MR09

MONTHLY REPORT • ECONOMIC AND FINANCIAL MARKET OUTLOOK

NUMBER 426 | SEPTEMBER 2018

ECONOMIC & FINANCIAL ENVIRONMENT

DOSSIER: GLOBALISATION AT THE CROSSROADS

CaixaBank Research

MONTHLY REPORT - ECONOMIC AND FINANCIAL MARKET OUTLOOK
September 2018

The *Monthly Report* is a publication developed jointly by CaixaBank Research and BPI Research (UEEF)

CaixaBank Research
www.caixabankresearch.com
research@caixabank.com
Enric Fernández
Chief Economist
Oriol Aspachs
Director, Macroeconomics and Financial Markets
Estel Martín
Director, Banking Strategy

BPI Research (UEEF)
www.bancobpi.pt /
http://www.bancobpi.pt/grupo-bpi/estudos-e-mercados/mercados-financeiros
deef@bancobpi.pt
Paula Carvalho
Chief Economist

Date this issue was closed:
31 August 2018

INDEX

Lessons from Greece

In October 2009, the Government of George Papandreou announced that Greece's public deficit that year was going to exceed 12% of GDP, twice as much as previously estimated. In reality, the deficit ended up exceeding 15% of GDP. It was the prologue of a true Greek tragedy.

After nine years, three bailout programmes – the last of which ended in August – and the largest debt restructuring in history, Greece has managed to stabilise its economy and is beginning to grow. However, the cost of this long process of adjustment has been tremendous: GDP has fallen by 25%, the unemployment rate exceeds 20% and public debt stands at over 180% of GDP.

From the experience of Greece, we can draw at least five lessons:

i) Transparency and the quality of the information provided by governments is of the utmost importance (a maxim that, of course, also applies to companies). The review of the deficit in 2010 represented a mortal blow to the credibility of the Greek institutions and resulted in the immediate loss of access to the markets. The poor quality of information (either because it was not correctly compiled or because it was directly falsified) also made any early detection of the imbalances that were accumulating in the public accounts a difficult task.

ii) The costs associated with a sustained loss of competitiveness within the monetary union can be enormous. Before the crisis, Greece's current account deficit exceeded 15% of GDP. Given that resorting to an exchange-rate adjustment was not an option, closing this gap has required an enormous and costly internal devaluation in order to recover the competitiveness that had been lost. In fact, the process is not yet over: it seems incredible but, despite the reduction in domestic demand, Greece still imports more than it exports.

iii) There is a high price to pay for questioning ones country's membership of the monetary union. After accounting for the impact of these doubts, the cost has been very high, with additional declines in economic activity and outflows of deposits. Besides mere statements, a country's commitment to the euro is demonstrated through its willingness and capacity to implement an economic policy that promotes competitiveness, sustainable public finances and an equitable sharing of the costs of the financial crisis (which requires strong resolve in the face of interest groups protecting certain privileges).

iv) Fiscal discipline in the good times is key for being able to manage during a period of slowdown or recession. In the years prior to the crisis, with reasonably good growth, Greece recorded fiscal deficits of around 6% of GDP, while the public debt stood at over 100% of GDP. The situation before the arrival of the Great Recession, therefore, was one of extreme vulnerability. The good years were not used as an opportunity to put the country's accounts in order and gain the fiscal headroom necessary to implement countercyclical policies when they would become necessary.

v) The Economic and Monetary Union (EMU) needs to be strengthened. Greece has suffered much more than it should have, due to the financial fragmentation which exists within the Union, due to the *doom loop* between sovereign risk and banking risk, and due to the absence of a European fiscal authority with the capacity to absorb asymmetric shocks within the EMU. The Banking Union (BU) and the European Stability Mechanism (ESM) are intended to cover these deficiencies, but they do so imperfectly, since the BU is still incomplete and the ESM is not a true European treasury.

As for the Greek tragedy, we still do not know how it will end. The EU has recently extended the maturities of the Greek debt by 10 years, which gives the country's Government a substantial respite. It also ensures a long performance. It remains to be seen if its ending can be a happy one.

Enric Fernández
Chief Economist
31 August 2018

Chronology

AUGUST 2018

20 Greece completes the third bailout programme after eight years of supervision by the EU, the ECB and the IMF.
23 The second phase of tariff hikes between the US and China enters into force (on 16 billion dollars of imports, out of the total of 50 billion).
27 The US and Mexico announce a preliminary trade agreement to replace the North American Free Trade Agreement (NAFTA).

JUNE 2018

13 The Fed raises the official rate by 25 bps, placing it within the range of 1.75%-2.00%.
14 The ECB announces that the net purchases of assets will decrease to 15 billion euros per month starting in October, before being brought to an end in December 2018.

APRIL 2018

13 The credit rating agency Moody's raises Spain's credit rating from Baa2 to Baa1.

JULY 2018

6 The first phase of tariff hikes between the US and China enters into force (on 34 billion dollars of imports, out of the total of 50 billion).

MAY 2018

8 The US abandons the Iran nuclear deal reached in 2015 and announces the restoration of sanctions.
Argentina requests financial aid from the IMF to deal with the country's significant macroeconomic imbalances.
31 The US imposes tariffs on imports of steel and aluminium from Europe, Mexico and Canada.

MARCH 2018

8 President Trump imposes tariffs on imports of steel and aluminium.
21 The Fed raises the fed funds rate by 25 bp to a range of 1.50%-1.75%.

Agenda

SEPTEMBER 2018

4 Spain: registration with Social Security and registered unemployment (August).
12 Portugal: CPI (August).
13 Governing Council of the European Central Bank meeting.
18 Spain: quarterly labour cost survey (Q2).
20 Portugal: loans and deposits (July).
24 Spain: balance of payments (Q2).
Spain: net international investment position (Q2).
25 Portugal: state budget execution (August).
25-26 Federal Open Market Committee meeting.
27 European Council meeting.
Euro area: economic sentiment index (September).
Spain: household savings rate (Q2).
28 Spain: GDP breakdown (Q2).
Spain: CPI flash estimate (September).
Spain: loans, deposits and NPL ratio (July and Q2).
Portugal: employment and unemployment (August).

OCTOBER 2018

2 Spain: registration with Social Security and registered unemployment (September).
11 Portugal: CPI (September).
15 Spain: financial accounts (Q2).
18 Spain: loans, deposits and NPL ratio (August).
22 Portugal: loans and deposits (August).
25 Governing Council of the European Central Bank meeting.
Spain: labour force survey (Q3).
Portugal: state budget execution (September).
26 US: GDP (Q3).
30 Euro area: economic sentiment index (October).
Euro area: GDP (Q3).
Spain: CPI flash estimate (October).
Portugal: employment and unemployment (September).
31 Spain: GDP flash estimate (Q3).

Global uncertainty begins to take its toll

The financial markets point towards a less placid scenario. For several months now, the financial markets have been leaving the phase of very low volatility of recent years behind. In the summer, this new predicament then became all-the-more present: after a start to the summer marked by the stock markets alternating between indecision and gains, in August the financial markets were stressed by doubts surrounding the strength of growth in China, the succession of trade threats with the US and a spike in financial turmoil in Turkey. These factors, framed within the context of a global tightening of monetary policy and greater risk aversion, affected the emerging economies in particular, with their stock markets and currencies suffering major losses during August. The advanced economies, meanwhile, dealt with the turmoil unevenly. In Europe, prices on the financial markets were erratic, not only because of the turmoil in the emerging markets but also due to a spike in uncertainty surrounding Italy's fiscal policy. In the US, in contrast, the stock markets continued to break records and reached new all-time highs. However, if we set aside the idiosyncrasy of the US, the performance of the markets suggests that the uncertainty is taking its toll on investor sentiment. In fact, this is a situation that is also reflected in the real economy.

The growth of the emerging markets, and consequently global growth, will be lower than expected. The economic indicators known in the summer months confirm that the growth rate of global economic activity is readjusting: while there is growing evidence that the persistent economic uncertainty is taking its toll on the growth of some emerging economies, it is also clear that the advanced economies are on a different wavelength. The US experienced significant acceleration in its growth rate in Q2 and continues to have cyclical momentum, although this should lose strength in 2019 (due to the dissipation of the fiscal impulse, among other factors). The euro area, meanwhile, saw only a slight moderation in the growth of its economic activity. Overall, the scenario forecast by CaixaBank Research has been adjusted to account for this progressive weakening. Specifically, the growth figures for the emerging markets expected for the current year and the next have been revised downwards, as have those for the global economy as a result. Despite the moderation of the outlook set out above, the balance of risks continues to point towards a possible weakening of the economy in the future. In particular, the protectionist shift of the US and its possible global implications continue to play a prominent role and, unfortunately, remained active throughout the summer. In this regard, the good news that the US and Mexico have reached a bilateral trade agreement in principle was overshadowed by the resurgence of the threats of tariffs between the US and China.

The Spanish economy tempers its growth rate, and the Portuguese could follow a similar path. In line with the scenario foreseen by CaixaBank Research, the Spanish economy is entering a more mature phase of the business cycle, and in Q2 2018, GDP growth slowed moderately down to 0.6% quarter-on-quarter (2.7% year-on-year), 1 decimal point below the figure for Q2. All in all, this new phase will not represent an abrupt change in the rate of economic activity, since after growing by 3.1% in 2017, we expect GDP to grow by a solid 2.7% this year and by 2.3% in 2019 (in both years, 1 decimal point less than previously expected). Furthermore, this shift does not change the fact that most of the macroeconomic trends seen in recent months remain in force. For instance, the labour market remains highly dynamic (in Q2, 469,000 jobs were created, the biggest quarter-on-quarter increase since the series began), inflation remains stable and bank lending is growing at a good rate (new bank lending for consumption and for housing grew by 22% and 16% in the year to date up to July, respectively, compared with the same period in the previous year). In Portugal, meanwhile, quarter-on-quarter growth in Q2 stood at 0.5%, 1 decimal point above the previous quarter. In year-on-year terms, the acceleration went from 2.1% to 2.3%. The cornerstone of the growth continues to be domestic demand, which is being supported by the buoyancy of the labour market (in Q2, employment grew by 2.4% year-on-year and the unemployment rate stood at 6.7%, the lowest ever recorded in the historical series). Despite this recent progress, various indicators suggest that domestic and external demand will be less buoyant in the future than in the past. This leads us to revise the growth forecasts for 2018 and 2019 down to 2.1% and 1.9%, respectively (2 tenths less than in CaixaBank's previous scenario).

Financial markets

	Average 2000-2007	Average 2008-2015	2016	2017	2018	2019	2020
INTEREST RATES							
Dollar							
Fed funds	3.43	0.48	0.64	1.39	2.50	3.00	3.25
3-month Libor	3.62	0.69	0.98	1.61	2.80	3.29	3.20
12-month Libor	3.86	1.18	1.67	2.05	3.10	3.41	3.25
2-year government bonds	3.70	0.72	1.18	1.84	2.90	3.42	3.30
10-year government bonds	4.70	2.70	2.49	2.41	3.10	3.65	3.55
Euro							
ECB depo	2.05	0.50	–0.40	–0.40	–0.40	–0.20	0.25
ECB refi	3.05	1.13	0.00	0.00	0.00	0.25	0.75
Eonia	3.12	0.77	–0.35	–0.34	–0.35	–0.10	0.40
1-month Euribor	3.18	0.93	–0.37	–0.37	–0.34	–0.08	0.42
3-month Euribor	3.24	1.13	–0.32	–0.33	–0.32	–0.04	0.44
6-month Euribor	3.29	1.30	–0.22	–0.27	–0.22	0.12	0.62
12-month Euribor	3.40	1.51	–0.08	–0.19	–0.12	0.27	0.79
Germany							
2-year government bonds	3.41	0.85	–0.76	–0.69	–0.45	0.08	0.73
10-year government bonds	4.30	2.21	0.29	0.35	0.65	1.26	1.96
Spain							
3-year government bonds	3.62	2.59	–0.13	–0.04	0.06	0.68	1.35
5-year government bonds	3.91	3.16	0.30	0.31	0.48	1.11	1.77
10-year government bonds	4.42	4.13	1.43	1.46	1.50	2.06	2.66
Risk premium	11	192	114	110	85	80	70
Portugal							
3-year government bonds	3.68	4.85	0.76	–0.05	0.08	0.85	1.68
5-year government bonds	3.96	5.42	2.05	0.46	0.72	1.44	2.20
10-year government bonds	4.49	5.90	3.75	1.84	1.95	2.51	3.11
Risk premium	19	369	346	149	130	125	115
EXCHANGE RATES							
EUR/USD	1.13	1.33	1.05	1.18	1.21	1.23	1.24
EUR/JPY	129.50	127.13	122.41	133.70	131.89	129.15	127.72
USD/JPY	115.34	96.09	116.06	113.02	109.00	105.00	103.00
EUR/GBP	0.66	0.83	0.85	0.88	0.89	0.88	0.87
USD/GBP	0.59	0.62	0.80	0.75	0.74	0.71	0.70
OIL PRICE							
Brent ($/barrel)	42.32	90.70	54.92	64.09	68.00	66.00	66.00
Brent (euros/barrel)	36.35	67.78	52.10	54.17	56.20	53.66	53.23

Note: *The figures correspond to the average for the last month in the period, unless otherwise specified.*

Forecasts

Percentage change versus the same period of the previous year, unless otherwise indicated

International economy

	Average 2000-2007	Average 2008-2015	2016	2017	2018	2019	2020
GDP GROWTH							
Global	4.5	3.3	3.2	3.7	3.8	3.7	3.6
Developed countries	*2.6*	*1.1*	*1.7*	*2.4*	*2.3*	*2.1*	*1.8*
United States	2.7	1.4	1.6	2.2	2.8	2.3	1.9
Euro area	2.3	0.2	1.8	2.5	2.1	1.9	1.7
Germany	1.7	0.9	1.9	2.5	2.1	2.0	1.8
France	2.0	0.5	1.1	2.3	1.7	1.9	1.6
Italy	1.5	–1.0	1.0	1.6	1.1	1.0	1.0
Portugal	1.5	–0.6	1.6	2.7	2.1	1.9	1.9
Spain	3.8	–0.4	3.3	3.1	2.7	2.3	2.2
Japan	1.5	0.3	1.0	1.7	0.9	1.1	0.6
United Kingdom	2.8	1.0	1.8	1.7	1.3	1.7	1.9
Emerging countries	*6.6*	*5.2*	*4.4*	*4.7*	*4.9*	*4.8*	*4.7*
China	11.7	8.6	6.7	6.9	6.5	6.2	6.0
India	9.7	6.7	7.9	6.2	7.4	6.9	6.2
Indonesia	5.5	5.8	5.0	5.1	5.1	4.9	4.8
Brazil	3.6	2.3	–3.5	1.0	1.5	2.1	2.0
Mexico	2.4	2.0	2.9	2.0	2.1	2.3	2.3
Chile	5.0	3.4	1.3	1.5	3.7	3.0	2.7
Russia	7.2	1.1	–0.2	1.5	1.7	2.0	2.0
Turkey	5.4	5.0	3.2	7.3	4.0	2.5	3.3
Poland	4.0	3.2	3.0	4.7	4.7	3.0	2.7
South Africa	4.4	2.0	0.7	1.3	1.1	1.3	1.6
INFLATION							
Global	4.1	3.9	2.8	3.0	3.4	3.3	3.2
Developed countries	*2.1*	*1.6*	*0.8*	*1.7*	*2.1*	*2.0*	*1.9*
United States	2.8	1.7	1.3	2.1	2.4	2.0	2.1
Euro area	2.1	1.5	0.2	1.5	1.7	1.7	1.8
Germany	1.7	1.4	0.4	1.7	1.8	1.8	1.9
France	1.8	1.3	0.3	1.2	2.1	1.7	1.8
Italy	1.8	1.4	0.0	1.3	1.2	1.5	1.6
Portugal	3.0	1.3	0.6	1.6	1.4	1.5	1.8
Spain	3.2	1.5	–0.2	2.0	1.7	1.8	2.0
Japan	–0.3	0.4	–0.1	0.5	0.7	0.8	1.2
United Kingdom	1.9	2.6	0.7	2.7	2.5	2.1	2.1
Emerging countries	*6.7*	*6.0*	*4.3*	*4.0*	*4.4*	*4.5*	*4.0*
China	2.6	2.7	2.0	1.6	2.0	2.4	2.4
India	4.5	8.0	4.9	3.3	4.8	4.9	4.6
Indonesia	8.7	6.0	3.5	3.8	3.4	3.5	2.7
Brazil	7.3	6.2	8.8	3.5	3.6	4.1	4.1
Mexico	5.2	4.1	2.8	6.0	4.5	3.8	3.4
Chile	3.1	3.5	3.8	2.2	2.5	2.9	3.0
Russia	14.2	9.5	7.1	3.7	2.9	3.9	4.0
Turkey	27.2	8.1	7.8	11.1	13.4	12.0	8.1
Poland	3.5	2.3	–0.2	1.6	1.4	2.7	2.5
South Africa	5.3	6.1	6.3	5.3	5.0	5.5	5.1

Forecasts

Percentage change versus the same period of the previous year, unless otherwise indicated

Spanish economy

	Average 2000-2007	Average 2008-2015	2016	2017	2018	2019	2020
Macroeconomic aggregates							
Household consumption	3.6	–1.1	2.9	2.4	2.2	1.9	1.9
Government consumption	5.0	0.8	0.8	1.6	1.9	0.9	0.7
Gross fixed capital formation	6.0	–4.2	3.3	5.0	4.8	3.4	2.7
Capital goods	5.4	–0.3	4.9	6.1	5.1	3.8	2.4
Construction	6.2	–7.0	2.4	4.6	5.0	3.2	2.9
Domestic demand (vs. GDP Δ)	4.6	–1.6	2.5	2.8	2.7	2.0	1.8
Exports of goods and services	4.8	2.4	4.8	5.0	2.2	3.6	3.9
Imports of goods and services	7.1	–1.4	2.7	4.7	2.3	2.9	2.9
Gross domestic product	**3.8**	**–0.4**	**3.3**	**3.1**	**2.7**	**2.3**	**2.2**
Other variables							
Employment	3.4	–1.9	3.0	2.8	2.5	2.0	2.0
Unemployment rate (% of labour force)	10.5	21.0	19.6	17.2	15.4	13.7	12.0
Consumer price index	3.2	1.5	–0.2	2.0	1.7	1.8	2.0
Unit labour costs	3.3	0.4	–0.6	–0.1	0.7	1.9	2.4
Current account balance (cum, % GDP)[1]	–6.0	–2.1	1.9	1.9	1.3	1.3	1.2
External funding capacity/needs (cum., % GDP)[1]	–5.3	–1.7	2.2	2.1	1.5	1.5	1.4
Fiscal balance (cum., % GDP)[2]	0.4	–7.3	–4.3	–3.1	–2.7	–2.0	–1.4

Notes: *1. Four-quarter cumulative total. 2. Four-quarter cumulative total. Excludes losses for assistance provided to financial institutions.*

Forecasts

Portuguese economy

	Average 2000-2007	Average 2008-2015	2016	2017	2018	2019	2020
Macroeconomic aggregates							
Household consumption	1.7	–0.5	2.1	2.3	2.3	2.0	1.9
Government consumption	2.3	–0.8	0.6	–0.2	0.4	0.4	0.2
Gross fixed capital formation	–0.3	–4.2	1.5	9.2	5.7	4.9	4.5
Capital goods	1.3	–1.0	5.2	13.8	7.5	6.5	5.5
Construction	–1.6	–7.0	–0.3	9.2	5.6	6.2	5.5
Domestic demand (vs. GDP Δ)	1.5	–1.4	1.7	2.9	2.6	2.3	2.1
Exports of goods and services	5.2	3.4	4.4	7.9	6.2	5.2	4.4
Imports of goods and services	3.6	1.2	4.2	7.9	6.7	5.6	4.5
Gross domestic product	**1.5**	**–0.6**	**1.6**	**2.7**	**2.1**	**1.9**	**1.9**
Other variables							
Employment	0.4	–1.4	1.2	3.3	2.5	0.8	0.6
Unemployment rate (% of labour force)	6.1	12.3	11.1	8.9	7.0	6.6	6.3
Consumer price index	3.0	1.3	0.6	1.6	1.4	1.5	1.8
Current account balance (cum, % GDP)[1]	–9.4	–4.8	0.6	0.3	0.2	0.2	0.2
External funding capacity/needs (cum., % GDP)[1]	–7.9	–3.4	1.6	1.4	1.2	1.2	1.2
Fiscal balance (cum., % GDP)[2]	–4.4	–6.8	–2.0	–3.0	–0.9	–1.0	–0.9

Notes: *1. Four-quarter cumulative total. 2. Four-quarter cumulative total. Excludes losses for assistance provided to financial institutions.*

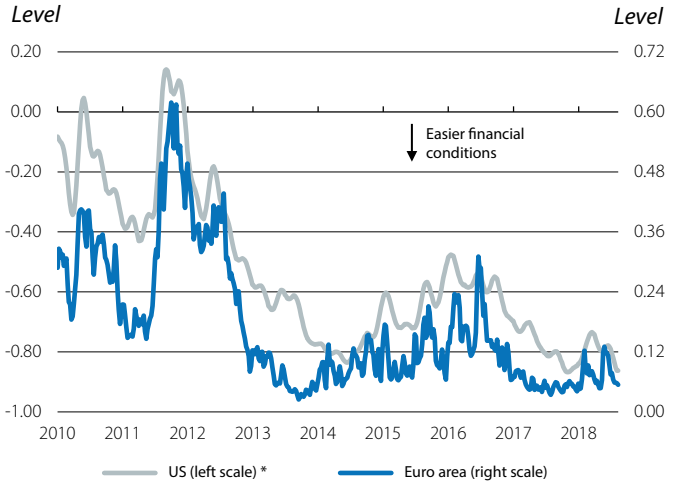
Forecasts

Volatility and the financial markets diverge in summer

The summer has also left behind the environment of very low volatility. The financial markets are leaving behind the period of very low volatility of recent years, with erratic stock market prices, higher risk premiums and interest rates, and weakness in the international currencies against the US dollar (particularly among the emerging economies). This change of panorama was also palpable during July and August. After a start to the summer marked by the stock markets alternating between indecision and gains, in August the financial markets were stressed by doubts surrounding the strength of growth in China, the succession of trade threats with the US and a spike in financial turmoil in Turkey (which had a severe impact in Turkey itself and also spread, to some extent, to the rest of the markets). These factors, framed within the context of a global tightening of monetary policy and greater risk aversion (fed by the geopolitical tensions), affected the emerging economies in particular. The emerging stock markets and currencies suffered major losses during the course of August and, once again, there were net outflows of capital according to the most recent (albeit still preliminary) data. The advanced economies, meanwhile, suffered the turmoil unevenly. In Europe, it was added to a spike in uncertainty surrounding Italy and its fiscal policy, and both the major stock markets and interest rates and risk premiums suffered instability. In the US, in contrast, the stock markets continued to break records and reached new all-time highs, although some indicators still shed concerns regarding the sustainability of these high valuations, especially in an environment of higher interest rates.

