 2017 Eurobarometer, 57% of Poles are against Monetary and Economic Union while 43% oppose a common migration policy.
4. See Buzogány, A. (2017), «Illiberal democracy in Hungary: authoritarian diffusion or domestic causation?», Democratization.

# Emerging Europe: growing with fewer risks

Since 2014, emerging Europe[1] countries have posted several consecutive years of solid growth, with an average GDP growth above 3% per year. For 2018, the outlook remains positive: the consensus of analysts and major international institutions expect the region to continue to grow strongly. In this context, and given that, in previous expansionary cycles, especially in the period leading up to the global financial crisis, the region's growth was accompanied by increased macroeconomic imbalances (such as a sharp rise in private debt levels and a significant deterioration of the external position), it is important to determine whether such vulnerabilities are being built up in the current expansion. In order to answer this question, we analyse the evolution of the main macrofinancial imbalances that were present in the region in 2008.

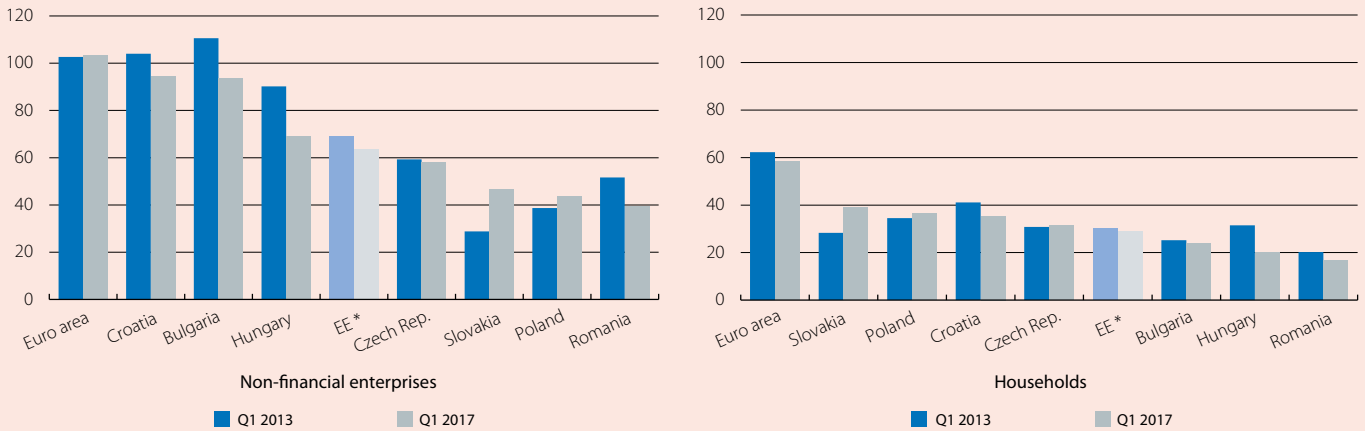
Firstly, the recent economic upswing has not been accompanied by an increase in private debt levels. Quite the opposite: private sector leveraging has fallen in most of these countries. As the first chart shows, corporate debt has decreased by 5.4 pp on average, to 63.7% of GDP in 2017, while household debt has fallen by 1.2 pp on average, to 29.0% of GDP, well below the euro area average[2] and the threshold set by the European Commission in its Macroeconomic Imbalance Procedure (MIP).[3] However, private debt levels are still relatively high in Croatia (almost 130% of GDP) and Bulgaria (117% of GDP), and have risen considerably in Slovakia,[4] albeit from a relatively low base.

Similarly, bank credit, both to corporates and households, has started to recover, and is advancing at a moderate pace, below nominal GDP growth. Moreover, credit is increasingly denominated in local currency, unlike the period leading up to the financial crisis, when a significant proportion of credit was denominated in foreign currency. In particular, loans to households denominated in local currency account for circa 82% of total loans, compared with 61% in 2013; while loans to non-financial corporates denominated in local currency have increased slightly, to 63% of total loans (57% in 2013). Nevertheless, developments in some countries warrant close monitoring. For example, credit is growing at a much faster pace (10% year-on-year) in Slovakia and the Czech Republic. And in Croatia, Poland, and Romania a considerable proportion of loans is still denominated in foreign currency, which makes them vulnerable to a depreciation of the currency.

Secondly, these countries' external position, which was a significant source of vulnerability before the global financial crisis, has improved considerably over the past few years, placing the region in a better position when confronted with changes in global financial conditions. In particular, over the past four years, the net international investment position (NIIP) has improved by 18.1 pp, to –53.2% of GDP in 2017, although it remains above the European Commission's vulnerability threshold (–35% of GDP).

