MR01

MONTHLY REPORT · ECONOMIC AND FINANCIAL MARKET OUTLOOK

NUMBER 430 | JANUARY 2019

ECONOMIC & FINANCIAL ENVIRONMENT

FINANCIAL MARKETS
An Italian fiscal expansion

INTERNATIONAL ECONOMY
Euro area growth: neither very fast nor particularly slow

SPANISH ECONOMY
Will greater wage growth lead to higher inflation in Spain?

PORTUGUESE ECONOMY
Portugal: the automotive industry leads exports of goods

DOSSIER: INCLUSIVE GROWTH: CREATING OPPORTUNITIES FOR ALL

Inclusive growth: the forces of the future

Education as a lever for inclusive growth

Employment policies for inclusive growth

Social cohesion and inclusive growth: inseparable

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INDEX

Inclusive growth

A significant and growing portion of society does not directly perceive the economic growth shown by the macroeconomic data. This sensation reflects the pressure on inequality in most Western economies, which is caused by various phenomena. Some are underlying trends, such as globalisation and technological change, which have fostered economic growth but have also had a negative impact on the level of employment and wages in certain sectors and professions. In addition to these trends is the ageing of the population, which limits the growth of public pensions. On the business cycle front, the financial crisis has resulted in an increase in long-term unemployment and, in turn, greater pressure on public finances, which in many cases has led to cuts in social spending.

In this situation, an economic agenda that supports a more inclusive form of growth is essential. This is obviously needed for reasons of equity and social justice. It is also needed for efficiency reasons because, for example, unequal growth makes it difficult for households on lower incomes to accumulate human capital, which leads to wasted talent. In addition, it is needed to avoid the proliferation of populist movements that aggravate the situation and jeopardise an entire economic system which, at the end of the day, has demonstrated its capacity to generate long-term prosperity, as well as jeopardising our very political system of liberal democracy, which can best protect our individual freedoms and political pluralism.

An economic policy that encourages inclusive growth must, as a necessity, nurture high-quality employment. A job that allows people to live with dignity and offers prospects for professional and personal development is the primary means of directly participating in – and benefiting from – the general progress of the economy. To achieve this, education policies are key, and they must prepare us for the technological change to come and for a world in which lifelong learning and the ability to retrain oneself are becoming increasingly important.

We must recognise, however, that changes in education policies will only have a significant effect in the long term. In the short term, policies related to the labour market are key. In this area, the reduction of duality – which holds back the accumulation of human capital – and a greater role of active policies – which include training and retraining unemployed people – are two clear priorities. Minimum wage policies can also be a mechanism for reducing inequality, but their possible adverse impact on job creation and on companies' competitiveness must be monitored. Fiscal policy can complement minimum wage policies with the introduction, for instance, of negative rates on the lowest incomes (which increases the progressive nature of the system and encourages, rather than penalises, job creation).

In general, promoting inclusive growth policies will require resources that can be obtained in two ways: by reducing non-priority expenditure, or by increasing tax revenues. Realigning priorities, however, requires an evaluation of the results of public policies and of the costs associated with them, something not usually done. Doing so would allow resources to be diverted towards actions that prove more effective. There is an urgent need to encourage a culture and an institutional structure geared towards evaluating results in the sphere of general government. On the revenue side, anti-fraud measures and a rethinking of certain concessions included in the tax system could provide some gains, without the need to raise taxes.

It is often emphasised that fostering inclusion – equity – comes with a cost in terms of economic growth – of efficiency. No doubt there are circumstances in which this is indeed the case. I suspect, however, that in most cases this is due to clumsiness when designing economic policies intended for this purpose. Without a doubt, the present time requires more finesse.

Enric Fernández
Chief Economist
31 December 2018

Chronology

DECEMBER 2018

7 OPEC and its partners agree to cut crude oil production by 1.2 million barrels per day between January and June 2019.

13 The ECB confirms that it is bringing the net purchases of assets to an end in December 2018.

19 The Fed raises the official rate by 25 bps, placing it within the 2.25%-2.50% range.

OCTOBER 2018

12 The rating agency Moody's improves Portugal's credit rating, from Ba1 to Baa3 (once again investment grade).

19 The rating agency Moody's downgrades Italy's credit rating, from Baa2 to Baa3.

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).

NOVEMBER 2018

5 The US reinstates sanctions on Iran.

21 The European Commission recommends launching an excessive deficit procedure against Italy.

25 The EU and the United Kingdom sign a Brexit agreement.

SEPTEMBER 2018

24 The US implements a new tariff rise on 200 billion dollars of Chinese imports. China applies a new tariff rise on 60 billion dollars of US imports.