The emerging stock markets suffer, the European markets hesitate and the American markets break records. The main international stock markets exhibited differing behaviour over the course of the summer, which was marked by the turmoil suffered in August. In particular, the doubts surrounding the strength of the growth of the Chinese economy and the fears of a rise in protectionism at the global level had a widespread negative impact on the emerging economies' stock markets. In addition to these two factors, Turkey suffered a spike in financial volatility (caused by its high and growing macroeconomic imbalances). While the contagion was only moderate, on the Istanbul stock market this episode led to a correction of –10% (which was mitigated by the end of August). Thus, in July and August together, the MSCI index for the emerging markets as a whole closed down (–1.3%), driven by both the Asian indices (where the Shanghai stock market particularly suffered, with a decline of 4.3%) and those of Latin America. Among the advanced economies, the stock markets of the euro area showed a mixed performance, with slight gains in the core economies (the German DAX +0.5% and the French CAC +1.6%) and somewhat more marked losses in the periphery (Ibex 35 –2.3%, PSI 20 –1.9% and the Italian MIB –6.3%). In contrast, the US stock market enjoyed strong gains

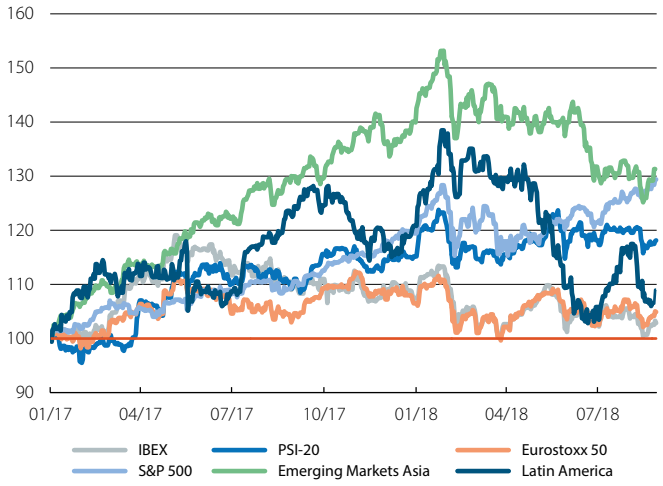
Financial conditions indicators



Notes: ** Financial Conditions Index of the Federal Reserve Bank of Chicago.*
*** Indicator of systemic stress of the ECB (two-week moving average).*
Source: *CaixaBank Research, based on data from Bloomberg.*

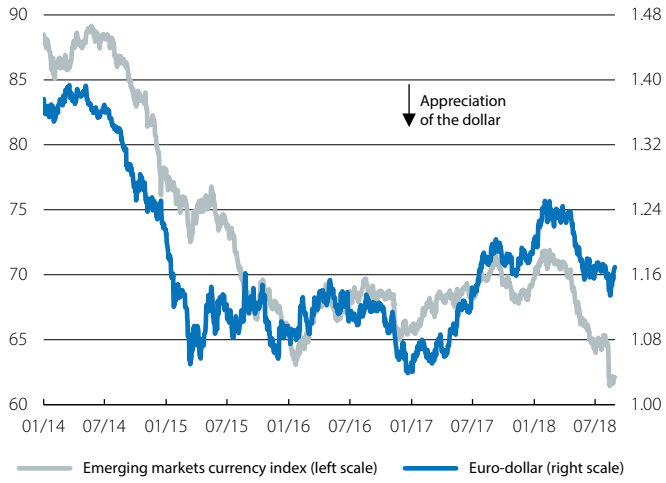
Main international stock markets

Index (100 = January 2017)



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

International currencies against the US dollar



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

(S&P 500 Index +6.7%), surpassing the levels registered prior to the corrections at the end of January and reaching new all-time highs.

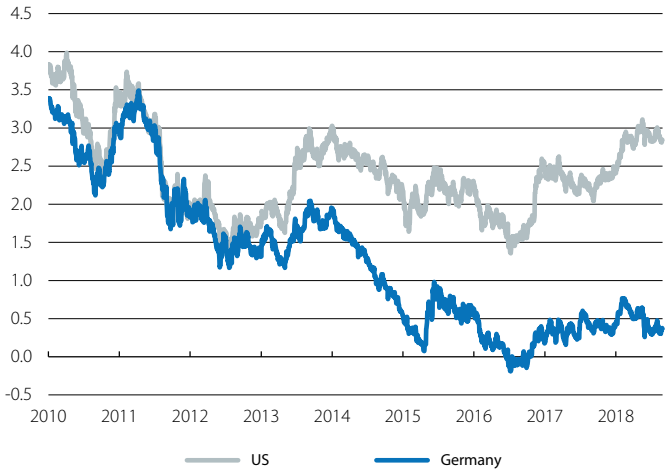
Widespread depreciation of the emerging currencies. Throughout the summer, the foreign exchange market served as a thermometer for the financial turmoil suffered by the emerging economies. The currencies that suffered the most over the summer were those that were already being watched by international investors (such as the Argentinian peso and the Turkish lira, which have depreciated by more than 100% and 70% since the start of the year and suffered depreciations over the summer of around 30% and 40%, respectively). That said, practically all the emerging currencies suffered against the US dollar (the JP Morgan Emerging currencies index lost around 5%). The Mexican peso was the notable exception, appreciating by 4% thanks to the progress made in the trade negotiations with the US, which culminated at the end of August with a preliminary bilateral agreement to replace NAFTA.

The advanced economies' central banks reiterate a positive view of the scenario. This summer, the Fed and the ECB offered no surprises and sent messages of continuity for their macroeconomic scenarios. In the US, the Fed kept its reference rates within the 1.75%-2.00% range at its meeting in late July, but reiterated that the strength of economic activity and the firmer inflationary dynamics support an approach of gradually increasing rates over the coming quarters. The ECB, meanwhile, offered no significant updates at its meeting in July, which focused on reinforcing the decisions taken at the June meeting (ending the net purchases of assets next December and the intention not to modify interest rates before September 2019). In this context, US sovereign interest rates fluctuated without following any clear trend, while in the euro area, the upturn in the Italian risk premium (reaching around 280 bps, close to the year's high point) due to the uncertainty surrounding its fiscal policy caused a slight rise in the premiums of the rest of the peripheral countries. On the whole, and despite the turmoil experienced over the summer, the macroeconomic scenario of the US and the euro area remains positive. Therefore, at their September meetings, the Fed and the ECB can be expected to continue with their strategies. Both investors and most analysts, including CaixaBank Research, expect the Fed to increase interest rates again and the ECB to reinforce its commitment to the announcements made in June.

Oil prices remained relatively stable. Despite the volatility suffered by the financial markets of the emerging economies over the summer, the price of crude oil was relatively stable and fluctuated between 70 and 75 dollars per barrel of Brent. Although the OPEC agreement to cut production (and the recent easing of quotas announced in June) supported this price stability in the case of oil, other commodities (such as copper, which experienced a fall of nearly 10% in its price between July and August) were significantly affected by the financial turmoil and the succession of trade threats exchanged by the US and China.

10-year public debt yield

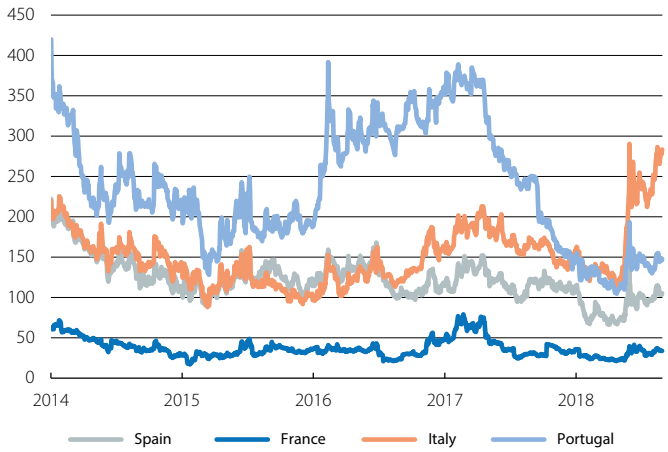
(%)



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

Euro area: risk premiums of 10-year public debt

(bps)



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

Brent oil price

(Dollars per barrel)

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

Can we predict volatility spikes and their consequences?

After a year of extraordinarily low levels of financial volatility in 2017, in 2018 the markets have shifted towards a more variable environment. However, for several years we saw relatively low volatility and very accommodative financial conditions coexist, with few interruptions. This raises questions about the accumulation of risks to financial stability, especially given the fear that the current situation has parallels with the years 2003-2007, which resulted in the last financial crisis. Can low volatility lead to episodes of instability in the future? What consequences can it have for economic growth? We address these questions below.

Recent lessons

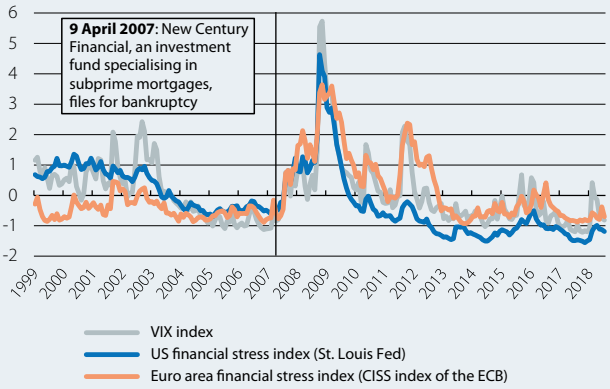
Financial and economic crises tend to be preceded by a period of high volatility. For example, greater volatility can be a symptom of a high degree of uncertainty that depresses investment, employment and economic growth in general. However, the red alert flag provided by a spike in volatility can come too late. As can be seen in the first chart, in the last financial crisis, both the stock market volatility indicators, exemplified by the VIX index, and the financial stress indicators produced by the major central banks remained at very low levels and did not indicate the onset of a financial crisis until it was virtually underway.[1] In fact, it was precisely during the period of low volatility (2003-2007) that the imbalances that would ultimately lead to the crisis of 2007-2008 accumulated.

The volatility paradox: «stability is destabilising»

The experience of 2007-2008 fuelled interest in the theories of the American economist Hyman Minsky (1919-1996), who argued that the prolongation of an environment of low volatility acts as fertiliser for the accumulation of imbalances that can lead to a financial crisis.[2] In particular, according to this view, an environment of low volatility generates excess optimism,[3] which in turn feeds strong growth in credit, leveraging and, ultimately, excess risk taking.[4] For example, optimism about the economic outlook raises asset valuations, which encourages investment and indebtedness. In addition, by underestimating the risks,

Financial stress and volatility indicators

Index (0 = historical average)



Note: ** The three indicators have been normalised with an average equal to 0 and a standard deviation equal to 1.*
Source: *CaixaBank Research, based on data from Bloomberg.*

economic players end up investing in lower-quality operations or in those with a higher probability of failure. Eventually, an increase in the number of failed projects and the resulting losses expose the poor decision-making of the past and cause a spike in volatility and, potentially, a financial crisis.

However, when this volatility spike is observed, it is already too late to take measures to prevent or mitigate a crisis. Therefore, this view calls into question both the idea of waiting to observe higher volatility before taking action against a possible crisis and the validity of using instruments, such as financial stress indices presented in the first chart, to predict a crisis sufficiently early.[5] On the contrary, the «volatility paradox» shows us that it is precisely during periods of low volatility that we must try to detect the generation of imbalances.

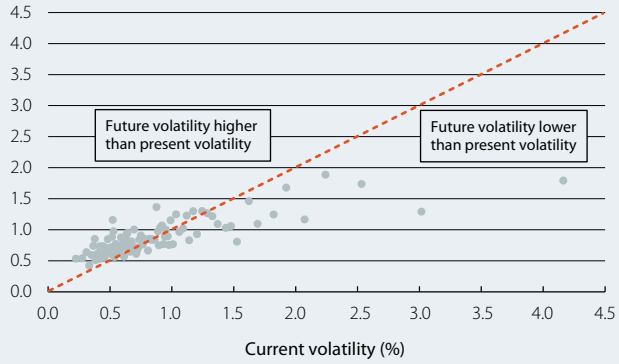
Empirical Evidence

In the second chart, we present a first empirical estimate of the relationship between present and future volatility.[6] This shows that periods of very low volatility tend to be followed by periods of slightly higher volatility, while

1. In the financial markets, the first clear signal appeared in April 2007, when New Century Financial, a US fund specialising in subprime mortgages, filed for bankruptcy. The tensions escalated rapidly in August 2007, when BNP Paribas was the first major bank to freeze investment products and to recognise problems in assessing the underlying assets linked to subprime mortgages.
2. See, for example, H. Minsky (1992), «The Financial Instability Hypothesis», Working Paper n° 74.
3. For example, because when economic players are unable to identify the true risk of an investment, they infer it based on the volatility observed in the past.
4. There are important studies documenting the link between strong growth in credit and the occurrence and severity of financial crises. See, for example, O. Jorda, M. Schularick and A. Taylor (2016), «Macrofinancial History and the New Business Cycle Facts», NBER Macroeconomics Annual, and other references that can be found in the Dossier «Bubbles and monetary policy» of the MR11/2017.
5. Analyses of the 2007-2008 financial crisis also conclude that indicators of this type would not have been capable of anticipating it sufficiently early. See Rose and Spiegel (2009), «Could an early warning system have predicted the crisis?», column at voxeu.org, and S. Giglio *et al.* (2016), «Systemic Risk and the Macroeconomy: An Empirical Evaluation», NBER Working Paper.
6. Figures relating to the realized volatility in US stock market returns in the period 1926-2018.

Volatility: persistence and mean reversion

*Average volatility 12 months in the future (%) **



Note: ** Realized monthly volatility of the daily returns of a portfolio that includes all the companies listed on the NYSE, AMEX, and NASDAQ with a CSRP code equal to 10 or 11.*
Source: *CaixaBank Research, based on data for the period 1926-2018 from the website of Kenneth R. French.*

periods of high volatility tend to fade and give rise to an environment of lower volatility. Although this historical relationship suggests that it is reasonable for the extraordinarily low volatility of 2017 to result in a somewhat more unstable financial environment in 2018, it does not indicate that an environment of very low volatility causes upheaval in the future.

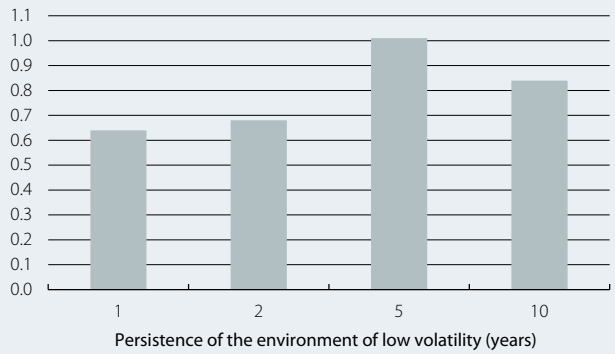
However, the hypothesis of the «volatility paradox» finds empirical support in a more refined analysis of the data. According to the 2018 study by Danielsson *et al.*,[7] which analyses a long period of time and a wide range of countries (they have information for 60 countries and 211 years of history, with an average of 62 years per country), over the course of history, a persistent decline in volatility has foretold episodes of financial instability. Specifically, although they observe that the level of volatility does not in itself predict an upturn in financial tensions, they do find that persistent reductions in volatility below its recent trend tend to indicate financial tensions in the future. In particular, as shown in the third chart in which we present the main results of the study, the effect varies depending on the persistence of the environment of low volatility. For example, when volatility lies 1% below its trend for five years, the likelihood that this will lead to a financial crisis increases by 1.0%. Furthermore, the authors find evidence that long periods of low volatility induce excessive credit growth and an increase in leverage.

Consequences for growth

The relationship between the persistence of an environment of low volatility and future financial crises has parallels with the impact that an accommodative financial environment has on future economic growth. Specifically, although favourable for short-term growth, the prevalence of very lax financial conditions may have a negative impact on economic activity in the medium and long term. Following on from this, in the fourth chart we set out the results of a recent study by Adrian and co-authors,[8] which analyses the consequences of a relaxation of the financial conditions on the future growth of the economy. Their analysis of the data indicates that, in the short term, easier financial conditions reduce the severity of a risk scenario. However, according to their results, the data also suggest that this may have a cost in the medium and long term: easier current financial conditions exacerbate the impact on growth of an adverse scenario, if one arises in the medium term. Therefore, it is important to avoid complacency in an accommodative financial environment and, especially at the current juncture, to remain alert to the risks associated with the process of normalisation of monetary policy and geopolitical tensions and trade.

Low volatility and financial instability

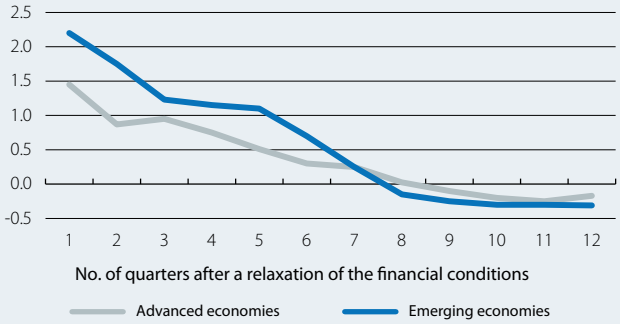
*Increase in the likelihood of a banking crisis following a period of low volatility (%) **



Note: ** Effect of a reduction of volatility of 1% below its average level.*
Source: *CaixaBank Research, with the calculations and estimates of J. Danielsson et al. (2018), «Learning from History: Volatility and Financial Crises», The Review of Financial Studies.*

*Impact on growth of a relaxation of the financial conditions **

(pps)



Note: ** Impact on GDP growth in an adverse scenario with a 5% probability of occurrence. Positive values indicate that a relaxation in the financial conditions today increases the GDP growth forecast in the adverse scenario. Negative values indicate that the growth forecast in the adverse scenario decreases.*
Source: *CaixaBank Research, with the calculations and estimates of T.* et al. *(2018), «The Term Structure of Growth-at-Risk», IMF Working Paper.*

7. J. Danielsson *et al.* (2018), «Learning from History: Volatility and Financial Crises», The Review of Financial Studies.

8. T. Adrian *et al.* (2018), «The Term Structure of Growth-at-Risk», IMF Working Paper.

Does the Fed control interest rates?

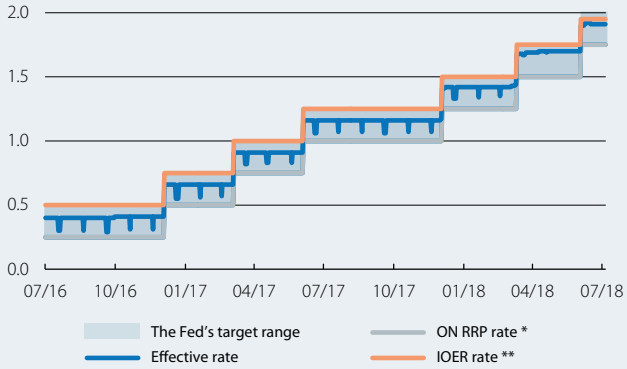
In recent months, the reference rate of the US Fed has come the closest it has been to the upper limit of its target range since 2009. Is this a technical fault not worth paying attention to? Or, on the other hand, is it a sign that the tools currently used by the Fed to regulate its monetary policy are becoming obsolete? These questions, which we analyse below, may shed some light on the future of US monetary policy.

To answer these questions, we need to know how the Fed has implemented its monetary policy in recent years and explore whether, in the current context in which the central bank is reducing the size of its balance sheet, the instruments it has used to date remain effective. In the years prior to the financial crisis, the Fed established the desired interest rate by adjusting the volume of reserves that banks held in the central bank by acquiring or selling assets in the secondary market. For example, if the Fed wanted to decrease the interest rate, it had to increase the supply of reserves. To do so, it would acquire securities in the secondary market, thus increasing liquidity in the market and exerting downward pressure on the interest rate. This mechanism was effective at times when banks held relatively few reserves in the Fed, since slight adjustments by the Fed affected the market's supply and demand for federal funds in the very short term (where financial institutions lend themselves reserves), as well as pushing the interest rate (the effective federal funds rate, or EFFR) towards its target.