### *Emerging Europe: gross private debt*

*(% of GDP)*



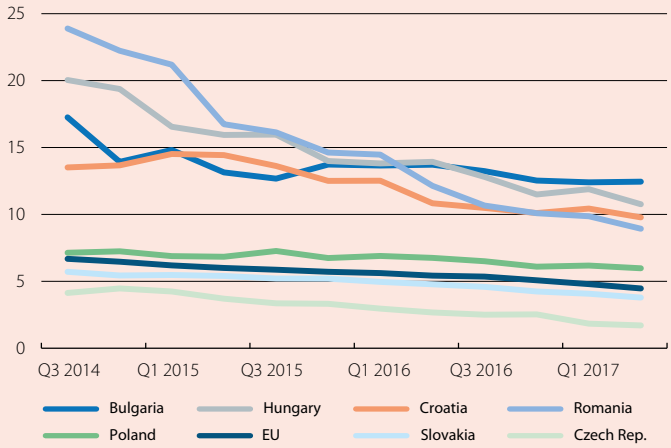

***Note:*** ** EE refers to the average for the emerging Europe countries analysed (Croatia, Bulgaria, Hungary, Czech Republic, Slovakia, Poland and Romania).*
***Source:*** *CaixaBank Research, based on data from Eurostat.*

1. Bulgaria, Slovakia, Hungary, Poland, Czech Republic and Romania.
2. From 161.2% of GDP in total (enterprises and households), according to Eurostat figures for Q1 2017.
3. 133% of GDP for all private debt.
4. 28.7 pp of GDP between Q1 2013 and Q1 2017.
5. External liabilities account for approximately 100% of GDP on average.
6. IMF (2017), «Regional Economic Issues: Central, Eastern and Southeastern Europe».

Moreover, the composition of these countries' external liabilities[5] is a mitigating factor, given that the bulk of the stock is direct investment and intercompany lending, which are generally more stable.[6] Likewise, current accounts have also improved considerably. In fact, most of these countries have replaced their high external deficits, which reached 9.7% of the GDP on average in 2007, with surpluses, which will help to improve their debt position should they continue to post surpluses. Lastly, international reserves, one of the buffers against external crises, are within the levels deemed safe by the IMF.

***Emerging Europe: NPL ratio***

*Non-performing loans (% of total credit)*




***Source:*** *CaixaBank Research, based on data from the EBA Quarterly Dashboard.*

Banks are also in a stronger position to continue to support the region's growth. The sector is generally well-capitalised, with CET1 (fully-loaded) capital ratios above the European average (14.0%), and with coverage ratios[7] above 60% on average. Moreover, profitability is also relatively high (average ROE is 13%, compared with 7.0% in the EU) although it has also been affected by factors that are impacting all European banks, such as the low interest rate environment and the increased regulatory pressure.

Similarly, over the past few years, efforts have been made to repair bank balance sheets. In particular, asset quality has improved considerably thanks to sales of NPLs, the conversion of loans denominated in foreign currency (with higher default rates) into local currency and the more favourable economic context. The average NPL ratio has fallen from 13.1% of total credit in 2014 to 7.6% in 2017, although in some countries, such as Bulgaria and Hungary, NPLs are still high (see the second chart). In this context, a recent report by the Vienna Initiative[8] notes that some factors are still hindering the resolution and sale of non-performing loans, and recommends strengthening the legal framework for bankruptcy and foreclosure proceedings to deepen the secondary market for NPL.

Nonetheless, some sources of vulnerability persist. Over the past few years, some policies have had a strong impact on the banking sector, such as the bank levies in Hungary and Poland and the FX-denominated mortgage conversion programmes in Hungary and Croatia.[9] Such policies have reduced profitability and had a negative impact on credit activity. Although some of this risk has diminished recently,[10] the political sphere is still a source of uncertainty in some countries. For instance, Poland has yet to specify the conversion plan of FX-denominated mortgages into zlotys. Although the initial proposals, which entailed considerable costs for banks, appear to have been ruled out, uncertainty remains high. Meanwhile, in Hungary, Romania and Poland, the correlation between sovereign and bank risk is increasing, as domestic banks are holding increasingly more sovereign bonds, which now account for over 15% of all bank assets.

To sum up, the region's improved macroeconomic situation has been accompanied by a reduction of macrofinancial imbalances, although some sources of vulnerability remain and should be closely monitored.

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

7. Reserves as a share of total non-performing assets.
8. Public-private initiative set up in 2009 whose aim is to safeguard the financial stability of emerging Europe.
9. Prior to the GFC crisis, many consumers in the region took out loans denominated in Swiss francs, attracted by Switzerland's lower interest rates. However, with the global financial crisis and, subsequently, with the abandonment by the Swiss National Bank of fixed exchange rate with the euro, the Swiss franc appreciated sharply in relation to these countries' currencies, increasing debt service costs substantially.
10. In 2015, the Hungarian government signed an agreement with the EBRD, in which the Hungarian government committed itself to promote a stable and predictable policy framework to encourage macroeconomic stability; to gradually reduce the bank levy, and to implement measures to help reduce NPLs. In Romania, risks have decreased for now after two rulings of the Constitutional Court against the conversion law of FX-denominated mortgages and part of the law on debt repayment (which allowed mortgage holders to pay off their debts without penalty if the bank took over the mortgaged property).

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| | MILLION € |
|---|---|
| Customer funds | 350,014 |
| Loans and advances to customers, gross | 225,166 |
| Profit attributable to Group, YTD | 1,488 |
| Market capitalisation | 25,346 |
| | |
| Customers (million) | 15.8 |
| Employees | 37,304 |
| Branches | 5,397 |
| Branches in Spain | 4,697 |
| Self-service terminals in Spain | 9,403 |

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| | MILLION € |
|---|---|
| Social | 307.5 |
| Excellence in research and training | 91.1 |
| Raising awareness of culture and knowledge | 121.4 |
| ***TOTAL BUDGET*** | **520** |

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