26 The Fed raises the official rate by 25 bps, bringing it up to the 2.00%-2.25% range.

30 Canada is incorporated into the preliminary trade agreement between the US and Mexico to replace the North American Free Trade Agreement (NAFTA).

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).

Agenda

JANUARY 2019

3 Spain: registration with Social Security and registered unemployment (December).

8 Portugal: employment and unemployment (November).

9 Portugal: international trade (November).

11 Portugal: CPI (December).

15 Spain: financial accounts (Q3).

22 Spain: loans, deposits and NPL ratio (November).

24 Governing Council European Central Bank meeting.

29 Spain: labour force survey (Q4).

29-30 Federal Open Market Committee meeting.

30 Portugal: state budget execution (December).
Portugal: employment and unemployment (December).
Euro area: economic sentiment index (January).
US: GDP (Q4 and 2018).

31 Spain: GDP flash estimate (Q4).
Spain: CPI flash estimate (January).
Euro area: GDP of the euro area (Q4).

FEBRUARY 2019

4 Spain: registration with Social Security and registered unemployment (January).

6 Portugal: employment and unemployment (Q4).

8 Portugal: international trade (December).

11 Portugal: CPI (January).

14 Japan: GDP (Q4).
Portugal: GDP flash estimate (Q4).

21 Spain: international trade (December).

22 Spain: loans, deposits and NPL ratio (December).

27 Euro area: economic sentiment index (February).

28 Spain: CPI flash estimate (February).
Spain: balance of payments (December).
Portugal: state budget execution (December).
Portugal: employment and unemployment (January).

At the gates of a demanding year

Financial volatility has returned to stay. The end of 2018 has been turbulent in the financial markets, bringing a close to a year unlike any in recent memory. In the last 12 months there have been three major stock market corrections: a fateful start to 2018, the so-called «Red October» and, finally, one of the worst Decembers in a long time, making it the worst year since the Great Recession for virtually all the stock market indices. The performance of the fixed-income market has also been far from placid. The yield of US sovereign debt fluctuated at around 3% for most of the year, but ended up falling to around 2.5%, while the sovereign risk premiums of Europe's periphery and of many emerging countries have spiked once again. It is the oil price, however, that has fluctuated the most, reaching a yearly high of 85 dollars per barrel of Brent in October before ending the year at around 55 dollars. What explains this year of extreme swings in the financial markets? Without a doubt, the continued tightening of monetary policy in the US, coupled with the early stages of departure from the exceptional monetary policy in Europe, have played an important role. However, generally speaking, none of this could be seen as a surprise, since the central banks communicated their intentions to the market well in advance. No, the key is to be found in uncertainty, which has given no respite.

Uncertainty gives no respite. Indeed, uncertainty is probably the word that sums up 2018. There has been uncertainty close to home, such as that which has gripped Europe in the form of a lack of clarity regarding Brexit and many doubts over Italy's real commitment to the sustainability of its public finances. There has also been slightly more distant uncertainty regarding the final extent of the protectionist shift in the US and China's response. Uncertainty has also arisen over the US' real capacity for growth as the fiscal boost dissipates; as well as regarding whether, in the mature phase of the North American cycle, we will be able to avoid inflation surprises that alter the Fed's route map towards greater tightening in its monetary policy. In short, there is uncertainty over what real rate of growth we will experience in 2019.

Yet, despite everything... we are not in such bad shape. Although the balance of risks is clearly tilted to the downside, and merely reviewing the different sources of uncertainty is enough to give you vertigo, it must be borne in mind that the global slowdown is taking place in a context of strong growth in economic activity in the recent past. In 2017, global growth stood at 3.7%, that of the euro area was 2.5%, while that of Spain reached 3.0%, and that of Portugal, 2.8%. For 2018, the estimated global growth is similar to that of the previous year, while in Europe the slowdown is more evident: the euro area will register growth of 1.9%, while for Spain it will be 2.5%, and 2.1% for Portugal. These are reasonably positive figures, especially considering that a large part of the slowdown is due to the fading of temporary support factors.

The tailwinds were important, but even without them Spain and Portugal continue to grow at a healthy rate. In recent years, various European economies, including those of Spain and Portugal, have benefited from so-called tailwinds – that is, growth contributed by a series of factors that have been beneficial for economic activity, such as the decline in oil prices, the depreciation of the euro and accommodative financial conditions. According to our estimates, in the case of Spain's growth, the partial reversal of these factors alone explains practically all of the slowdown witnessed in 2018. In the case of Portugal, meanwhile, this reversal is also responsible for a substantial portion of the economic slowdown.