However, the irruption of non-conventional monetary policy measures following the outbreak of the financial crisis, in particular the large-scale purchase of assets by the Fed[1], caused an increase in liquidity the likes of which had never been seen before. This, in turn, boosted the level of bank reserves, reducing the effectiveness of the traditional implementation of monetary policy. As a result, the Fed had to find new ways to adjust interest rates. These new methods included the interest on excess reserves (IOER), which is the rate the Fed uses to remunerate banks for holding their reserves in the central bank, and the overnight reverse repurchase agreement (ON RRP), an agreement between the Fed and non-banking financial institutions through which they receive remuneration for lending their funds to the Fed overnight.[2] These two

US: official interest rates

(%)



Notes: ** ON RRP: overnight reverse repurchase agreement.*
*** IOER: interest rate on excess reserves.*
Source: *CaixaBank Research, based on data from Bloomberg.*

interest rates limit the Fed's target range in the federal funds market, in which banks finance their reserves. On the one hand, players that can access ON RRP facilities have no incentive to lend at an EFFR below that at which the Fed remunerates its funds (ON RRP). On the other hand, banks with excess reserves in the Fed have no incentive to borrow at an EFFR higher than that at which the Fed remunerates them (IOER), although they would like to receive financing at a lower rate, either to achieve the minimum level of liquidity required by the central bank or to finance excess reserves from which they will obtain a return greater than the cost of financing through the IOER.[3] Therefore, in the federal funds market, the former (players with access to the ON RRP but not the IOER) provide the supply, while the latter (banks with access to the IOER but not to the ON RRP) participate in the demand side. In the first chart, we can see how the EFFR has historically remained within the Fed's target range. However, since the end of 2017, the EFFR has come very close to the upper limit. Does this mean that imbalances have begun to emerge in the implementation of the Fed's monetary policy?

The EFFR is determined, like almost all goods and services, according to supply and demand. Thus, if the interest rate in this market has increased, it could be due to an increase in demand for this type of financing or a reduction in the supply of funds. There are solid

1. In August 2008, the Fed's balance sheet amounted to 0.9 trillion dollars, while at its peak it exceeded 4.5 trillion dollars.
2. Examples of non-banking financial institutions include hedge funds, money market funds and public mortgage agencies. These institutions have access to ON RRP facilities, but they cannot hold their reserves in the Fed and benefit from the IOER, while the reverse is the case for banking institutions. For a more detailed description of these tools, see the Focus «Monetary normalisation in the US: the Fed's new toolbox» in MR07/2015.

3. In relation to this arbitration opportunity, the former Chairman of the Fed, Ben Bernanke, argues in his article «The Fed's interest payment on banks» that it is very small, given the various transaction costs associated with these transactions.

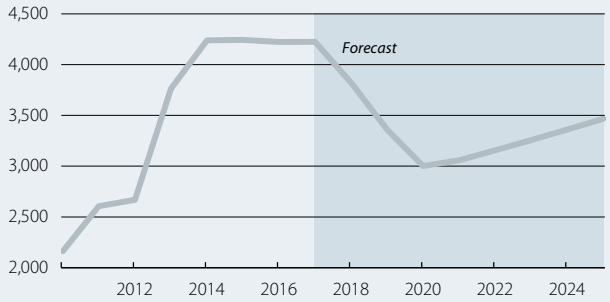
arguments[4] that suggest it is a decrease in supply that is causing the EFFR to approach the upper limit of the Fed's target range. The closing of the gap between the EFFR and the IOER is occurring in a context in which the issuance of US sovereign debt (treasuries) is increasing due to the fiscal expansion policies of the US Administration. This trend, together with the decrease in treasuries held by the Fed (due to the reduction of its balance sheet), has caused the yield of these bonds to increase. Furthermore, given how important this asset is for the financial system, this increase has been transmitted to all the other interest rates in the economy.

There are also signs that suggest that demand is also putting upward pressure on the EFFR (and that this pressure will increase even further in the coming quarters). The Fed is putting an end to its unconventional monetary policy measures by choosing not to renew assets when they reach their maturity, which means there will be a reduction in the reserves that banks hold in the central bank. In this situation, banks with less excess of reserves will find it harder to comply with the Fed's minimum liquidity requirements and will seek financing in the federal funds market, increasing demand and thus the EFFR. As we can see in the second chart, the reduction of the Fed's balance sheet has been scarcely notable to date, but it is expected to be accentuated over the next few quarters. Therefore, although banks have not had to worry about the minimum reserve requirements in the current context of excess liquidity, this will change as the decrease in the Fed's balance sheet drains the excess liquidity and reserves diminish. Specifically, banks with fewer excess reserves will go to the federal funds market to finance their minimum requirements, increasing the demand for federal funds and driving the EFFR upwards. In fact, according to estimates by economists from the New York Fed,[5] during this process the reference rate could even rise above the IOER, something which has not happened since these tools were introduced.

For the time being, the Fed has reacted to this by placing the IOER 5 basis points below the upper limit of its target range since June, thus managing to bring the EFFR closer to the centre of its desired range. Nevertheless, as we have seen, the withdrawal of the excess liquidity will continue to drive the EFFR upwards. Therefore, due to the interaction between the various instruments of monetary policy we have analysed, the withdrawal of the unconventional measures opens the door to the possibility of the US monetary authority once again revising the tools it uses to implement its monetary policy at some point in the future. What's more, communication will once again be key in order to prevent this realignment of the tools from generating a sense of lack of control on the part of the Fed over interest rates.

US: expectations of the size of the Fed's balance sheet

(USD billions)



Note: *Up to 2017, we show historical year-end data. From 2018 onwards, the chart shows the results of the survey conducted by the New York Fed among various financial institutions regarding what size they expect the Fed's balance sheet to be in the coming years. The median value of the answers is shown.*
Source: *CaixaBank Research, based on data from the Federal Reserve Bank of New York.*

4. In the minutes of the Fed's June meeting, the senior vice president of the Fed's Markets Group, Lorie K. Logan, stated that the surge in the repo interest rates associated with treasuries were behind the rise in the EFFR.
5. G. Afonso, R. Armenter, and B. Lester (2018) «Size is not all: Distribution of Bank Reserves and Fed Funds Dynamics» Federal Reserve Bank of New York Liberty Street Economics.

Interest rates (%)

	31-Aug	29-June	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	–0.32	–0.32	0	1.0	1.0
1-year Euribor	–0.17	–0.18	1	1.6	–0.9
1-year government bonds (Germany)	–0.62	–0.64	2	1.8	11.1
2-year government bonds (Germany)	–0.61	–0.67	6	1.7	11.7
10-year government bonds (Germany)	0.33	0.30	3	–9.7	–3.1
10-year government bonds (Spain)	1.47	1.32	15	–9.7	–9.2
10-year government bonds (Portugal)	1.92	1.79	13	–2.3	–91.2
US					
Fed funds	2.00	2.00	0	50.0	75.0
3-month Libor	2.32	2.34	–2	62.6	100.2
12-month Libor	2.84	2.76	8	73.3	112.7
1-year government bonds	2.45	2.31	14	71.8	123.3
2-year government bonds	2.63	2.53	10	74.7	130.5
10-year government bonds	2.86	2.86	0	45.5	74.3

Spreads corporate bonds (bps)

	31-Aug	29-June	Monthly change (bp)	Year-to-date (bp)	Year-on-year change (bp)
Itraxx Corporate	68	74	–6	23.5	12.8
Itraxx Financials Senior	85	90	–5	41.4	32.0
Itraxx Subordinated Financials	177	180	–3	72.9	54.1

Exchange rates

	31-Aug	29-June	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
EUR/USD	1.160	1.168	–0.7	–3.4	–2.6
EUR/JPY	128.840	129.360	–0.4	–4.8	–1.6
EUR/GBP	0.896	0.885	1.2	0.8	–2.8
USD/JPY	111.030	110.760	0.2	–1.5	1.0

Commodities

	31-Aug	29-June	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
CRB Commodity Index	411.4	439.1	–6.3	–4.8	–5.6
Brent ($/barrel)	77.4	79.4	–2.5	15.8	47.8
Gold ($/ounce)	1,201.4	1,253.2	–4.1	–7.8	–9.1

Equity

	31-Aug	29-June	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
S&P 500 (USA)	2,901.5	2,718.4	6.7	8.5	17.4
Eurostoxx 50 (euro area)	3,392.9	3,395.6	–0.1	–3.2	–0.8
Ibex 35 (Spain)	9,399.1	9,622.7	–2.3	-6.4	–8.7
PSI 20 (Portugal)	5,422.6	5,528.5	–1.9	0.6	5.2
Nikkei 225 (Japan)	22,865.2	22,201.8	3.0	0.4	16.4
MSCI Emerging	1,056.0	1,069.5	–1.3	–8.8	–2.9

The emerging markets suffer while the US shifts up a gear

The economic indicators known in the summer months confirm that the growth rate of global economic activity is rebalancing: while there is growing evidence that the persistent economic uncertainty is taking its toll on the growth of some emerging economies, it is also clear that the advanced economies are on a different wavelength. The US is experiencing significant acceleration in its growth rate thanks to the fiscal impulse, while the euro area is seeing only a slight moderation in the growth of its economic activity. Overall, the scenario forecast by CaixaBank Research has been adjusted to account for this progressive weakening. Specifically, the growth figures for the emerging markets expected for the current year and the next have been revised down to 4.9% and 4.8%, respectively (1 decimal point lower than the previous forecast). As a result, the expected global growth will also be slightly lower in 2018 and 2019.

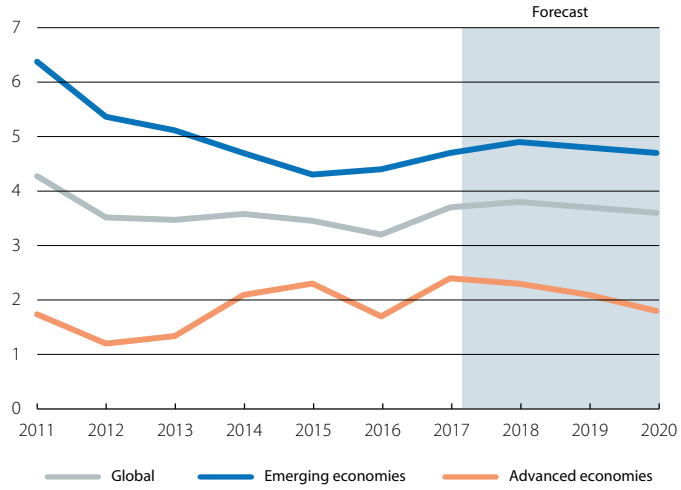
The downside risks remain considerable. Despite the moderation of the outlook set out above, the balance of risks continues to point towards a possible weakening of the economy in the future. The protectionist shift of the US and its possible global implications continue to play a prominent role in this balance. In the last few weeks, there has been a combination of negative and encouraging news in this area. The US has finished implementing the remainder of the package of tariff increases on Chinese products with a value of 50 billion dollars announced months earlier. In contrast, and somewhat unexpectedly, the US and Mexico have reached a bilateral trade agreement in principle which, once approved by the two countries' legislative authorities, will replace the NAFTA (while Canada is yet to be included). The terms of this future agreement have made it possible to balance both the US' demands (with a tightening of the rules of origin and an implicit rise in the minimum wage of the automotive sector) and the matters that Mexico considered important (with an extension of the adjustment periods, minimum terms and review periods, de facto protection against competition from Asia and without adversely affecting the primary sector). Besides the content of the agreement, the very fact that an agreement has been reached at all after months of complex negotiations and heated rhetoric provides some hope that, in the medium term, pragmatism will be able to lead to the resolution of trade tensions.

US

The US economy escapes the predicament of lower growth endured by other economies. The growth data for Q2 2018 (1.0% quarter-on-quarter, 2.9% year-on-year) confirm that the economy has accelerated thanks to the support of temporary and cyclical factors (such as the fiscal stimulus and a labour market that exceeds full employment). In particular, the breakdown of GDP by component of demand confirms that the bulk of the activity continues to come from domestic demand, leaving behind the bump experienced in Q1 thanks

Global GDP

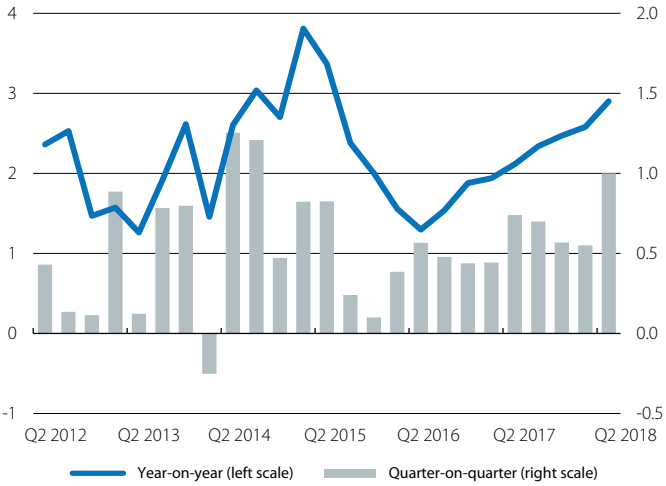
Year-on-year change (%)



Source: *CaixaBank Research.*

US: GDP

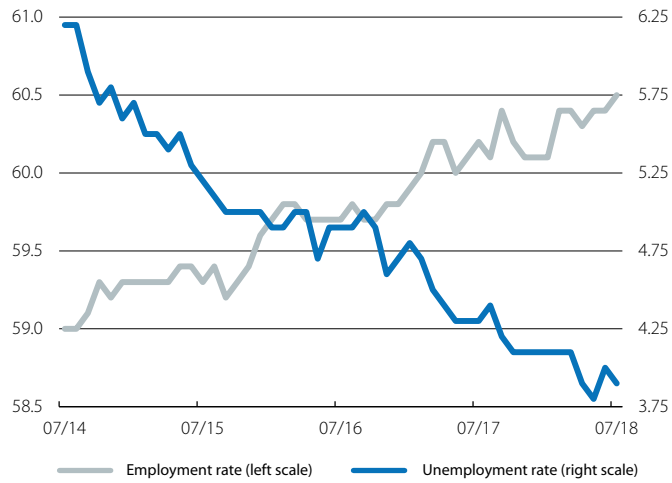
Year-on-year change (%) *Quarter-on-quarter change (%)*



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

US: labour market

(%) *(%)*



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

to the renewed strength of private consumption. Furthermore, it is worth noting that the contribution of external demand has also accompanied the acceleration of the economy, thanks to the robust performance of exports being combined with a reduction in imports. This reduction has been unexpected and, to some extent, surprising in light of the strength of domestic demand.

The labour market continues to be a source of stability. The strength of domestic demand is largely attributable to the labour market, which continues to show signs of growth. In July, nearly 160,000 jobs were created (slightly less than in previous months, but still a high figure if we consider that the previous figures have been revised upwards), while the unemployment rate stood as low as 3.9%. Wages, meanwhile, rose by 2.7% in year-on-year terms.

Inflation continues to rise and the Fed will take action soon. In the last few months, inflation has been gradually on the rise, in July reaching 2.9% (the headline index) and 2.4% (the core index, i.e. excluding the most volatile items of energy and food). This is another sign that the US economy is passing through the mature phases of the business cycle. In this context, we expect the Fed to continue its strategy of increasing the reference rate (with two further increases expected in what remains of the year, up to 2.5%). Beyond this, both the macroeconomic scenario and, therefore, that relating to monetary policy become more uncertain. That said, the strong inertia of the current rate of growth in economic activity should be more contained in 2019 when the effect of fiscal policy is reduced.

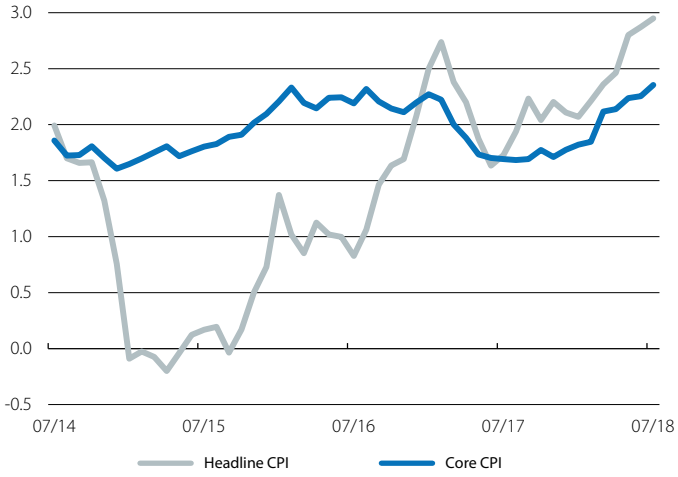
EUROPE

Slowdown in growth in the euro area. The GDP of the euro area grew in Q2 by 2.2% year-on-year (0.4% quarter-on-quarter), a figure similar to the 2.5% registered in the previous quarter, but lower than those observed at the end of 2017. By country, Germany maintained a similar growth rate to the previous quarter (0.5% in quarter-on-quarter terms, 1.9% year-on-year), well above that of countries such as France (which had surprisingly low growth of just 0.2% quarter-on-quarter) and Italy (which also grew by 0.2%, although in this case it was expected and in line with past figures). Outside the euro area, Poland continued to show very buoyant growth, while the United Kingdom recovered a little vibrancy following a somewhat shaky start to the year.

Growth in the euro area: a warning sign or just a bump in the road? The relative disappointment of Q2 was interpreted as a warning signs among analysts. However, in the opinion of CaixaBank Research it should not be treated as a warning, although it cannot be considered an isolated result either. The stability of the PMI indicator of the euro area for August (going from 54.3 points in July to 54.4), together with the gentle decline in other economic sentiment indicators, suggests that growth remains at levels similar to those of Q2. On the whole, although production capacity utilisation remains relatively low, it could be said that the strong cyclical upswing experienced by the euro area in 2017 moderated somewhat faster than expected. Therefore, it is foreseeable that the

US: CPI

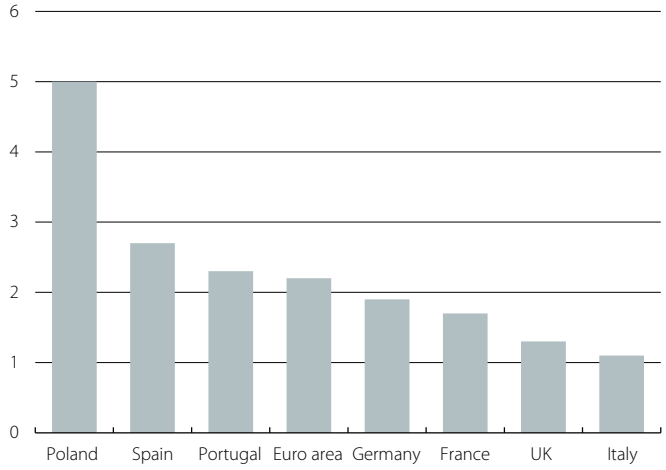
Year-on-year change (%)



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

European Union: GDP for Q2 2018

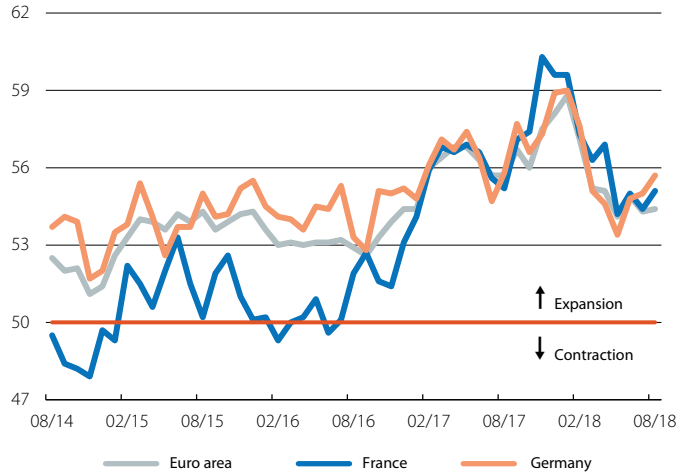
Year-on-year change (%)



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

Euro area: composite PMI economic activity indicator

Level



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

growth rate of economic activity in the first semester is representative of the growth to come in the next few quarters. Finally, inflation has continued to follow the same trend of recent months, with modest pressures on prices besides the fluctuations in energy prices. In August, inflation in the euro area stood at 2.0%, just 1 decimal point less than in July.

EMERGING MARKETS

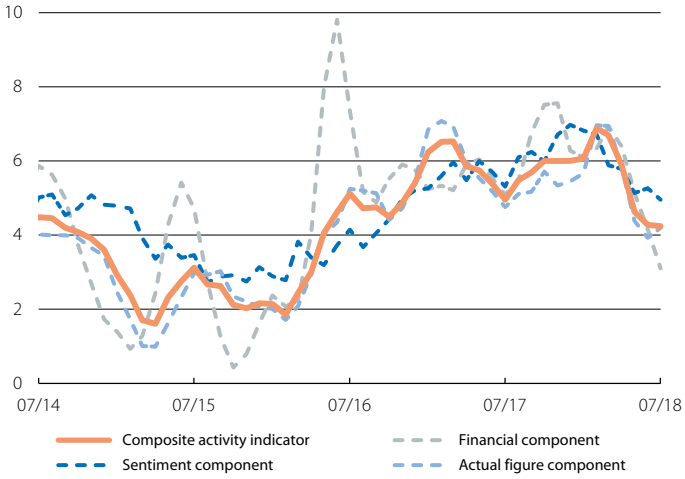
The emerging economies are beginning to acknowledge the adverse environment. In the last few weeks, there has been a notable increase in financial volatility in emerging market assets. This has resulted in significant depreciations of certain currencies, spikes in long-term interest rates and heavy declines in stock market prices. Besides the lead role of countries such as Turkey in this process, there are aspects not of an idiosyncratic nature which we believe are dragging down investor sentiment and which are already affecting the economic activity indicators. As is well known, the underlying context came about as a result of the progressive tightening of global financial conditions, a trend that is largely the result of the toughening of monetary policy in the US. This trend is affecting many emerging markets that previously made use of the lax financial conditions to accumulate debt in dollars and other strong currencies. Now, in addition to this, there is the added effect of the increased uncertainty caused by the escalation of protectionism by the US (although the preliminary agreement with Mexico is an encouraging development), as well as doubts surrounding the extent of the slowdown in China. As a result, indicators that attempt to capture the current rate of growth in the emerging markets, such as the composite activity indicator of the Institute of International Finance, are now showing notable declines that extend back to the end of Q1.

China's GDP slows and the economic activity data suggest more deceleration is to come. The increase in GDP in Q2 was 6.7% year-on-year, after three quarters growing at 6.8%. In addition, the economic activity indicators (such as industrial production) and the sentiment indicators for Q3 point towards a slowdown in economic activity that is somewhat higher than that indicated by the official GDP data. We expect the country's growth will continue to decelerate gradually in the second half of the year. That said, as mentioned previously, this process is not free of uncertainty and it has had an adverse effect on global investor sentiment.

Turkey, at the heart of the financial hurricane. As a result of an accumulation of excessive imbalances over too long-a-period (the most obvious is inflation, which stood at 15.8% in July, although there is also an unsustainable current account deficit of more than 6% of GDP in Q2) and a somewhat questionable economic policy, the Turkish economy is experiencing a sudden halt of capital inflows in Q3. This situation will likely lead to an abrupt slowdown in economic activity when faced with the inevitable credit crunch. Unfortunately, this sudden macroeconomic adjustment may not be the end of Turkey's problems if it is not accompanied by a shift in economic policy that tackles the latent imbalances.

Emerging markets: composite activity indicator

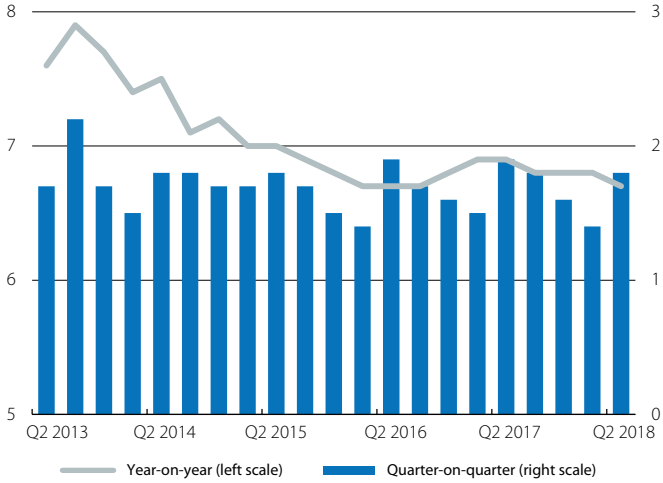
Annualised quarter-on-quarter change (%)



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

China: GDP

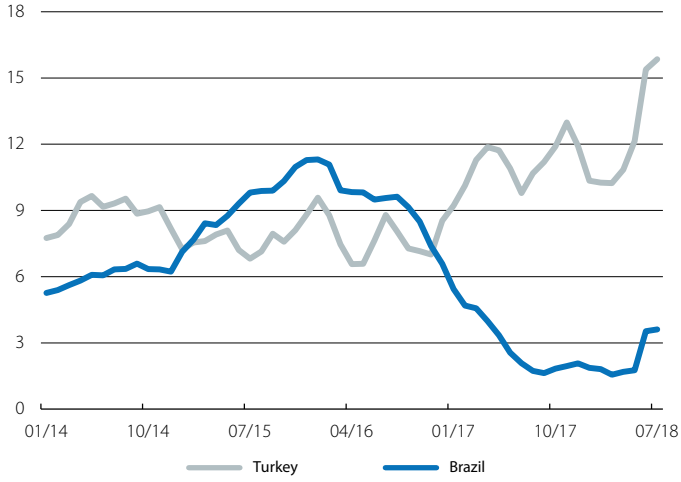
Year-on-year change (%) *Quarter-on-quarter change (%)*



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

Turkey and Brazil: CPI

Year-on-year change (%)



Source: *CaixaBank Research, based on data from the national statistics institutes.*

European Council: a lot of talk but little action

Over the past two years, a window of opportunity has emerged in Europe to advance the European project, to enable the bloc to face its present and future challenges. This window of opportunity has arisen due to a combination of factors. Internally, the EU has managed to agree on a common response to the existential challenge posed by Brexit. A more positive scenario also emerged following the defeat of populist Eurosceptic parties in the Dutch elections, the election of a deeply pro-European candidate in the French elections, and the formation of a coalition government in Germany no less pro-European than the previous one. Externally, new challenges underscore the importance of greater European coordination and integration on foreign policy, defence and security. These include the election of Trump as US president, Russia's defiant strategy, and the refugee crisis. In this context, we need to ask ourselves whether Europe is making the most of this opportunity.

Since the sovereign debt crisis, there have been continuous demonstrations by Europe's main political leaders in favour of advancing the European project and the need to strengthen the architecture of the Monetary Union. In fact, over the last year and a half, the level of support has intensified and a number of documents that discuss the European project and set out concrete initiatives have been published.[1] In this context, France and Germany agreed in June on a series of proposals to strengthen the single currency against future crises. This agreement, known as the Meseberg declaration, set out the vision shared by the two countries, put the reform momentum back on the table, and laid the foundations for a relatively ambitious agreement with the rest of the countries.[2] Thus, all the elements needed to advance towards the reform of the EU and euro area were in place ahead of the European Council meeting in June.

However, at the June Council meeting, the EU did not take a firm step forward, but a small step forward. Specifically, on euro area reforms, although decisions were expected in line with the agreement between Germany and France, expectations were not met, and further progress on this front was postponed. On the other hand, reforms to advance the Banking Union were put back on the table, something which only few countries were considering just a few months ago.

Specifically, it was agreed that the European Stability Mechanism (ESM) – the euro area's rescue fund – would act as a lender of last resort (backstop) for the Single Resolution Fund, in the event it runs out of resources to manage the resolution of banking institutions. Although its functioning has not yet been detailed, and its initial endowment has generated some doubts regarding its real capacity to deal with future systemic crises,[3] this backstop constitutes an important stabilising element for the euro area banking system and, therefore, it represents another step towards a full European Banking Union. Also of note is the commitment, albeit somewhat weak, to engage in political dialogue with a view to establishing a common European Deposit Insurance Scheme (EDIS), the third pillar of the European Banking Union.

On the other hand, migration policy was the main protagonist, due to the political tensions in some member countries. Thus, the 27 agreed to move towards greater cooperation with countries of origin and transit, and to introduce measures to limit the internal mobility of immigrants, such as the voluntary installation of control centres (within European territory) – although for now no country appears to be willing to install such centres. In this context, and despite being somewhat imprecise, the Council's agreement served to ease tensions, recognise that immigration is a challenge «for the whole of the EU» and relaunch the debate on the need to effectively coordinate a migration policy. The agreed proposals can therefore be considered a first step (albeit a distant one) towards reaching a consensus on a common policy.

In short, it seems that the EU is moving forward, albeit at a much slower pace than it should. Over the coming months, it would be desirable to take advantage of the current opportunity and the reform momentum to continue moving towards a more integrated EU and a more robust Monetary Union. In the latter case, the focus should be on breaking the doom loop between banks and national governments,[4] implementing counter-cyclical policies, and improving the functioning of the fiscal framework. After all, this window of opportunity will not remain open forever and the European Parliamentary elections in May 2019 are already rearing their heads.

1. Of particular note is the «White Paper on the Future of Europe» (2017) of the European Commission, in which five scenarios on the possible evolution of the European Union are presented.
2. Among other aspects, the agreement included the creation of a budget for the euro area, separate from that of the EU, focused on convergence and investment; the possibility of introducing a Europe-wide unemployment insurance, and transforming the ESM into a European Monetary Fund.
3. In the absence of more details, everything seems to indicate that its maximum balance could not exceed 55 billion euros.
4. For more details about this, see the Focus «The long road towards a secure European bond» of the MR05/2018.

UNITED STATES

	2016	2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	07/18
Activity							
Real GDP	1.6	2.2	2.3	2.5	2.6	2.9	–
Retail sales (excluding cars and petrol)	3.4	4.1	4.1	5.3	4.4	5.1	5.6
Consumer confidence *(value)*	99.8	120.5	120.3	126.0	127.1	127.2	127.9
Industrial production	–1.9	1.6	1.3	3.0	3.4	3.6	4.2
Manufacturing activity index (ISM) *(value)*	51.4	57.4	58.7	58.7	59.7	58.7	58.1
Housing starts *(thousands)*	1,177	1,208	1,172	1,259	1,317	1,254	1,168
Case-Shiller home price index *(value)*	189	200	200	205	209	211	...
Unemployment rate *(% lab. force)*	4.9	4.4	4.3	4.1	4.1	3.9	3.9
Employment-population ratio *(% pop. > 16 years)*	59.7	60.1	60.2	60.1	60.3	60.4	60.5
Trade balance [1] *(% GDP)*	–2.7	–2.8	–2.8	–2.8	–2.9	–2.9	...
Prices							
Consumer prices	1.3	2.1	2.0	2.1	2.2	2.7	2.9
Core consumer prices	2.2	1.8	1.7	1.8	1.9	2.2	2.4

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

	2016	2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	07/18
Activity							
Real GDP	1.0	1.7	2.0	2.0	1.1	1.0	–
Consumer confidence *(value)*	41.7	43.8	43.8	44.5	44.4	43.7	43.5
Industrial production	–0.2	4.5	4.4	4.1	2.5	2.0	...
Business activity index (Tankan) *(value)*	7.0	19.0	22.0	25.0	24.0	21.0	–
Unemployment rate *(% lab. force)*	3.1	2.8	2.8	2.7	2.5	2.4	...
Trade balance [1] *(% GDP)*	0.7	0.5	0.6	0.5	0.4	0.4	0.5
Prices							
Consumer prices	–0.1	0.5	0.6	0.6	1.3	0.6	0.9
Core consumer prices	0.6	0.1	0.2	0.3	0.4	0.3	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

	2016	2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	07/18
Activity							
Real GDP	6.7	6.9	6.8	6.8	6.8	6.7	–
Retail sales	10.4	10.2	10.3	9.9	9.9	0.0	8.8
Industrial production	6.1	6.6	6.3	6.2	6.6	6.6	6.0
PMI manufacturing *(value)*	50.3	51.6	51.8	51.7	51.0	51.6	51.2
Foreign sector							
Trade balance [1] *(value)*	512	435	435	435	420	395	376
Exports	–8.4	8.5	6.9	10.1	13.6	11.3	11.3
Imports	–5.7	16.1	14.7	13.2	19.2	20.1	27.6
Prices							
Consumer prices	2.0	1.6	1.6	1.8	2.2	1.8	2.1
Official interest rate [2] *(value)*	4.35	4.35	4.35	4.35	4.35	4.35	4.35
Renminbi per dollar *(value)*	6.6	6.8	6.7	6.6	6.4	6.4	6.7

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

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

EUROPEAN UNION

Activity and employment indicators

Values, unless otherwise specified

	2016	2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	06/18	07/18	08/18
Retail sales *(year-on-year change)*	1.6	2.3	2.6	2.0	1.6	1.4	1.2	...	...
Industrial production *(year-on-year change)*	1.6	3.0	4.1	4.2	3.1	2.2	2.5	...	...
Consumer confidence	–7.8	–2.5	–1.5	–0.2	0.5	0.0	–0.6	–0.5	–1.9
Economic sentiment	104.2	110.8	111.8	114.3	114.0	112.5	112.3	112.1	111.6
Manufacturing PMI	52.5	57.4	57.4	59.7	58.3	55.5	54.9	55.1	54.6
Services PMI	53.1	55.6	55.3	55.9	56.4	54.6	55.2	54.2	54.4
Labour market									
Employment (people) *(year-on-year change)*	1.4	1.6	1.7	1.6	1.4	...	–	–	...
Unemployment rate: euro area *(% labour force)*	10.0	9.1	9.0	8.7	8.6	8.3	8.2	8.2	...
Germany *(% labour force)*	4.2	3.8	3.7	3.6	3.5	3.4	3.4	3.4	...
France *(% labour force)*	10.1	9.4	9.5	9.1	9.2	9.1	9.1	9.2	...
Italy *(% labour force)*	11.7	11.3	11.3	11.0	11.0	10.8	10.8	10.4	...
Spain *(% labour force)*	19.6	17.2	16.8	16.6	16.2	15.4	15.2	15.1	...

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

Foreign sector

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

	2016	2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	06/18	07/18	08/18
Current balance: euro area	**3.8**	**3.7**	**3.7**	**3.7**	**3.9**	**3.8**	**3.8**	**...**	**...**
Germany	8.5	7.9	7.9	7.9	7.9	8.1	8.1	...	...
France	–0.8	–0.6	–0.6	–0.6	–0.4	–0.4	–0.4	...	...
Italy	2.6	2.8	2.7	2.8	2.7	2.8	2.8	...	...
Spain	1.9	1.9	1.8	1.9	1.8	1.4	1.4	...	...
Nominal effective exchange rate [1] *(value)*	**94.3**	**96.5**	**98.5**	**98.6**	**99.6**	**98.5**	**97.9**	**99.2**	**...**

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

	2016	2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	06/18	07/18	08/18
Private sector financing									
Credit to non-financial firms [1]	1.8	2.5	2.4	3.0	3.3	3.7	4.1	4.1	...
Credit to households [1, 2]	1.7	2.6	2.7	2.8	2.9	2.9	3.0	3.0	...
Interest rate on loans to non-financial firms [3] *(%)*	1.4	1.3	1.3	1.3	1.2	1.2	1.2	1.2	...
Interest rate on loans to households for house purchases [4] *(%)*	1.8	1.7	1.7	1.7	1.6	1.6	1.6	1.6	...
Deposits									
On demand deposits	10.0	10.1	10.6	10.1	9.2	8.1	8.2	7.5	...
Other short-term deposits	–1.9	–2.7	–3.0	–2.4	–2.1	–1.5	–0.9	–1.1	...
Marketable instruments	2.7	1.1	–0.4	–1.6	–5.8	–2.9	–2.0	–3.1	...
Interest rate on deposits up to 1 year from households *(%)*	0.5	0.4	0.4	0.4	0.4	0.4	0.3	0.3	...

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.*

The economy enters a more mature phase of the cycle

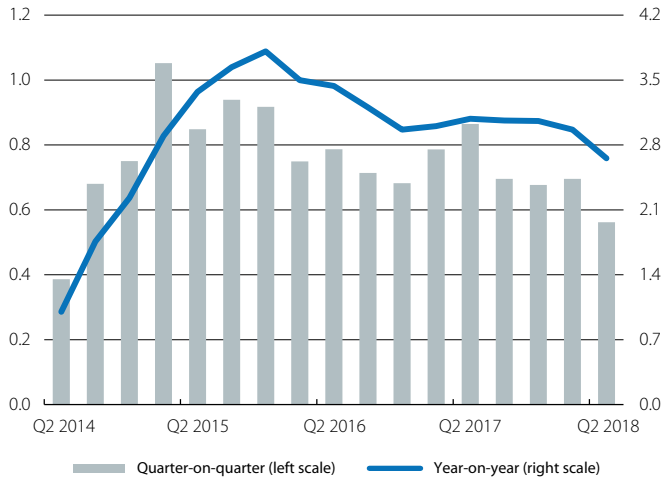
The pace of growth tempers. After growing at above 3% for three consecutive years, the latest GDP data confirm that the Spanish economy continues to grow at a steady rate, albeit somewhat below that of the last few quarters. In Q2, GDP grew by 0.6% quarter-on-quarter (2.7% year-on-year), 1 decimal point lower than in the previous quarter. As such, the economy is now entering a more mature phase of the business cycle, in line with the scenario envisaged by CaixaBank Research. Although growth will remain high in this new phase, it will be more moderate, both because the tailwinds that have benefited the economy in recent years are subsiding and because the slower growth of Spain's major trading partners will limit the scope for growth in exports. Furthermore, the low household savings rate (5.6% for the last four quarters as a whole) suggests that the ability of private consumption to spur growth in domestic demand will be more limited than in the last three years. As a result, here at CaixaBank Research we expect economic activity to grow by a solid 2.7% this year and by 2.3% in 2019.

Domestic demand remains the main driver of growth, although its composition is unexpected. Due to a change in the publication format used by the Spanish National Statistics Institute, the first estimate of GDP for Q2 also includes a breakdown by component. Of particular note is the 2.9 pp contribution to growth of domestic demand, although the contribution of private consumption was lower than expected, growing by just 0.2% quarter-on-quarter (in 2017, its average quarter-on-quarter growth was 0.6%). Nevertheless, the continued strength of the labour market and the continuity of a positive climate of confidence will continue to feed the buoyancy in private consumption over the coming quarters. In addition, the lower growth in private consumption was offset by a strong rebound in investment, which grew by 2.6% quarter-on-quarter (0.8% in Q1), almost entirely hoisted up by investment in capital goods (5.5% quarter-on-quarter, the highest growth rate since Q3 2013). External demand, meanwhile, subtracted 0.2 pps from GDP growth, with the quarter-on-quarter fall in exports exceeding that of imports (–1.0% and –0.3%, respectively). Over the coming quarters, external demand is expected to make a small net contribution due to the higher oil price and the lower growth rate of the euro area.

The labour market remains buoyant. In Q2, the increase in the number of people in employment (469,900 people) was much higher than expected by CaixaBank Research (350,000), with the highest quarterly increase ever recorded in the historical series of the Labour Force Survey. In addition, the positive outlook in the labour market has led to an increase in the active labour force (+163.900 people in Q2), bringing the activity rate up to 58.8% (+0.3 pps). Furthermore, the

Spain: GDP growth

Quarter-on-quarter change (%) *Year-on-year change (%)*



Source: *CaixaBank Research, based on data from the Spanish National Statistics Institute.*

Spain: GDP

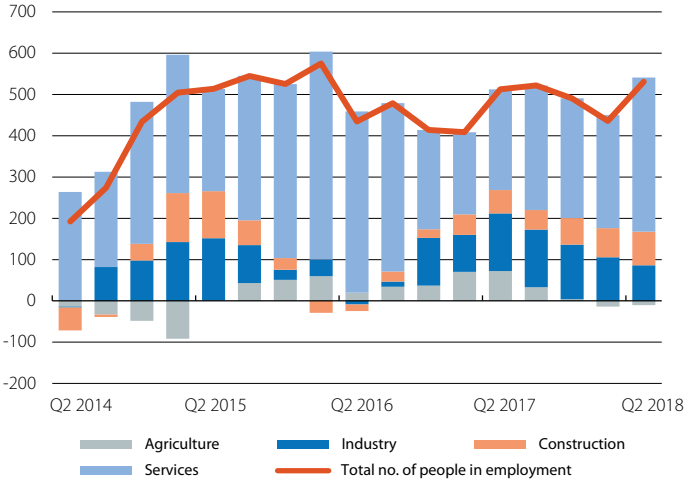
Quarter-on-quarter change (%)

	Q3 2017	Q4 2017	Q1 2018	Q2 2018
GDP	0.7	0.7	0.7	0.6
Private consumption	0.7	0.6	0.7	0.2
Public consumption	0.4	0.4	0.5	0.7
Investment	1.4	0.7	0.8	2.6
Investment in capital goods	2.8	0.9	–1.6	5.5
Investment in construction	0.2	1.0	2.4	1.1
Exports	0.6	0.3	1.3	–1.0
Imports	1.0	0.0	1.3	–0.3

Source: *CaixaBank Research, based on data from the Spanish National Statistics Institute.*

Spain: employment by sector

Year-on-year change (thousands)



Source: *CaixaBank Research, based on data from the Spanish National Statistics Institute.*

unemployment rate fell sharply, down to 15.3%, which represents a reduction of 1.9 pps in the last year. It should be noted that this decline in the unemployment rate is common in Q2 due to the start of the tourist season. This is reflected in the good performance of the services sector, which generated 371,400 jobs, even more than the number observed in Q2 2017 (272,400). Looking forwards to the next few quarters, the improvement in the labour market is expected to continue, albeit at a more moderate rate (in line with the tempering of the growth rate of the Spanish economy).

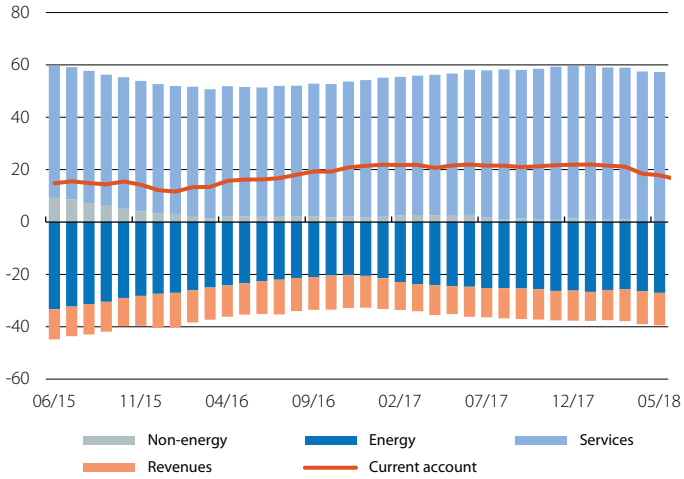
Trade in non-energy goods holds back the improvement of the foreign sector. In June, the current account surplus amounted to 16,246 million euros (+1.4% of GDP in the last 12 months in aggregate), considerably lower than the surplus of 21,962 million recorded in June 2017 (specifically, –0.5 pps of GDP). This poorer performance is mostly attributable to the deterioration of the balance in non-energy goods, in a context of slower growth in the euro area. In addition, the surplus of services fell by 1 decimal point in terms of GDP, driven particularly by the fall in exports of non-tourist services. All in all, the positive performance of the tourism sector will push the foreign sector to end the year with a current account surplus.

The public deficit continues to fall gradually. Based on the data up to May, the fiscal deficit stood at 1.3% of GDP, 3 decimal points below the figure for May 2017. Although the positive performance of the economy continues to propel revenues (6.2% growth in the year to date up to May), the higher growth of expenditure (4.1%), especially due to the increase in social benefits (3.0%) and gross capital formation (32.4%), has resulted in a more modest improvement in the public accounts.

New lending is growing at a good rate. In July, the European Commission published its surveillance report on the Spanish economy, drawn up following the financial assistance provided in 2014. The report highlights the resilience demonstrated by the financial sector during 2017 and early 2018 following the resolution of Banco Popular, the events in Catalonia and the spike in volatility in the markets caused by the formation of the new government in Italy. It also highlights the fact that the restructuring of the banking sector has encompassed the entire sector, not just the banks that received public aid. As a result, the sector has optimised its business model, cut costs and is better prepared to channel the flows of credit to the rest of the economy, as demonstrated by the latest data on new bank lending. In the year to date up to July, both credit for housing and consumer credit grew by more than 15%. In relation to non-financial companies, growth in lending to large firms, rose by 11.4%, well above the figure for 2017 (1.6%). Looking forwards to the coming quarters, we expect new bank lending to continue to rise, supported by the favourable financial conditions that are being sustained by the ECB's accommodative monetary policy.

Spain: current account balance

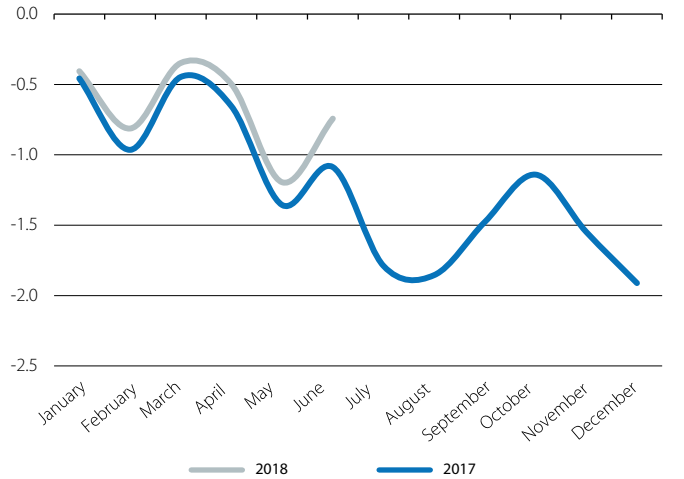
12-month cumulative balance (EUR billions)



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

Spain: central government balance

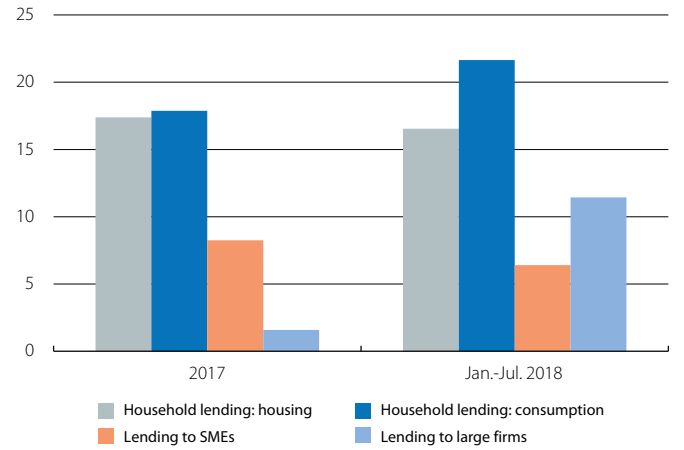
(% of GDP)



Source: *CaixaBank Research, based on data from the General Comptroller of the State Administration (IGAE).*

Spain: new bank lending

Year-on-year change (%)



Note: *Household lending excludes refinancing operations.*
Source: *CaixaBank Research, based on data from the Bank of Spain.*

Is Spain importing as much as it used to?

Spain has been accumulating a trade surplus of goods and services since the beginning of 2012, which is helping to reduce the high deficit in net international investment. But this has not always been the case. Before the 2008 financial crisis, Spain was accumulating trade deficits year after year. Since the crisis, the weakness in domestic demand, which meant fewer imports, and the increase in competitiveness, which facilitated the increase in exports, led to a rapid improvement in the balance of trade in goods and services. In November 2013, it reached a surplus of 3.3% of GDP, the highest since the beginning of the series in 1995. Unlike past recoveries, the balance of goods and services has remained in surplus despite a recovery in domestic demand and the logical recovery of imports, although the surplus has reduced to 2.6% (May 2018).

In the medium term, however, there are doubts as to whether the good rate of exports can continue to offset the growth of imports, which has been particularly strong since 2015. Specifically, in 2013 and 2014, imports of goods and services grew at an annualised rate of 5.8%, but between 2015 and 2017 the rate of growth has accelerated to 6.9%.[1] To what extent is this increase in the rate of imports cause for concern? On the one hand, imports undermine the trade surplus and may reflect a competitive deficit which forces the country to buy abroad. However, this change could also be the result of greater integration of the Spanish economy into global supply chains: Spanish companies buy competitive products from abroad at low prices and, in turn, they integrate these products into new products for export.

In order to assess the relative weight of each argument, we can look at the import intensity of the Spanish economy, that is, the level of imports needed in order to reach a certain level of economic activity.[2] Imports can grow either because of a composition effect, through which the components of demand that are linked with greater import intensity account for a larger portion of total demand, or alternatively because the import intensity of each component increases, which would be more worrying. The first factor – the composition effect – has contributed to higher growth in imports, since the gross capital formation and exports, which have a higher import intensity than public and private consumption, are precisely the components of demand that have grown the most since the start of the recovery (from June 2013 to March 2018, nominal GDP grew by 16.3%, compared to a growth of 33.9% and of 22.7% in gross fixed capital formation and in exports, respectively).

*Spain: changes in non-energy imports **

Index (100 = Q2 2013)

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

*Import intensity by components of final demand **

(%)

	Private consumption	Public consumption	Gross capital formation	Exports
Germany	25.8	9.4	40.0	47.4
Spain	29.0	13.3	35.8	39.0
France	26.6	9.8	29.8	34.4
Italy	23.5	7.8	31.3	29.1

Note: ** Information based on the Input-Output Tables of 2007 for Germany, France and Spain, and of 2005 for Italy. The import intensity is the sum of the import content in intermediate goods (i.e. the percentage of inputs that comes from imports) and imports of final products.*
Source: *CaixaBank Research, based on data from the Bank of Spain, the Spanish National Statistics Institute and Eurostat.*

With regards to the second factor, unfortunately we do not have any time series of the import intensity of the various components of demand, as the most recent data available correspond to the estimated import intensity for 2007.[3] Back then, the picture was not very flattering: component by component, Spain had an import intensity higher than France and Germany. How have things changed since then?

To answer this question, we can estimate whether the growth of imports has been higher or lower than would be expected if the import intensity of the various components had remained constant. To this end, we built

1. Excludes energy imports, which are closely linked to the volatility of oil prices.
2. More specifically, import intensity is the sum of the import content in intermediate goods (i.e. the percentage of inputs that comes from imports) and imports of final products.

3. Bank of Spain (2012), «The import content of the branches of economic activity in Spain», Economic Bulletin.

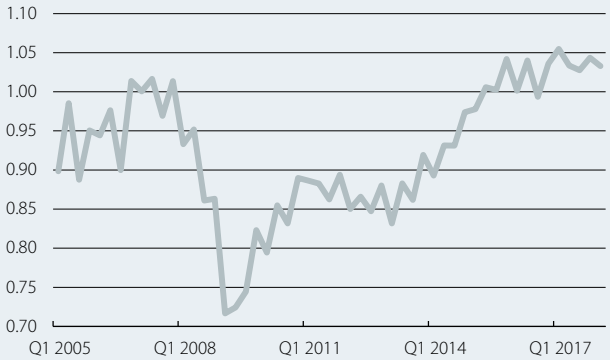
an «import surprise» indicator.[4] According to this indicator, an import surprise of 1 would indicate that, on average, the import intensity ratios of 2007 remain in place. An import surprise above 1, meanwhile, indicates that the import intensity of the various components of demand has risen on average. Finally, an import surprise of less than 1 indicates that the import intensity has fallen.

The trend in the import surprise over time shows four distinct phases. Firstly, we have a pre-crisis period (2005-2008) characterised by stability, with values close to 1, meaning that the ratios of 2007 dominated. This was followed by the hiatus of the financial crisis, which saw a paralysis of trade. This brought about a sudden drop in imports and, as a consequence, a decrease in the import surprise (imports fell more than would have been expected based on the contraction of economic activity). The third phase is the first phase of recovery, between 2013 and 2014, where the import surprise temporarily stabilises at values below 1, meaning that, on average, the import intensity is lower than it was during the pre-crisis period. The fourth phase begins in 2015 and is the second phase of recovery, characterised by a rapid rebound of the import surprise to the values seen prior to the financial crisis, close to 1.

What can we conclude from these trends in the import intensity? The lower import intensity of the first phase of the recovery could be attributed to the Spanish economy's increased competitiveness, with a higher preference for domestic goods and services over foreign ones. Seen in this way, the recovery of the import intensity to pre-crisis values would be a negative trend. However, we should remember that the positive performance of exports has made it possible to maintain the trade surplus despite the boom in imports, which indicates that exports are maintaining their competitiveness. In fact, we will conclude by pointing out three factors that can explain why the recovery of the import intensity does not point to a loss of competitiveness. The first is the differing cyclical sensitivity of the sub-components that make up the consumption, investment and exports. Thus, the recent increase in the import intensity could reflect the fact that, due to their sensitivity to the business cycle, the sub-components that have a higher import intensity (such as durable goods, within private consumption) are starting to grow more.[5] The second factor is integration: it could be the case that the growth of imports is due to Spanish companies becoming more integrated into global supply chains, as a result of increased competitiveness and the recovery of supply chains that were broken during the financial crisis.[6] The third factor is the pause in the trend of the Spanish economy moving towards tertiary sectors, which has been taking place since the 1990s. In this regard, since 2013, the weight of industry in the total gross value added of the economy as a whole has stopped declining, supposedly supported by the increased competitiveness which has helped to boost exports of goods. Given that industry has a higher import content than services,[7] this could also contribute to the greater import intensity observed in the economy as a whole.[8]

*Spain: Import surprise **

Index (1 = 2007 average)



Note: ** Ratio between observed and predicted imports if the import intensity had remained constant at the level of 2007.*
Source: *CaixaBank Research, based on data from the Department of Customs, the Spanish National Statistics Institute and the Bank of Spain.*

Spain: weight of industry in the gross value added (GVA)

GVA of industry (% of the total GVA)

Source: *CaixaBank Research, based on data from the Spanish National Statistics Institute.*

4. Specifically, we calculate the ratio between the nominal observed imports of goods and services (excluding energy) and the imports predicted by the import intensity of the various components of demand estimated in 2007 and the observed growth of these components. The indicator is normalised so that a value of 1 represents the average for 2007.
5. To validate this hypothesis, we would need information on the import intensity of the various components of demand at a more disaggregated level that would allow us to distinguish, for instance, between the consumption of durable and non-durable goods.
6. Reaching a clearer conclusion on this matter would require a more granular analysis by economic sector, identifying the branches of industry with a high and medium-high technological content, as well as a comparison with France and Germany.
7. The industrial sector has the highest import content of all sectors, at 38.2%. See the Focus «Towards a less import-dependent production model» of the MR10/2015.
8. Here we would need to look at the change in import intensity over time of the different branches of services, which in recent years have made a positive contribution to the trade surplus, compared with industry.

Consumer lending: excess or normalisation?

In recent months, there has been some concern about the strong growth in consumer credit and the possible risk it poses to financial stability. In its latest Financial Stability Report, the Bank of Spain warns of the need to monitor it closely to ensure that the banks' exposure to this segment of credit remains at reasonable levels.

Indeed, consumer financing has grown by 40% between December 2014 and June 2018, and now stands at 85 billion euros (79% of the peak reached in 2008). Part of this strong growth can be explained by the low levels at the starting point, since during the financial crisis it shrank by nearly 50%. When analysed in detail, it is also clear that the main driver is the consumption of durable goods.[1] Financing for this form of consumption has grown by 57% since the end of 2014 and it accounts for 75% of the rise in consumer credit.

The consumption of durable goods represents more than 50% of the consumption financed by the banking sector, because of the high initial outlay it requires,[2] and it is particularly sensitive to the business cycle. Therefore, this higher level of activity is supported by demand which, after remaining contained throughout the crisis, is currently on the rise as a result of a better economic outlook, job creation and good financing conditions for families. In a recent report,[3] the ECB stressed that the sharp fall in the consumption of durable goods during the financial crisis (–28% in real terms in Spain) has resulted in a decline in the effective stock of these goods and an increase in their average age. In other words, we kept our cars and refrigerators for longer than usual during the financial crisis, and now, with a consolidated recovery, we are replacing them. Therefore, the fast pace of growth we are currently witnessing has a strong cyclical – and thus temporary – component. This means that it will tend to slow down to more balanced rates when this piled-up demand reaches its conclusion.

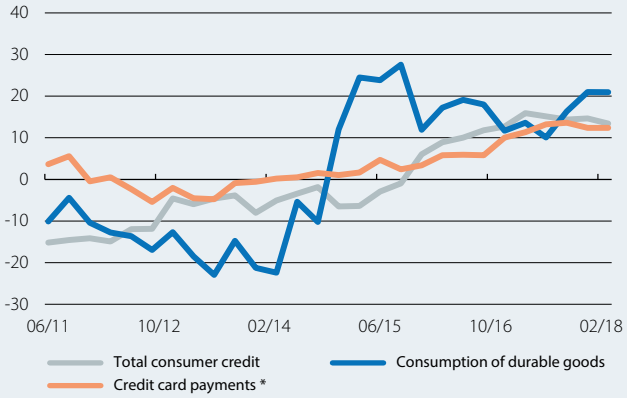
Could this rise in consumer credit pose a risk for the banking sector? For now, the exposure of Spanish banks to this segment of credit remains limited, making up only 6.9% of the total credit portfolio. This is similar to the level of the banking sector in the euro area as a whole, which stands at 6.6%. In terms of GDP, consumer credit in Spain represents a slightly higher portion than that of the euro area (6.9% versus 5.9%, respectively), but this is still a far cry from the previous positions. In terms of credit quality, the Bank of Spain's figures also confirm that it has improved, with an NPL ratio that fell to 5.2% in December 2017 (7.7% in December 2014) and with a reduction in doubtful credit of 7.5%.

In short, the origin of the strong growth in consumer credit is supported by the normalisation of demand, which remained contained during the financial crisis. In addition, this greater dynamism has not excessively increased Spanish banks' exposure to this segment, since it remains at levels similar to those of the euro area, while the quality of this segment has improved and remains at comfortable levels. For now, therefore, the surge in consumer credit seems to have more to do with a process of normalisation than with an excess. As the supervisor has warned, it will be important to ensure that this remains the case.

1. This category includes furniture, household appliances, vehicles, etc. The rest of financed consumption includes everything from deferred payments using credit cards to non-durable goods and services, such as medical or travel-related items.
2. By financing the purchase of these goods, the payment is distributed throughout the item's useful life, bringing it more in line with its use.
3. ECB (2018), «Consumption of durable goods in the ongoing economic expansion», Economic Bulletin, Issue 1 - Boxes.

Spain: stock of consumer lending

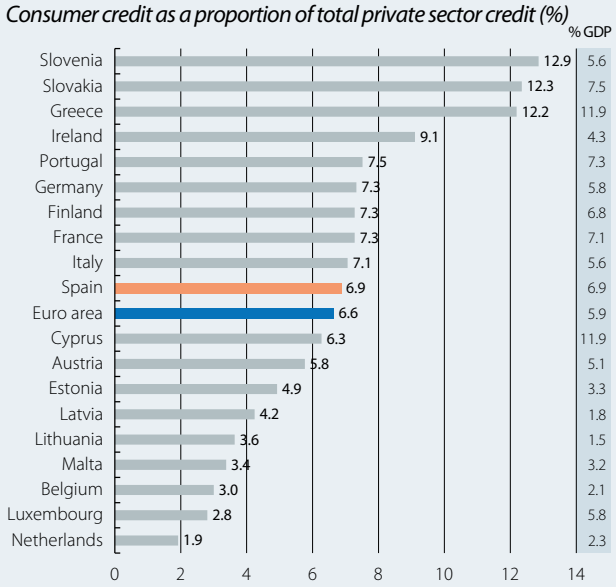
Year-on-year change (%)



Note: **Excludes revolving cards and overdrafts.*
Source: *CaixaBank Research, based on data from the Bank of Spain.*

Euro area: consumer credit by country

Consumer credit as a proportion of total private sector credit (%)



Note: *Data for Q1 2018.*
Source: *CaixaBank Research, based on data from the ECB and Eurostat.*

Activity and employment indicators

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

	2016	2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	06/18	07/18	08/18
Industry									
Industrial production index	1.9	3.2	2.8	5.2	2.7	1.0	0.2	...	...
Indicator of confidence in industry *(value)*	–2.3	1.0	–0.1	4.3	2.8	1.2	–0.5	–1.3	–3.5
Manufacturing PMI *(value)*	53.2	54.8	53.6	55.9	55.3	53.7	53.4	52.9	...
Construction									
Building permits *(cumulative over 12 months)*	43.7	22.9	23.5	25.1	25.1	...	...	...	...
House sales *(cumulative over 12 months)*	13.1	13.8	13.3	14.4	15.0	15.2	13.5	...	...
House prices	1.9	2.4	2.7	3.1	2.7	...	–	–	...
Services									
Foreign tourists *(cumulative over 12 months)*	8.2	10.0	10.4	9.2	8.2	5.3	4.3	...	...
Services PMI *(value)*	55.0	56.4	56.8	54.5	56.8	55.8	55.4	52.6	...
Consumption									
Retail sales	3.8	0.9	0.8	0.5	1.8	0.0	–0.1	–0.4	...
Car registrations	11.4	7.9	6.7	10.8	11.8	9.2	8.0	19.3	...
Consumer confidence index *(value)*	–3.8	–0.7	0.2	–1.5	–0.6	0.5	1.8	0.6	–2.5
Labour market									
Employment [1]	2.7	2.6	2.8	2.6	2.4	2.8	–	–	...
Unemployment rate (% labour force)	19.6	17.2	16.4	16.5	16.7	15.3	–	–	...
Registered as employed with Social Security [2]	3.0	3.6	3.5	3.5	3.4	3.1	3.1	3.0	...
GDP	**3.3**	**3.1**	**3.1**	**3.1**	**3.0**	**2.7**	**–**	**–**	**...**

Prices

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

	2016	2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	06/18	07/18	08/18
General	–0.2	2.0	1.7	1.4	1.0	1.8	2.3	2.2	2.2
Core	0.8	1.1	1.3	0.8	1.0	1.0	1.0	0.9	...

Foreign sector

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

	2016	2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	06/18	07/18	08/18
Trade of goods									
Exports *(year-on-year change, cumulative over 12 months)*	1.7	8.9	7.6	8.9	5.8	5.2	5.2	...	...
Imports *(year-on-year change, cumulative over 12 months)*	–0.4	10.5	9.0	10.5	6.6	6.9	6.9	...	...
Current balance	**21.5**	**21.9**	**21.0**	**21.9**	**21.1**	**16.2**	**16.2**	**...**	**...**
Goods and services	33.7	33.4	32.7	33.4	33.3	28.6	28.6	...	...
Primary and secondary income	–12.2	–11.5	–11.7	–11.5	–12.2	–12.4	–12.4	...	...
Net lending (+) / borrowing (–) capacity	**24.2**	**24.6**	**23.5**	**24.6**	**24.0**	**19.0**	**19.0**	**...**	**...**

Credit and deposits in non-financial sectors [3]

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

	2016	2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	06/18	07/18	08/18
Deposits									
Household and company deposits	2.5	2.8	2.3	3.2	2.5	3.0	4.3	3.5	...
Sight and savings	16.0	17.6	17.2	15.9	12.2	11.0	11.9	10.4	...
Term and notice	–16.0	–24.2	–25.1	–24.6	–23.1	–20.8	–19.4	–19.2	...
General government deposits	–14.2	–8.7	6.8	13.1	16.7	17.6	20.9	12.4	...
TOTAL	**1.2**	**1.9**	**2.6**	**3.7**	**3.2**	**3.8**	**5.2**	**4.0**	**...**
Outstanding balance of credit			...	...	...	...			
Private sector	–3.6	–2.2	–2.3	–1.9	–2.2	–2.8	–2.1	–2.4	...
Non-financial firms	–5.3	–3.6	–3.9	–3.3	–4.4	–6.4	–5.1	–5.8	...
Households - housing	–3.7	–2.8	–2.7	–2.6	–2.4	–2.0	–1.8	–1.7	...
Households - other purposes	2.0	3.7	3.3	4.5	4.9	5.0	4.9	5.2	...
General government	–2.9	–9.7	–11.6	–11.4	–12.5	–9.4	–8.8	–9.1	...
TOTAL	**–3.6**	**–2.8**	**–3.0**	**–2.5**	**–2.9**	**–3.2**	**–2.6**	**–2.8**	**...**
NPL ratio *(%)* [4]	**9.1**	**7.8**	**8.3**	**7.8**	**6.8**	**6.4**	**6.4**	**...**	**...**

Notes: *1. Estimate based on the Active Population Survey. 2. Average monthly figures. 3. Aggregate figures for the Spanish banking sector and residents in Spain. 4. Period-end figure.*

Source: *CaixaBank Research, based on data from the Ministry of Economy, the Ministry of Public Works, the Ministry of Employment and Social Security, the National Statistics Institute, the State Employment Service, Markit, the European Commission, the Department of Customs and Special Taxes and the Bank of Spain.*

Keeping up the pace after a good first semester

The economy consolidates its positive performance. The latest data confirm that economic growth remains firm thanks to the good performance of domestic demand and exports. It is precisely the buoyancy of domestic demand (within which the recovery of the consumption of durable goods and investment are of particular note), coupled with the higher oil price and the high import content of some exports (such as fuels and cars), that is fuelling a significant growth in imports. This, together with the decline in exports to Angola and the United Kingdom, explains one of the dissonant notes of Portugal's macroeconomic environment: a lower net contribution to growth by the foreign sector. Nevertheless, on the whole, the scenario for the Portuguese economy remains positive and over the coming quarters it is expected to maintain the vibrancy of the first six months of the year, with a growth rate slightly above 2%. In addition to this is the good performance of the labour market, where job creation and the fall in unemployment continue to be better than expected, as well as the positive trend in the real estate market, which is benefiting from foreign demand and the growth of tourism. However, the risk factors, particularly those related to trade tensions, the tightening of global financial conditions and the turmoil in the emerging economies, are still present and could trigger changes to the country's economic scenario.

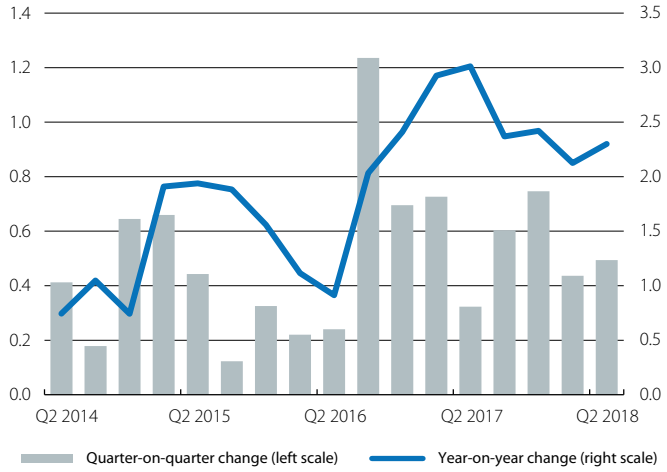
Economic activity continued to grow at a solid rate in Q2. In particular, in Q2 GDP growth accelerated to 2.3% year-on-year (0.5% quarter-on-quarter), 0.2 pps above the figure for Q1. The breakdown by component published by the National Statistics Institute shows that domestic demand played a prominent role, contributing 2.9 pps to growth (2.6 pps in Q1) driven by the strong increase in private consumption (2.6% year-on-year) and investment (6.4%). External demand, on the other hand, had a negative contribution for the fourth consecutive quarter (–0.7 pps) despite the acceleration in exports (6.8% versus 4.7% in Q1), given that imports accelerated even more (7.9% versus 5.6%).

The labour market continues to produce pleasant surprises and spur consumption. In Q2, the unemployment rate stood at 6.7%, with a reduction of 2.1 pps compared to the level recorded in Q2 of 2017. This decrease is largely due to the reduction in the number of long-term unemployed. This is a particularly positive sign because, typically, this group has more difficulties in rejoining the labour market. Furthermore, job creation maintained a good rate of growth (2.4%), with a significant contribution from the services sector and especially from those associated with the general government.

Inflation slowed in August. After rising to 2.2% in July, driven by the increase in energy prices (7.9%), in August headline

Portugal: GDP

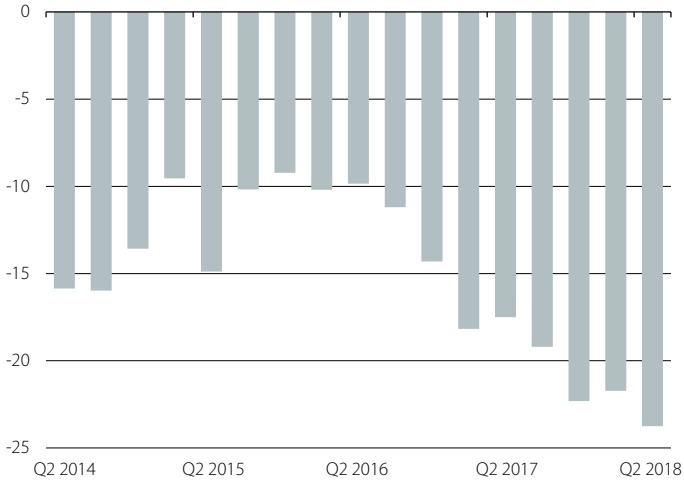
Quarter-on-quarter change (%) *Year-on-year change (%)*



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

Portugal: unemployment

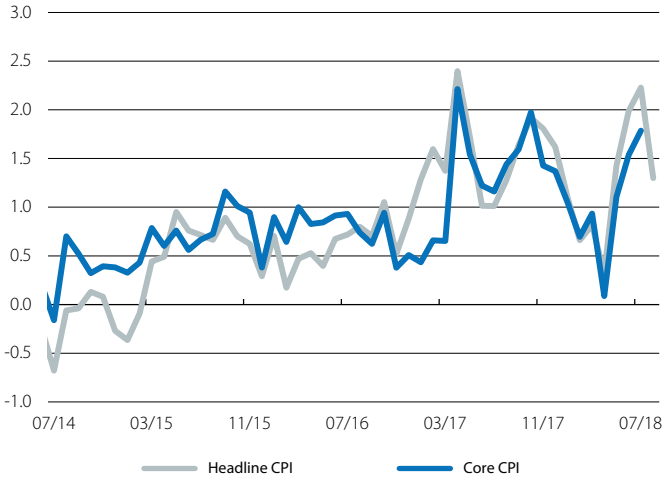
Year-on-year change (%)



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

Portugal: CPI

Year-on-year change (%)



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

inflation stood at 1.4%. While the breakdown by component is not yet known, the slowdown would appear to be largely due to the underlying component (which excludes changes in the particularly volatile prices of energy and unprocessed foods), which in July rose to 1.8%.

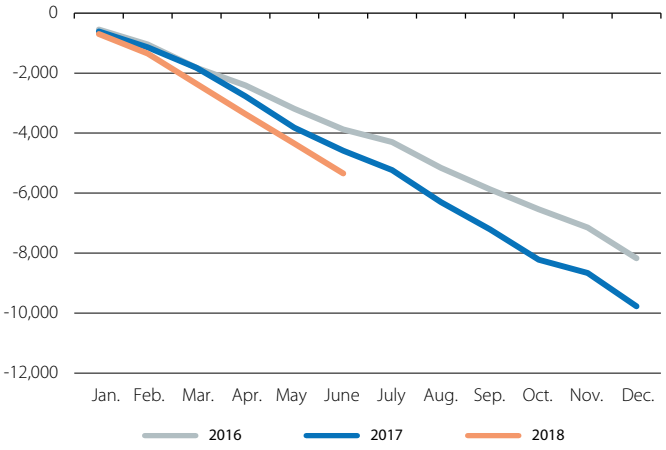
The foreign sector sees a moderation in the current account balance. Despite the sustained surplus in the trade balance in services and the positive performance of certain segments of exports of goods (such as cars), over the course of the first half of 2018 the current account balance has gradually deteriorated, worsening by 0.4 pps compared to the same period in the previous year and reaching 0% of GDP in June (12-month cumulative balance). This is due to the higher price of oil in recent quarters, as well as to the recovery of the consumption of durable goods and the buoyancy of investment, which have a high import content. However, the foreign surplus in terms of services, with tourism at the helm, continues to serve as a mitigating factor. Finally, it should be noted that there has also been a reduction of the deficit in the primary income balance, both due to a decline in revenues received and due to an increase in outgoing payments.

The public accounts continue to benefit from the positive economic context and the growth of the labour market. Based on the cumulative data up to July, the budget deficit stands at 2,624 million euros (–2.2% of GDP), which represents a reduction in the deficit of 1,110 million euros compared to the same period last year. The collection of taxes continued to grow at a faster rate than expected by the Government and accounted for 77% of the increase in collections settled up to July. Nevertheless, compared to last year, a substantial portion of the increase in corporate tax net incomes in 2018 to date is due to the deferment of the payment of state reimbursements payable to companies. Therefore, its effect should fade over the coming months. At the same time, contributions to Social Security continue to benefit from the growth in the labour market, while expenditure continues to grow below the budget projections (of particular note is the lower investment, with 39% up to July compared to 49% up to July 2017).

New bank lending grows in line with economic activity. New bank lending to individuals has shown steady growth in the first half of the year, in line with the acceleration in private consumption. In particular, the two main segments (lending for housing and for consumption) have experienced growth of 25.5% and 14.9% year-on-year up to June (new operations and annual cumulative lending). New bank lending to companies has also followed a positive trend, both for SMEs (2.5%) and for large firms (18.5%). However, lending to the non-financial private sector has continued to decline (–1.6% year-on-year).

Portugal: trade balance in goods (excl. energy)

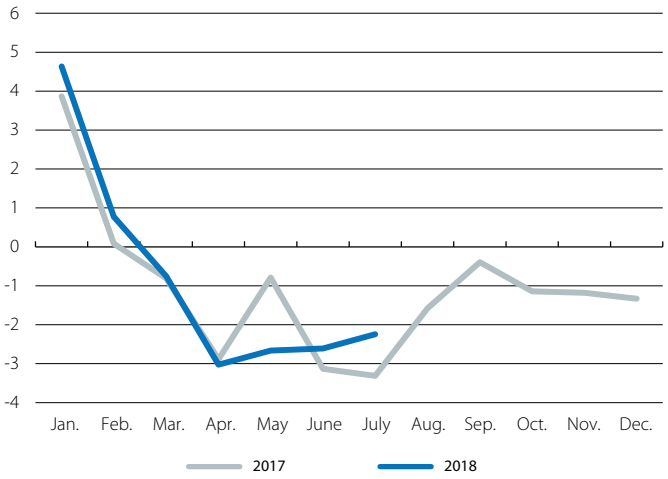
Annual cumulative balance (EUR millions)



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

Portugal: central government balance

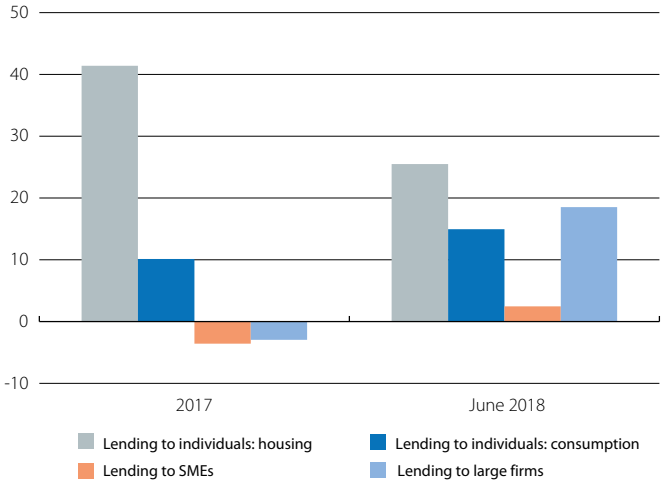
(% GDP)



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

Portugal: new credit operations

Year-on-year change in the annual cumulative balance (%)



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

Portugal: evaluating the country through tourism

In 2017, the tourism sector reached new record figures and underscored even more the growing trend seen in recent years: the number of foreign tourists, of hotel establishments and, ultimately, the revenues generated by the sector are at an all-time high. Furthermore, the importance acquired by tourism has made it an attractive opportunity for both small and large investments: from the renting of rooms and small flats to the construction of new hotel establishments, in addition to restaurants and transportation.

The Portuguese economy has been able to take advantage of the rise of international tourism, since Europe remains among the most popular destinations for international tourists. In particular, Portugal has features that fit the preferences of those looking for sun, sea and sand, as well as cultural attractions, leisure activities, beautiful landscapes and other attractions such as lower prices, good transportation and safety.

In this context, overnight stays by tourists in 2017 reached a total of 57.6 million (+7.6% year-on-year), with the United Kingdom and Spain as the first and second leading sources of tourists and with a significant increase in visitors from Brazil and the US. In addition, the average revenue per available room (RevPAR) increased to 50.3 euros, +16.3% compared to 2016 and a new all-time high. Thus, tourism has become Portugal's main export product and represents 17.8% of total exports.

Performance in 2018 and future outlook

In 2018, the tourism sector is expected to continue to break records. Indeed, the figures for the first half would suggest this to be the case: total overnight stays increased by 0.5% year-on-year, the number of foreign tourists rose by 1.9%, the revenue of the sector grew by 8.9% and the RevPAR stood at 44.2 euros, 7.7% more than in the first half of 2017.

Despite these new highs, the figures suggest a slowdown in the growth of foreign tourists. In fact, there has been a reduction in the entry of European tourists: between January and June 2018, arrivals from major sources, such as the United Kingdom and Germany, declined by 6.4% and 1.1% respectively, and similar figures were recorded for other countries, such as the Netherlands and Poland. In any case, we should interpret these figures with a grain of salt, given that the sector tends to be more dynamic in the second half of the year and could yet correct this less buoyant trend.

At the same time, domestic tourism among residents has grown in importance (a sign of the strength of the recovery in domestic demand), although it still accounts for less than tourism of non-residents.[1]

Future challenges

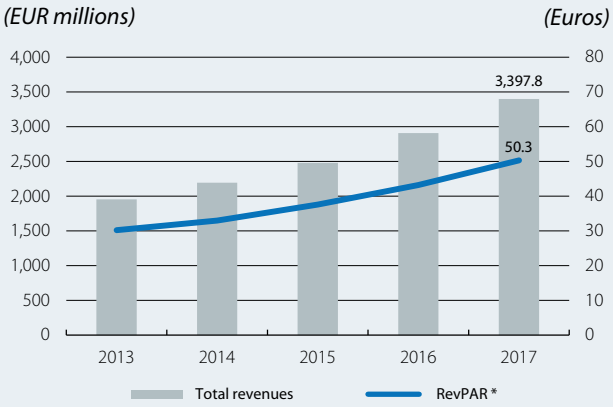
Considered a strategic economic area, the Government has created a National Strategic Plan for Tourism, covering the period 2017-2027. With this plan, it has identified five major challenges for the consolidation of the sector: i) combating seasonality, ii) showcasing heritage and culture, iii) decentralising demand, iv) improving the qualification of labour and v) stimulating innovation. With all this, it has also set an objective: to reach 80 million overnight stays and 26,000 million euros in revenue (average annual growth of +7.0%) in 2027.

Portugal: key figures of the tourism sector

	Unit	2005	2011	2017[1]
Tourists	10^3	11,469.3	13,992.8	20,691.3
Residents	10^3	5,513.6	6,580.6	7,979.8
Non-residents	10^3	5,955.7	7,412.2	12,711.5
% of the total	%	51.9%	53.0%	61.4%
Total overnight stays[2]	10^3	35,520.6	39,440.3	57,622.9
Total revenue[2]	10^6	1,589.2	1,906.0	3,397.8
Tourism exports[3]	10^6	6,198.6	8,145.6	14,969.1
% of GDP	%	3.9%	4.6%	7.8%
% of total exports	%	14.5%	13.2%	17.8%
Trade balance of tourism[3]	10^6	3,744.4	5,172.0	10,668.9
% of the services trade balance	%	82.3%	64.6%	68.3%
Number of establishments	unid.	2,012	2,019	5,840
Employment[4]	10^3	–	286.5	323.3
% of the total employed population	%	–	6.0%	6.8%

Notes: *1. The total number of tourists in 2017 was 24,077.1 thousand if we include the hospitality, rural tourism and local accommodation sectors (additional data from the National Statistics Institute). 2. In hotel establishments and other accommodation. 3. In euros at current prices. 4. Employment in accommodation, restaurants and similar fields.*
Source: *CaixaBank Research, based on data from the National Statistics Institute of Portugal and the Bank of Portugal.*

Portugal: revenues of the hospitality sector and other accommodation



Note: ** Average revenue per available room.*
Source: *CaixaBank Research, based on data from the National Statistics Institute of Portugal.*

1. The contribution of non-residents is slightly above 60%.

Portugal: a booming real estate market

The real estate market is going through a period of great buoyancy, which is reflected in the growth of prices and the number of transactions, as well as in a wide range of other indicators (see table below). What factors are stimulating supply and demand? What trend will they follow? We analyse this below.

Unlike previous business cycles, domestic credit does not currently appear to be the main driver of this buoyancy. In particular, the latest data (relating to Q1 2018) show that new mortgage credit represents a relatively small fraction of the total value of transactions carried out in the market (specifically, 37%, a far cry from the nearly 65% recorded prior to 2010). Meanwhile, despite the marked increase in new mortgage credit transactions, the stock of credit for housing is going down, since the repayment of mortgages still exceeds new transactions.[1]

In the current cycle, on the other hand, the entry of foreign investors has played a key role in revitalising the Portuguese real estate market. Two factors stand out in particular: the strength of tourism, which has contributed to the increase in real estate refurbishments, and the adoption of measures to attract foreign investment, by offering very attractive tax benefits and granting residence permits. For example, since the Golden Visa[2] programme came into force in October 2012, the purchase of homes by non-residents has risen to 3.5 billion euros, approximately 5% of the total transactions carried out to date in the sector.[3]

After five years with positive growth rates, the price indicators also reflect a sector which is clearly on the rise. In this case, the difficult task of evaluating the sustainability of the price increases is hampered by the important role played by foreign investment. Nevertheless, some indicators have recently stood at levels suggesting that prices could be overvalued. For example, the ratio between house prices and household disposable income, as well as the real estate market overvaluation index drawn up by the European Central Bank,[4] have increased steadily. However, other indicators paint a less negative picture: for example, the percentage of households for which the total cost of housing represents more than 40% of their disposable income is less than 10% (and lower than the average for the euro area).

Finally, it is important to remember that, throughout the last decade, a reduction in the number of new houses built has created a gap between supply and demand, which also pushes up the prices of the sector. Between 2009 and 2014, the number of homes completed barely exceeded an average of 24,000 per year, compared to the 60,000 that were completed in 2008. A slight recovery began in 2015, but in the last 12 months, based on the data available up to March 2018, the figure for completed homes remains below 10,000. The increase in new construction applications (which exceed 15,000) points towards a further increase to come over the next few years. Thus, this trend will gradually reduce the imbalance that exists between supply and demand, which should favour a moderate slowdown in the growth of prices in the medium term. In fact, this is the prevailing view in the sector: a recent survey shows that real estate professionals expect prices will continue to rise over the next 12 months at a robust pace, but the rate of growth will gradually stabilise at around 5% over the next five years.[5]

Portugal: real estate market indicators

	2008	Average 2009-2014	Average 2015-2016	2017	Q3 2017	Q4 2017	Q1 2018
Sector indicators							
Construction (% of GDP)	13.0%	9.8%	7.6%	8.0%	7.9%	8.1%	8.2%
Residential construction (% of GDP)	4.7%	3.1%	2.5%	2.6%	2.6%	2.7%	2.6%
New construction applications/homes completed	77%	65.8%	125.4%	147%	158%	135%	164%
No. of homes on the market	–	97,398	117,204	153,292	38,783	42,445	40,716
Value of transactions (EUR millions)	–	10,969	13,642	19,338	4,861	5,579	5,423
Price of housing (current prices, year-on-year change)	–6.3%	–1.4%	5.6%	9.2%	10.4%	10.5%	12.2%
Price of housing (deflated, year-on-year change)	–8.9%	–2.1%	4.1%	7.9%	9.2%	9.2%	–
Measure of the overvaluation of prices*	–3.5	–10.7	–10.4	–2.3	0.3	–0.3	3.5
Confidence index	–	–25.8	32.9	37.3	36.1	33.7	38.2
Household indicators							
Housing cost overburden rate**	7.6%	7.2%	8.3%	6.7%	–	–	–
Price of housing/disposable income (index)	101.2	97.5	96.9	103.8	106.4	105.8	–
Credit indicators							
Credit for housing (stock), year-on-year change	4.1%	–1.4%	–3.6%	–1.8%	–3.0%	–1.8%	–1.7%
New housing credit transactions, year-on-year change	–31.9%	–19.4%	51.7%	41.4%	42.8%	46.4%	22.8%
New credit transactions/value of the transactions	–	46%	33%	38%	39%	38%	37%

Notes: ** Index compiled by the ECB in which positive values suggest overvaluation.*
*** Fraction of the population living in households where the total cost of housing represents more than 40% of their disposable income.*
Source: *CaixaBank Research, based on data from the Bank of Portugal, the National Statistics Institute of Portugal, the ECB and Eurostat.*

1. The volume of repayments increased substantially in 2017 and, according to data from the Bank of Portugal, 50% of them corresponded to early repayments which, for the most part, were not associated with the purchase of a new home.
2. Residence permits granted to non-residents who invest in the country. In the case of real estate investment, the minimum investment is 500,000 euros.
3. The Bank of Portugal has pointed out the importance of the entry of non-residents into the real estate market, particularly in relation to the increase in the sale of properties belonging to the banking sector and the reduction of unproductive credit. See the Bank of Portugal's Financial Stability Report for June 2018.
4. This index, calculated based on the ratio between house prices and gross disposable income per capita, indicates that there has been a slight overvaluation since late 2017.
5. See the «Portuguese Housing Market Survey», Confidencial Imobiliário.

Activity and employment indicators

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

	2016	2017	Q4 2017	Q1 2018	Q2 2018	04/18	05/18	06/18	07/18	08/18
Coincident economic activity index	1.5	2.7	2.8	2.5	2.0	2.2	2.0	1.9	1.8	...
Industry										
Industrial production index	2.4	4.0	2.5	2.3	0.5	4.4	–2.7	–0.2	–1.7	...
Confidence indicator in industry *(value)*	–0.7	2.3	3.5	2.1	0.0	0.1	–0.5	0.5	0.9	1.6
Construction										
Building permits *(cumulative over 12 months)*	7.9	19.8	15.6	8.8	10.3	...	...	10.3	...	...
House sales	18.8	20.5	23.6	15.7	...	...	...	...	...	...
House prices *(euro/m² - valuation)*	3.8	5.0	4.5	5.4	...	...	...	...	...	...
Services										
Foreign tourists *(cumulative over 12 months)*	10.9	12.1	11.8	10.9	7.5	8.5	7.7	6.2		
Confidence indicator in services *(value)*	7.3	13.8	14.8	13.2	14.4	10.5	13.7	18.9	18.3	14.5
Consumption										
Retail sales	2.7	4.1	4.1	5.9	2.6	–1.1	5.6	3.2	2.3	...
Car registrations	1.7	2.4	2.5	2.4	2.1	2.2	2.1	1.9	1.6	...
Consumer confidence index *(value)*	–11.1	0.5	2.3	2.0	2.8	3.0	4.1	1.3	–1.4	–1.3
Labour market										
Employment [1]	1.2	3.3	3.5	3.2	2.4	2.6	2.5	2.8	2.1	...
Unemployment rate (% labour force)	11.1	8.9	8.1	7.9	6.7	7.1	7.0	6.7	6.8	...
GDP	**1.6**	**2.7**	**2.4**	**2.1**	**2.3**	**...**	**...**	**2.3**	**...**	**...**

Prices

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

	2016	2017	Q4 2017	Q1 2018	Q2 2018	04/18	05/18	06/18	07/18	08/18
General	0.6	1.6	1.8	0.9	1.2	0.3	1.4	2.0	2.2	1.3
Core	0.8	1.3	1.6	0.9	0.9	0.1	1.1	1.5	1.8	...

Foreign sector

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

	2016	2017	Q4 2017	Q1 2018	Q2 2018	04/18	05/18	06/18	07/18	08/18
Trade of goods										
Exports *(year-on-year change, cumulative over 12 months)*	0.8	10.1	10.1	6.5	7.3	7.9	7.1	7.3	...	...
Imports *(year-on-year change, cumulative over 12 months)*	1.5	12.6	12.6	10.4	9.8	10.6	8.8	9.8	...	...
Current balance	**1.1**	**0.9**	**0.9**	**0.9**	**0.0**	**0.4**	**0.6**	**0.0**	**...**	**...**
Goods and services	3.8	3.5	3.5	3.2	3.1	3.2	3.6	3.1	...	...
Primary and secondary income	–2.7	–2.6	–2.6	–2.3	–3.1	–2.8	–3.0	–3.1	...	...
Net lending (+) / borrowing (–) capacity	**3.0**	**2.7**	**2.7**	**2.7**	**1.9**	**2.1**	**2.3**	**1.9**	**...**	**...**

Credit and deposits in non-financial sectors [2]

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

	2016	2017	Q4 2017	Q1 2018	Q2 2018	04/18	05/18	06/18	07/18	08/18
Deposits										
Household and company deposits	3.7	1.7	2.1	2.6	4.3	3.5	4.3	4.9	...	...
Sight and savings	19.5	15.7	2.1	2.6	4.3	14.2	15.4	16.2	...	...
Term and notice	–3.2	–5.8	–4.4	–4.1	–2.9	–3.3	–2.9	–2.5	...	...
General government deposits	–17.9	1.3	12.1	1.9	–0.8	–5.5	–9.7	12.8	...	...
TOTAL	**2.3**	**1.6**	**2.6**	**2.6**	**4.0**	**3.1**	**3.5**	**5.4**	**...**	**...**
Outstanding balance of credit										
Private sector	–3.9	–4.0	–3.4	–1.8	–1.8	–1.9	–1.7	–1.6	...	...
Non-financial firms	–5.6	–6.5	–6.0	–3.1	–3.7	–3.8	–3.6	–3.6	...	...
Households - housing	–3.3	–3.1	–2.1	–1.9	–1.6	–1.7	–1.6	–1.4	...	...
Households - other purposes	–0.5	0.9	0.2	3.0	4.1	3.6	4.3	4.5	...	...
General government	–9.4	9.3	22.9	19.0	14.8	16.3	17.4	10.6	...	...
TOTAL	**–4.2**	**–3.5**	**–2.4**	**–1.0**	**–1.1**	**–1.2**	**–1.0**	**–1.2**	**...**	**...**
NPL ratio *(%)* [3]	**17.2**	**13.3**	**13.3**	**13.0**	**...**	**...**	**...**	**...**	**...**	**...**

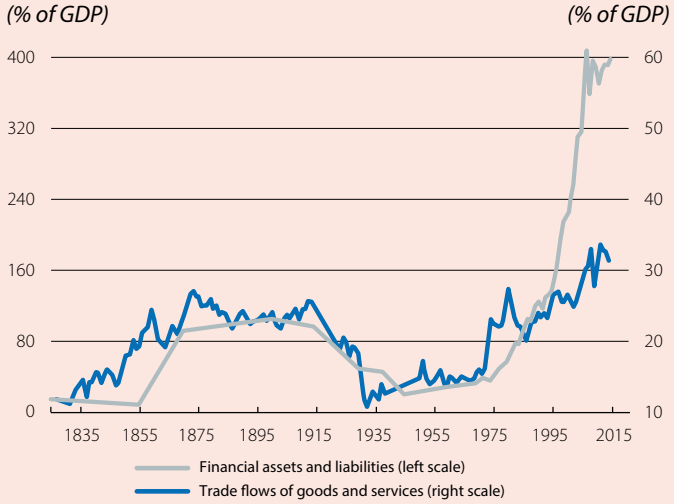
Notes: *1. Estimate by the National Statistics Institute. 2. Aggregate figures for the Portuguese banking sector and residents in Portugal. 3. Period-end figure.*
Sources: *CaixaBank Research, based on data from the National Statistics Institute, Bank of Portugal, European Commission and European Automobile Manufacturers' Association.*

Globalisation at a historic crossroads: deglobalisation or reglobalisation?

Globalisation, defined as the global integration of markets for goods, services, capital and people, is a phenomenon with very old roots and which still has a lot of life left in it. Most studies agree that we are currently in the aftermath of the so-called second wave of globalisation and that, in the event of a new drive towards greater globalisation, we could shortly enter into the third wave. Each wave is associated with a particular process of technological change: the first took place between 1870 and the Great Depression and is associated with the Industrial Revolution; the second lasted from the end of the Second World War up to the present day and is associated with the ICT revolution; and the third, if it occurs, will be heavily driven by the digital revolution. Globalisation is currently at a crucial inflection point, as it is facing major challenges on which its development over the next few years will depend. We must therefore be aware that the current environment is somewhat unstable and that the challenges we face must be addressed if we want to make progress towards achieving a more robust form of globalisation.

Today, globalisation has reached heights never seen before: the globalisation index drawn up by the Swiss Economic Institute is at an all-time high and three of its four key pillars (goods, capital and people, but not services) also reflect the extent of globalisation. Similarly, total trade flows as a percentage of GDP in the 1970s exceeded the previous all-time high seen in the first wave of globalisation in 1913. This was a result of the liberalisation of the trade of goods and, despite a slowdown in recent years attributed to cyclical factors (the Great Recession) and structural factors (the fragmentation of some global supply chains), trade flows remain at high levels today. Services, on the other hand, continue to be the major sticking point: despite them growing as a percentage of total exports from 9% in 1970 to 25% today, regulatory barriers remain high in many sectors (such as financial services and telecommunications). Many economists have suggested[1] establishing more ambitious free trade agreements to boost trade in services, which would be particularly desirable at a time when technological change is making it easier for many services to be exported and imported. With regards to the financial element, this shows very high levels of integration, despite a slight slowdown following the financial crisis that has curtailed cross-border banking flows.

Commercial and financial globalisation



Note: *Trade flows do not cover all countries of the world, as they relate to a fixed sample of countries for which data is available dating back to 1825.*
Source: *CaixaBank Research, based on data from the Bank for International Settlements.*

Globalisation of people is also key and has become an area of particular interest in the public debate, both due to its economic impact and due to the human drama of the refugee crises (33,000 migrants lost their lives between 2000 and 2017 in the Mediterranean while attempting to reach Europe, according to the United Nations). Although the number of migrants as a percentage of the total population has remained stable at around 3% over the last 100 years, its number in absolute terms has grown to 244 million, of which 19% reside in the US and 23% in the EU. Most of the migrant flows have been from emerging countries towards developed countries, and 40% of migrants have university studies. This trend has arisen in a context of competition for global talent that has led to a brain drain in the emerging economies.

Having briefly covered the various components of globalisation, we must analyse what challenges it is facing today. The first challenge is to strengthen the major global institutions (the IMF, the Bank for International Settlements - or BIS - and the WTO), which were created after the Second World War and have supported the current wave of globalisation. The IMF, for example, should modernise its corporate governance mechanisms to give greater weight to the emerging economies, which have grown dramatically precisely thanks to globalisation. It is hardly justifiable that the OECD countries have 64% of the decision-making power in the fund, when they only represent 46% of the world's GDP, or that China's share of the power amounts to only 6% when it now accounts for as much as 19% of the global economy. As for the BIS, the greater interconnectedness of the global financial cycle suggests that this institution and other financial bodies should play a more active role, with a view to facilitating greater

1. See R. Staiger and A. Sykes (2016), «The Economic Structure of International Trade-in-Services Agreements», NBER Working Paper.

coordination on monetary and macrofinancial policy. Finally, the WTO should play a more important role in helping China to integrate more harmoniously into global trade.

The second challenge is to achieve better distribution of the overall benefits. It is important to emphasise that the globalisation of recent decades has had a positive effect overall: it has helped millions of people out of poverty in emerging countries, while in advanced economies it has generated substantial gains in the population's well-being, as consumers have been able to enjoy a wider variety of consumer goods and at more affordable prices. However, it is fair to add that, despite these benefits, globalisation has also harmed some specific sectors: according to the MIT economists Acemoglu and Autor,[2] 10% of the manufacturing jobs that were lost in the US between 1999 and 2011 (amounting to 560,000 jobs) were due to greater commercial competition with China. In any case, we must ask ourselves why the debate surrounding a more inclusive model of globalisation, which manages to compensate the losers and prevent them from being excluded from the new economy, is hotter today than ever. The answer is that, when an economy's exposure to globalisation is limited, the benefit of greater integration is high, given that there is a marked increase in the aggregate real income of the economy. However, when globalisation has already reached a more advanced stage, there is less scope to increase the size of the cake, so to speak, while the relative magnitude of the losses suffered by the sectors that are adversely affected increases. This is the reason for the growing importance of promoting measures such as active labour market policies or income protection policies during the period of unemployment endured by those who are adversely affected by the process of change.

Finally, a third challenge posed by globalisation inextricably involves adopting mechanisms that help the process of technological change we are witnessing to be both successful and inclusive. Clearly, the digital revolution forced us to reformulate the current process of globalisation and will result in different forces working in different directions. On the one hand, the rise in the use of robots could dramatically reduce the rate of job offshoring (according to Deloitte, the cost of a robot is expected to represent 10% of the cost of an onshore employee and 35% of an offshore employee). On the other hand, the increased scalability of production at the global level could lead to the emergence of global corporate giants, which could be potentially detrimental for competition and the pace of innovation.

If globalisation and its institutions do not tackle these challenges as a matter of urgency, populist political options that advocate reversing globalisation could gain momentum. Several studies[3] show that they have already begun to reap the first benefits: both in the US and in the EU, the areas most affected by the increase in imports from China have seen a much greater rise in the support for populist parties - so much so that some political scientists are already going as far as to state that the political debate, which has traditionally focused on the axis of left and right, will switch to a fierce struggle between globalists and populists.

Before concluding, it is important to analyse how the first wave of globalisation was derailed, to see if we can draw any lessons from it. The regression began at the end of the 19th century when the governors of the time decided to give in to the pressures exerted by a very select group of sectors (such as the agricultural lobbies) which were demanding an increase in tariffs. At the same time, countries such as the US, Canada, Australia and Argentina were not able to properly manage the levels of mass migration from Europe, which led to them closing their borders in the second decade of the 20th century. Some authors[4] consider that the anti-globalisation sentiment among many segments of the population was one of the factors that led to the First World War between 1914 and 1918. Finally, the Great Depression gave the final blow to the first wave: countries reacted by implementing protectionist policies on a large scale, which led to a substantial worsening of the economic crisis of 1929, with far-reaching global repercussions. Not in vain, according to the economist Jakob Madsen,[5] the volumes of real trade at the global level fell by 33% between 1929 and 1932, with almost two thirds of the decline being caused by the protectionist policies that were implemented.

In short, in this article we have recognised that globalisation is facing an historic crossroads and that now is the time to tackle the remaining challenges that have cast doubt over it. What is certain is that we are cautiously optimistic: the current system of global governance has a wide range of tools at its disposal to forge a more modern and inclusive form of globalisation. However, unless progress is made along that path, we run the risk of the shadow of the past becoming the nightmare of the present. Our ability to avoid tripping over the same stone twice depends on it.

Javier Garcia-Arenas
CaixaBank Research

2. See D. Acemoglu *et al.* (2016), «Import competition and the great US employment sag of the 2000s», Journal of Labor Economics.
3. See I. Colantone and P. Stanig (2017), «The Trade Origins of Economic Nationalism: Import Competition and Voting Behavior in Western Europe», American Journal of Political Science.
4. See M. Bordo (2017), «The Second Era of Globalization is Not Yet Over: An Historical Perspective», NBER Woking Papers.
5. See J. Madsen (2001), «Trade barriers and the collapse of world trade during the Great Depression», Southern Economic Journal.

The benefits and costs of globalisation

When Marco Polo reached China in the 13th century via the Silk Road, he found a prosperous land where agriculture and industry were flourishing thanks to trade, supported in turn by a vast network of roads, bridges and canals. The per capita wealth of the Chinese far exceeded that of the Europeans, as illustrated by the fact that steel production in China was five times higher than in Europe. However, in the early 15th century, at the peak of its prosperity, the Ming dynasty made a radical change to the country's economic policy, isolating it from the outside and, in doing so, oppressing its capacity for innovation. Four centuries later, China had been left behind, while Europe, which was more open, powerful and richer, began its colonialist phase in the Asian country.

In times like those we are living in today, in which voices have arisen in favour of greater protectionism, it is more necessary than ever to understand the benefits and costs of globalisation.

The benefits of globalisation on economic growth

The economic literature identifies several channels through which the phenomenon of globalisation affects economic growth and, therefore, our well-being. The first channel is known as knowledge spillover and refers to the benefits generated by the fact that knowledge gained in one country can be used in other countries.[1] Flows which contribute to globalisation (such as trade transactions or migratory movements) allow the dissemination of new ideas. These ideas, in turn, facilitate improvements in productivity in the countries which receive these flows, as well as in other countries, leading to improvements in the overall well-being of the population. One feature that makes this channel particularly relevant is the fact that knowledge is a factor of production that can be used simultaneously by different people in different countries (it is a non-rival factor, in economic terms).

Secondly, we have the «scale effect», which is derived from the larger market which is intrinsic to a more globalised world. In particular, globalisation gives companies a bigger playing field in which to exploit their ideas. Thus, they are able to earn profits from sales abroad, in addition to those from local sales. This increased market size encourages firms to grow and to acquire greater knowledge, which increases the country's productivity and, therefore, economic growth. This effect, however, has a direct counterpart at the local level, which is that the greater profit which companies can earn in this more globalised economy due to increased demand can be offset by the loss of market share in the face of competition from foreign companies. This gives rise to the «competition effect» of globalisation, which, contrary to the scale effect, can discourage some companies from acquiring greater knowledge. This occurs when, for example, upon losing market share and thus earning lower profits, local companies have fewer funds to invest in R&D. Similarly, at the global level, increased globalisation can also end up leading to a greater concentration of companies and, therefore, lower rates of investment.

On the other hand, a more global environment increases the variety of products available for consumers, since they now have access to foreign products, which increases their well-being («gains in variety»). Finally, economists have identified a last channel, known as «technological dissemination». The link between globalisation, technology and growth is as follows: in a globalised economy, companies are forced to use technology that is equal to or greater than that of their global competitors. Therefore, the greater competition means that only those companies that employ cutting-edge technology survive. The confluence of these elements means that new players entering a more globalised market are more technologically advanced than those in one with only local competition, resulting in better well-being in a globalised world.

Although we have identified the various channels that link globalisation and economic growth, we cannot assure that the former's impact on the latter will always be positive. This is because, although the majority of effects are beneficial for growth, the «competition effect» is detrimental to improvements in the population's well-being. Furthermore, the importance of this relationship must be tested: it could be the case that there is a positive and statistically significant relationship, but it is not economically significant.

Indeed, numerous empirical studies that take into account the different channels we have spelled out demonstrate that the aggregate effect on economic growth is positive and quite significant. In particular, in a baseline study using information from 150 countries, Frankel and Romer demonstrated how increases in an economy's trade flows lead to significant increases in its real per capita income. Specifically, an increase in international trade as a percentage of GDP of 1 pp translates into a 0.9% increase in per capita income. Such an increase in Spain would represent a boost of 225 euros to GDP per capita, while in Portugal it would represent an increase of 170 euros.[2]

1. See Grossman, G.M. and Helpman, E. (1990), «Trade, innovation, and Growth», The American Economic Review 80, n° 2: 86-91; and also Grossman, G.M. and Helpman, E. (1991), «Trade, Knowledge Spillovers, and Growth», European Economic Review 35, n° 2-3: 517-526.
2. International trade can be estimated using the ratio of imports plus exports over GDP. See Frankel, J.A. and Romer, D.H. (1999), «Does Trade Cause Growth», American Economic Review 89, n° 3: 379-399.

Weinstein and Broda, meanwhile, identify that the variety of imports in the US increased fourfold between 1972 and 2001, and that this greater variety led to a significant improvement in the well-being of the American people.[3]

The losers of globalisation in advanced countries

Despite the proven positive effects which globalisation can have on people's well-being, it can be the case – and, in fact, it is – that this better well-being is not equitably distributed among all individuals: some not only do not benefit but actually come out worse-off. They are the losers of globalisation.

Numerous studies have analysed the harmful effects of this phenomenon. In particular, the effects of globalisation on the labour market have been the subject of extensive research, especially in relation to the adverse effects it has on certain groups of workers in developed countries.

In this case, we can also identify different channels through which they are affected. The main one is related to the increase in direct competition suffered by certain groups of workers (generally, low-skilled workers) when faced with the possibility for companies in developed countries to relocate part of their production to emerging countries (with much lower labour costs). This can result in a reduction in the demand for local workers and, therefore, their salary.

There is, however, an effect that counteracts this unfavourable situation: companies opting to offshore part of their production (either by relocating or outsourcing) are able to lower their costs and thereby increase their productivity. In this situation, the company will have greater incentives to expand, which can increase the demand for workers (both qualified and non-qualified) in the country of origin and, with it, their remuneration. Finally, this decrease in the costs borne by companies opting to offshore their production leads to a decrease in the prices of the final goods and services they produce, leading to an increase in the real wages of all local workers.

At this point, and to assess the relevance of such costs, we once again turn to what the empirical analyses show us, including those conducted by the MIT economist David Author. In one of his most notorious articles, «The China Syndrome», he warns of a significant negative impact on some groups of American workers caused by the strong rise in imports from the Asian country following its entry into the World Trade Organization in 2001.[4] As such, workers in regions of the US which produced a high percentage of goods directly exposed to Chinese competition (such as electronic goods or textiles) suffered significant declines in wages and an increase in unemployment. As an example, manufacturing jobs (as a percentage of the total population) fell by 5 pp between 1991 and 2007, and their estimates indicate that greater exposure to Chinese imports was responsible for half of this deterioration. Similarly, other studies show real wage reductions of up to 12% in the face of greater exposure to international trade in the US.[5]

Besides labour costs, some studies have focused on the negative consequences for workers' health. The loss of employment or a reduction of wages can lead to depression. In addition, for those workers who have not lost their jobs and have even been able to keep their remuneration intact, the new scenario of greater competition which their employers face can have a substantial impact on their working day (both in terms of tasks and in terms of timetables), leading to greater occupational stress.[6]

In short, globalisation is capable of improving countries' well-being through improvements in productivity, lower prices and greater variety in the products that are available. However, it generates significant adjustment costs for those workers who suffer the most from the direct competition posed by the new flows arising in a globalised world.

Its staunch detractors have focused on highlighting these costs, while its outright defenders have sometimes only emphasised its benefits. None of them are lying, but neither are they telling the whole truth. Partial truths are of little use when faced with a phenomenon that has not stopped growing in recent decades and that affects us directly. Knowing the benefits and the costs brought about by globalisation is essential for deciding what form of globalisation we want to see from today onwards.

Clàudia Canals
CaixaBank Research

3. See Broda, C. and Weinstein, D.E. (2006), «Globalization and the Gains from variety», The Quarterly Journal of Economics 121.2: 541-585.
4. See Autor, D.H., Dorn, D. and Hanson, G.H. (2013), «The China Syndrome: Local Labor Market Effects of import Competition in the United States», American Economic Review 103, nº 6: 2121-68.
5. See Ebenstein, A., Harrison, A., McMillan, M. and Phillips, S. (2014), «Estimating the impact of Trade and Offshoring on American Workers using the Current Population Surveys», The Review of Economics and Statistics 96(4).
6. See Italo, C. , Crinó, R. and Ogliari, L. (2015), «The Hidden Cost of Globalization: import Competition and Mental Distress»; as well as Autor *et al.* (2013), referenced in note 4.

The challenge of *America First* for globalisation: threat or opportunity?

It is highly unlikely that the names Reed Smoot and Willis C. Hawley will be familiar to the contemporary reader, and yet the 1929 law that bears their name brought about the mass introduction of tariffs on some 20,000 products imported into the US. While the world was left astounded at how a stock market crash gave way to an unexpected fall in economic activity, the reaction of most countries to the Smoot-Hawley tariff was to respond with their own tariff measures. All this contributed to turning a recession that could have been «normal» into one which became extremely harmful. A few years later, the Second World War gave the final blow to the international system.

Out of its ashes, and under the undisputed leadership of the US, the current architecture of global governance was erected, known as the liberal international order: a set of rules and values embodied in a series of institutions whose ultimate goal was to ensure macroeconomic stability at a global level. Thus, after the Second World War, a set of economic and financial institutions were created (the IMF; the World Bank; the GATT, which was the predecessor of the current World Trade Organization; and the first incarnation of the future OECD). At the same time, other institutions were converted (the Bank for International Settlements) and new projects were sponsored (such as the EEC, which would lead to the current EU). These institutions and projects gave form to a common framework of shared values. This framework included a number of beliefs, such as that exporting, importing and investing should not be driven by countries' political power, that the growth of different countries was not a zero-sum game, and that property rights should be protected (including intellectual property rights, a requirement for the international dissemination of knowledge). Incorporating these values into good practices required many elements. These included ensuring that the system provided common mechanisms for conducting international trade and financial transactions, ensuring that there was a virtually universal currency conversion system, and defining mechanisms to establish, calculate and control tariffs and customs rules, to name just the most essential aspects. In addition, the system defined institutions and methods for resolving differences between the partners (commercial differences in particular), it established technical harmonisation mechanisms and it offered protection schemes against certain risks (of a natural, macroeconomic and financial nature), ranging from emergency humanitarian aid to the exceptional provision of liquidity among central banks.

Well, all this institutional architecture is now being challenged. By whom? Paradoxically, by the founding partner, the US. Under the slogan *America first*, the current US Administration has embarked on what appears to be a profound rethinking of the world liberal order. Whereas the US' international strategic approach to date has been multilateral and based on compliance with rules, it now appears to want to establish a bilateral philosophy, analysing each case from a cost-benefit perspective (in economic terms, but also political).

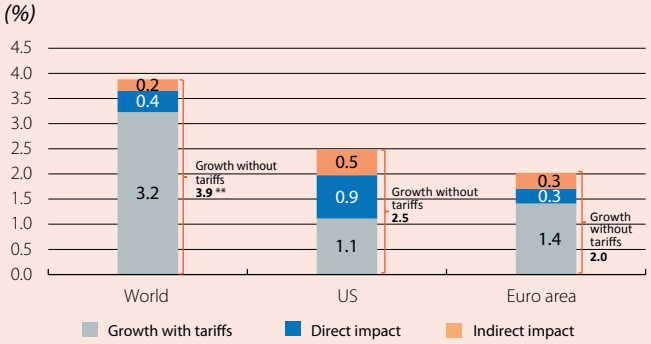
Let us go over what has been proposed to date, although this is an area which is constantly evolving and perhaps, when the reader reads this article, new measures may have been announced. From the very beginning of the new Administration, the US has abandoned the Trans-Pacific Partnership (TPP), it has withdrawn from the Paris Agreement on climate change, it has chosen not to renew its participation in the Nuclear Non-Proliferation Treaty with Iran (reimposing sanctions instead), it has begun an ambitious (albeit somewhat unrealistic) review of NAFTA and it has cast doubt, if not over NATO itself, over its military and financial commitment with the alliance. Furthermore, it has questioned the World Trade Organization and has left the United Nations Human Rights Council.

This litany of decisions has been accompanied by a progressive threat (and, in some cases, the actual implementation) of imposing tariffs on imported goods. In January 2018, the US applied tariffs to imported washing machines and solar panels. Shortly afterwards, in March, it announced its intention to apply tariffs on purchases of steel and aluminium, as well as on a wide variety of Chinese products. In addition, on various occasions it has threatened to impose tariffs on cars, and even on all Chinese imports. If these two measures were to be implemented (tariffs on cars and on all Chinese imports), a situation which seems unlikely (although nothing can be ruled out entirely), the average tariff of the US would go from 1.7% to 6.5%, a level not seen since the early 1970s. At present, and in response to the tariffs applied, the US' trading partners have begun to respond by establishing similar measures: since the beginning of July, Canada, Mexico, the EU and China have already applied tariffs on some of their US imports to compensate – partially for the time being – the new tariffs imposed by the US.

Could these skirmishes (calling them a trade war is still debatable) mutate into something more serious and end up damaging global growth? A shock of this kind would affect growth in two ways, one direct and the other indirect. The direct impact would come in the form of a reduction in trade flows, disruption to global supply chains and higher prices of imported goods. The indirect impact would materialise in the deterioration of business and consumer confidence and in the tightening of financial conditions.

The quantitative exercises that have been undertaken tend to confirm that, if protectionism remains at current levels, or even slightly higher, its impact on global growth should be contained. But the situation would change if the level of tariff protection were to increase significantly (at the high end of the tariffs threatened by the US Administration). According to calculations by CaixaBank Research, using estimates provided by the Bank of England as a starting point, a 10-pp increase in tariffs between the US and its trading partners lasting for three years (2018-2020) would reduce global growth, over the same period, from the expected annual average of 3.9% down to 3.2%. This decline, which is rather significant, would be mostly driven by the direct impact, which would affect growth approximately twice as much as the indirect impact. However, we must not lose sight of the fact that the indirect impact can take various forms, some of which are potentially very harmful to growth. This being the global impact, the US would be particularly affected, since its average annual growth currently expected for the period 2018-2020, of 2.5%, would be reduced to a meagre 1.1%. The euro area, meanwhile, would suffer slightly less, growing by 1.4% in the event of a trade shock compared to the 2.0% expected today.

Impact of a protectionist shift on average annual GDP growth in 2018-2020 *



Notes: ** The direct impact is obtained based on a mutual increase of 10 pps in tariffs between the US and its trading partners for a three-year period. The indirect impact comes from more restrictive financial conditions and an increase in uncertainty. It is assumed that global monetary policy remains unchanged over the next five years. Estimates are based on simulations by the Bank of England.*
*** The difference between the total and the sum of the components is due to rounding of the second decimal.*
Source: *CaixaBank Research, based on data from the Bank of England and the IMF.*

To reiterate the point, this represents an adverse scenario for the global economy. The levels of tariffs resulting from the aforementioned 10-pp increase would result in a situation similar to that last seen in the early 1950s, when the GATT had just started to remove tariffs. But even if the situation does not reach this level of severity and the short-term impact ends up being relatively limited, this does not mean that the consequences for the global institutional architecture in the medium and long-term will not be significant. One way to explore this *terra incognita* is to develop scenarios that integrate some of the essential features of the international system, as well as its players, which are currently in flux. Let us delve into the future by taking ownership of the US Administration's slogan, as if under a small license, to offer three different visions of what might lay ahead.

Globalisation first. Let us imagine that the risks associated with the current situation are read properly and governments react accordingly. Now let us jump ahead a decade; what would we see? One possibility is that we would be decisively entering into what historians of the future would call the third wave of globalisation (after the first, which succumbed in the 1930s, and the second, which hypothetically ended with *America First*). The renewal of globalisation would have come at the hand of profound changes in the way in which institutions operate, giving a bigger voice to the new global powers (China, as well as other medium-sized powers such as Russia, India and Brazil) and opening up the agenda to new areas of globalisation. These would include the development of the agricultural sector (long-neglected demand from Africa and other exporting regions), alterations to financial globalisation (which enhances international coordination) and an intensification of trade in services (demanded by the advanced countries). The institutional reform should also allow them to resume their role as a forum for resolving competition issues and to effectively defend intellectual property. This renewed globalisation would also be more sustainable, incorporating solutions to the main sources of instability of previous years by finding creative ways to compensate those perceived as the «losers» of globalisation, whether citizens or countries. All this should allow the populist agenda to lose its grip. In this scenario, the world order would continue under the political and economic leadership of the US, but it would be a far cry from the unipolarity that followed the fall of the Berlin Wall.

America first, America out. Here we are moving away from win-win scenarios in which everyone benefits. One possible story would be as follows. As a result of the *America First* strategy and what earlier we have referred to as cost-benefit bilateralism, the US will have intensified its isolationist shift, an ever-present temptation in American foreign policy since the 19th century. The rest of the world, however, would not go down the same path: when dealing with the US, other countries would have little choice but to conform to the bilateral logic, but in all other cases globalisation would continue and its economic roots would remain deep. In its final stage, this scenario implies that a modified version of today's globalisation would continue to operate, albeit on a smaller scale. In order for this to be a success, the problems mentioned above (essentially institutional and redistributive problems) would need to be solved, probably with solutions set out in the first scenario mentioned above. Given that the isolationism of the US would imply a more-than-likely decrease in prosperity and, by extension, in the US' economic weight, under this scenario the system would swing towards a more pronounced multipolarity. This would involve a larger number of key players, possibly with China at the helm and probably followed by the EU as defenders of the new globalisation, as well as a myriad of medium-sized powers. The main complexity with this scenario is the transition from the current situation towards the new balance. At the end of the day, when it comes to international relations, history reminds us that wanting something is not the same thing as being able to implement it. In the 1930s, the only country with the capacity to exercise stabilising leadership was precisely the one that did not wish to do so, while the country which tried did not have the capacity to do it (the reader might have guessed that we are talking about the US and the United Kingdom, respectively). The complexity of the transition would be intensified by the need to implement a profound change in how the current form of globalisation operates. This would range from the reconfiguration of global production chains on a different scale, to the capacity to substitute the fundamental role of the US in the field of financial globalisation.

America first, Europe First, China first. In this scenario, the central element is the fragmentation of the global economic and political systems. To capture the essence of the scenario, we can think of a mercantilist form of globalisation in which each centre (the US, Europe and China) would integrate with its natural hinterland, accompanied by certain regional champions such as Brazil or India. Although this option might seem suboptimal but not disastrous, the truth is that it would lead to a clearly less efficient economy, on a smaller scale and with an even more complex transition process than the previous scenario. In addition, as happened with the historic phases of mercantilism of the 17th and 18th centuries, it would be a somewhat unstable system with a tendency for confrontations to arise between the different blocs.

Do these distant scenarios sound implausible, or perhaps overly dramatic? Of course, they have to be. All of us are children of a long period of prosperity and peace, and to think of sacrificing one of the key instruments of this result, the liberal institutional order, seems incomprehensible. For the common good, we must trust that the threats that are currently looming over globalisation result in a constructive process, leading to an enhanced and more sustainable version of the phenomenon. Not in vain, and on this point the consensus of economists is virtually unanimous, free trade is the most powerful tool for creating global prosperity that exists. Defending it, which does not mean sanctifying it but rather ensuring that it reaches its full potential, requires reform of the institutional system that protects it and improving the balance between the winners and losers of globalisation, even if this means giving minimum satisfaction to demands that are not always well founded. But renovating the building is very different to demolishing it, as the fateful history of the Great Depression reminds us. In 1930, they were well-aware that the Smoot-Hawley tariff was going to be a death sentence for future prosperity: in May of that year, 1,028 American economists signed a declaration calling for the policy to be vetoed. It was to no avail. Repeating the past is sad, but repeating errors of the enormity of those mentioned here is unforgivable. It should not happen.

Àlex Ruiz
CaixaBank Research

The challenges of financial globalisation

Since the 1980s, the world has witnessed a process of unprecedented financial globalisation, as illustrated, for example, by the significant increase of capital flows that has occurred both in the advanced and in the emerging economies. In addition, in recent years, along with the acceleration of financial flows, there have been a series of notable changes that force us to think about the challenges that this new phase of financial globalisation will bring. In order to make sense of a broad and complex matter, this article sets out those changes, and then provides an overview of the economic and financial consequences that they may entail.

A natural starting point is to consider what are the benefits of greater global financial integration. In general, financial globalisation brings important benefits for economic activity.[1] Specifically, in addition to supporting international trade, greater financial openness contributes to making the global allocation of capital more efficient, while also providing opportunities to diversify risks and obtain greater returns.[2] The increase in international trade that has occurred in recent years, therefore, has continued to favour the expansion of financial globalisation. Nevertheless, this has been accompanied by two very noticeable changes, which have bolstered it even more: the growing interconnection of monetary policy at the global level and the emergence of truly global financial institutions. Both innovations have introduced complexity in the way financial globalisation operates.

Thus, and in relation to the first of these developments, as a result of the changes in monetary policy in the context of advanced countries' response to the Great Recession (with the extension of monetary expansion to new heights with few historical precedents), spillovers between the main central banks and those in the periphery have increased.[3] One of the consequences of this dynamic is that it limits the ability of the monetary authorities of smaller economies to implement a monetary policy consistent with their domestic needs. As such, when global financial conditions become more accommodative, for example following an interest rate cut by the US Fed, there tend to be significant capital inflows in economies with a more restrictive monetary policy. These capital inflows can lead to a loosening of the country's financial conditions beyond what is desirable and, thus, to an overheating of the economy and macrofinancial imbalances.

The fear, expressed on numerous occasions by the Bank for International Settlements (BIS), is that this transmission mechanism is particularly relevant at the current juncture, given that the non-conventional monetary policy measures implemented by the central banks of the major advanced economies since the financial crisis have generated an important abundance of liquidity at the global level, which has been directed towards other economies in search of higher returns. Now that the monetary policy stance of the major central banks is starting to change, with the process of monetary normalisation underway in the US and Europe, some emerging economies could run into trouble if this process is not carried out very gradually.[4]

The greater protagonism of the global financial institutions is the second of the key developments of the current phase of financial globalisation. These global financial institutions operate in many countries of the world through branches and subsidiaries. Through this international presence, they are able to obtain resources in the major global financial centres with more favourable credit conditions, since they can obtain financing directly from the central bank and issue financial instruments to private investors at a lower cost, as well as being able to distribute these resources in other economies or provide liquidity to other banks through the interbank market. Thus, the monetary policy implemented by the main central banks affects the supply of credit and, since these institutions sometimes take on global risks, this contributes to the transmission of the financial conditions of the major advanced economies to all other countries.

The consequences of these institutional changes are multiple, but the two main ones refer to the greater degree of synchronisation of capital movements and the expansion of the use of «strong currencies». The first of these concerns is directly derived from the change in monetary policy and the greater importance of its global spillovers. Thus, in recent years, what is referred to in the literature as the global financial cycle has taken on greater importance. Although coming up with an empirical estimate of the extent of the phenomenon is not easy, there is evidence that the common - or global - factor which determines the evolution of the global flows of capital is important and that it also extends to aspects such as the dynamics of the returns of assets exposed to global risks.[5]

1. Bank of International Settlements (2017), «Understanding Globalization», 87th Annual Report.
2. The development of globalisation is also due to other reasons, in particular the political changes that allow it to thrive (through changes to policy and regulation) and the technology that provides the basis for moving capital quickly and cheaply.
3. On this matter, see the Dossier «The globalisation of monetary policy» of the MR09/2016.
4. See the Focus «Growth in the emerging economies and global financial conditions: a close relationship» of the MR05/2018.
5. On this matter, see, for instance, S. Miranda-Agrippino and H. Rey (2015), «US Monetary Policy and the Global Financial Cycle», NBER Working Paper 21722, and E. Cerutti, S. Claessens and A. Rose (2017), «How important is the Global Financial Cycle? Evidence from capital flows», BIS Working Paper 661.

A second consequence is the change in the use of global currencies – particularly the US dollar –[6] as a means of payment throughout the world and as a source of financing. This is largely the result of the incentives that access to abundant international financing and attractive financial conditions (in particular, a low interest rate) offers to borrowers. This dynamic contributes to the «strong currencies» playing a central role in the determination of the financial conditions of other countries. Furthermore, since the monetary authorities, including those that issue these currencies, tend to focus on the domestic conditions when implementing their policies, they may end up favouring an increase in macrofinancial imbalances beyond their borders if the economic cycles of these countries do not coincide.

Thus, when there are sharp increases in a country's debt through financing in strong foreign currencies - with more favourable financial conditions -, this practice leads to the borrower taking on a foreign exchange rate risk from which it can scarcely be protected. In fact, in recent years, in a context of ultra-accommodative monetary policies in the advanced countries, this exposure appears to have increased considerably. In particular, credit denominated in dollars of the non-financial sector in emerging markets has doubled in just eight years.[7] Furthermore, according to data from the BIS, credit denominated in euros to non-residents has increased by 34% in the last four years, reaching 3.1 trillion euros. It is therefore not surprising that, now that the major central banks have begun to change the tone of their monetary policy and the emerging currencies have depreciated significantly, the exchange rate risk is one of the major risks faced by many emerging countries.

Given the institutional changes and their potential consequences, it seems clear that in order to take advantage of the benefits of financial globalisation, it is important to have the necessary tools to be able to mitigate the risks we have spelled out. To this end, it is essential for countries to implement domestic policies that improve their ability to absorb shocks, make it less susceptible to global factors and prevent the accumulation of macrofinancial imbalances.

These policies include prudential policies,[8] which can help to safeguard financial stability by increasing the robustness of the financial sector and reduce the procyclicality of credit flows.

It is also essential for there to be effective international cooperation that complements the domestic policies and helps to manage the risks associated with greater financial interconnectedness at a global level. To this end, a consolidated, global regulatory and macrofinancial supervisory framework should be established to help prevent future crises. It is also increasingly necessary to improve international coordination on economic policy, and on monetary policy in particular.

Since the 2008 financial crisis, considerable efforts have been made in both directions. For example, regulatory reforms have been introduced that focus on increasing the resilience of banks that operate at the international level, which are a key element of global financial intermediation.[9] Attempts have also been made to improve the cooperation of macroeconomic and financial policies at the global level in response to the financial crisis.[10]

In any case, there is a lot of room for further discussion and evaluation of the effects of the monetary and macrofinancial policies of the major global financial centres in other countries. This could be done through an institution such as the IMF or the BIS, which could facilitate greater coordination between the major central banks.

In short, financial globalisation has become an important pillar in the development of the global economy, but it must be supported by a regulatory framework and by policies that help to contain the risks inherent to this increased interconnection.

Roser Ferrer
CaixaBank Research

6. In fact, according to data from the Bank for International Settlements, the dollar is used to denominate almost half of all cross-border banking claims and it appears in 90% of all foreign currency transactions.
7. Specifically, the total credit (loans and debt securities) denominated in dollars in the non-financial sector in emerging markets reached 3.68 trillion dollars in Q1 2018, compared to 1.82 trillion at the beginning of 2010. Data from the Bank of International Settlements, global liquidity indicators.
8. Prudential policies consist of measures that promote good practices and encourage economic players to act with caution in the face of potential risks. Examples include imposing additional capital requirements on financial institutions to protect them from shocks, as well as restrictions on their activities.
9. For example, stricter standards of banking capital and liquidity have been introduced, as well as regular stress tests and greater external banking supervision.
10. In particular, the countries of the G-20 coordinated their response to the crisis through the Financial Stability Board, and the IMF bolstered its mechanisms for multilateral surveillance.

KEY FIGURES

CAIXABANK GROUP
As of 31 March 2018

	MILLION €
Customer funds	351,420
Loans and advances to customers, gross	223,249
Profit attributable to Group, YTD	704
Market capitalisation	23,150
Customers (millions)	15.7
Employees	37,107
Branches	5,318
Retail branches in Spain	4,618
Number of ATMs in Spain	9,394

"LA CAIXA" BANKING FOUNDATION COMMUNITY
Projects: Budget 2018

	MILLION €
Social	307,5
Excellence in research and training	91,1
Raising awareness of culture and knowledge	121,4
Total Budget	**520** *

* Of which €10 million are allocated to Portugal.

BPI
As of 31 March 2018

	MILLION €
Customer funds	32,708
Loans and advances to customers, gross	22,697
Profit attributable, YTD	210
Profit attributable to operations in Portugal, YTD	118
Customers (millions)	1.9
Employees	4,896
Branches	503
Number of ATMs	1,350

PUBLICATIONS

Through its publications, CaixaBank Research stimulates debate and the exchange of experiences among all sectors of society and promotes the dissemination of the major themes of the socio-economic environment of our time.
All publications are available at: **www.caixabankresearch.com**

MR MONTHLY REPORT

Analysis of the economic outlook for Spain, Portugal, Europe and at the international level, as well as of the trends in the financial markets, with specialised articles on topical subjects.

WEEKLY ECONOMIC PULSE

Report which analyses and interprets the most significant economic indicators published in the last seven days.

WORKING PAPERS

Collection which brings together the scientific research currently being performed by CaixaBank Research's economists.

DOCUMENTOS DE ECONOMÍA

Studies which examine specific aspects of the economy and the financial sector in depth.

ECONOMIC PAPERS

Studies on key aspects of the global economy, to stimulate discussion and promote the exchange of experiences among the different economic players.

COLECCIÓN COMUNIDADES AUTÓNOMAS

Strategic diagnosis which seeks to help to provide a better understanding of Spain's complex economic and territorial situation.

CÁTEDRA "LA CAIXA" ECONOMÍA Y SOCIEDAD

Master classes and lectures to promote reflection and debate on the major economic and social challenges of our time.

Design and production: www.cegeglobal.com
Legal Deposit: B. 21063-1988 ISSN: 1134-1920

KEY ISSUES

Read online our latest articles on key issues related to the economy and the financial markets

This month we highlight:

Economic expansion in the emerging economies: on the verge of a lasting boom?

- Emergentes frágiles: Argentina y Turquía, ni casos excepcionales, ni los primeros de muchos otros
- Growth in the emerging economies and global financial conditions: a close relationship

Oil prices: in search of equilibrium

- What is behind the rise in oil prices?
- Shale production: the end of the golden age?

Policy, economy and finance in China: an indivisible triangle

- China's economic policies: tightening, but not too much
- China's economic growth under the microscope: past, present and future

Inflation that never was: reasons for the flatter Phillips curve

- The importance of wage pressures in price determination
- Inflation will gradually recover in the euro area

CaixaBank Research