A foundation of solid growth in the Iberian economies. The fact that Spain and Portugal continue to show notable growth rates, even as the tailwinds are dissipating, tells us that the current dynamics of their economies continue to benefit from the structural improvements implemented in recent years. In both countries, the recovery in lending to the private sector reflects the higher demand for financing and the favourable conditions for granting credit, while also confirming that the sanitation of the banking sector has been a success. A positive reading can also be taken from the trend in the public finances, which continue to improve and set the Spanish and Portuguese fiscal policy apart from their Italian equivalent, in case any doubts remained. Finally, the boom in the labour market in both countries is particularly noteworthy, providing significant support for domestic demand in addition to having clearly positive and much-needed social consequences. In short, 2019 will be a demanding year with significant risks on the horizon, but they will be addressed from a reasonably solid starting position.

Average for the last month in the period, unless otherwise specified

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	2.79	3.29	3.20
12-month Libor	3.86	1.18	1.67	2.05	3.08	3.41	3.25
2-year government bonds	3.70	0.72	1.18	1.84	2.68	3.20	3.10
10-year government bonds	4.70	2.70	2.49	2.41	2.83	3.40	3.30
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	−0.36	−0.10	0.40
1-month Euribor	3.18	0.93	−0.37	−0.37	−0.37	−0.08	0.42
3-month Euribor	3.24	1.13	−0.32	−0.33	−0.31	−0.04	0.44
6-month Euribor	3.29	1.30	−0.22	−0.27	−0.24	0.12	0.62
12-month Euribor	3.40	1.51	−0.08	−0.19	−0.13	0.27	0.79
Germany							
2-year government bonds	3.41	0.85	−0.76	−0.69	−0.60	0.08	0.73
10-year government bonds	4.30	2.21	0.29	0.35	0.25	1.26	1.96
Spain							
3-year government bonds	3.62	2.59	−0.13	−0.04	−0.02	0.84	1.43
5-year government bonds	3.91	3.16	0.30	0.31	0.36	1.29	1.86
10-year government bonds	4.42	4.13	1.43	1.46	1.42	2.26	2.76
Risk premium	11	192	114	110	117	100	80
Portugal							
3-year government bonds	3.68	4.85	0.76	−0.05	−0.18	0.98	1.73
5-year government bonds	3.96	5.42	2.05	0.46	0.47	1.56	2.24
10-year government bonds	4.49	5.90	3.75	1.84	1.72	2.56	3.11
Risk premium	19	369	346	149	147	130	115
EXCHANGE RATES							
EUR/USD (dollars per euro)	1.13	1.33	1.05	1.18	1.14	1.23	1.24
EUR/JPY (yen per euro)	129.50	127.13	122.41	133.70	127.89	129.15	131.44
USD/JPY (yen per dollar)	115.34	96.09	116.06	113.02	112.38	105.00	106.00
EUR/GBP (pounds per euro)	0.66	0.83	0.85	0.88	0.90	0.86	0.85
USD/GBP (pounds per dollar)	0.59	0.62	0.80	0.75	0.79	0.70	0.69
OIL PRICE							
Brent ($/barrel)	42.32	90.70	54.92	64.09	57.33	67.00	66.00
Brent (euros/barrel)	36.35	67.78	52.10	54.17	50.38	54.47	53.23

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	3.3	3.7	3.7	3.5	3.5
Developed countries	*2.7*	*1.1*	*1.7*	*2.3*	*2.3*	*2.0*	*1.8*
United States	2.7	1.4	1.6	2.2	2.8	2.3	1.9
Euro area	2.3	0.2	1.9	2.5	1.9	1.8	1.7
Germany	1.6	1.0	2.2	2.5	1.6	1.9	1.8
France	2.0	0.6	1.1	2.3	1.6	1.8	1.6
Italy	1.5	−1.0	1.3	1.6	1.0	0.9	1.0
Portugal	1.5	−0.6	1.9	2.8	2.1	1.9	1.9
Spain	3.8	−0.4	3.2	3.0	2.5	2.1	2.0
Japan	1.5	0.3	0.6	1.9	0.8	1.0	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*	*4.7*	*4.5*	*4.6*
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	−3.3	1.1	1.3	2.1	2.0
Mexico	2.4	2.0	2.9	2.1	2.0	2.3	2.3
Chile	5.0	3.4	1.3	1.5	3.8	3.2	3.0
Russia	7.2	1.2	−0.2	1.5	1.6	1.9	2.0
Turkey	5.4	5.0	3.2	7.3	3.7	−1.5	1.5
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	0.6	1.5	1.8
INFLATION							
Global	4.2	3.9	2.8	3.2	3.7	3.7	3.4
Developed countries	*2.1*	*1.6*	*0.8*	*1.7*	*2.0*	*1.9*	*1.8*
United States	2.8	1.7	1.3	2.1	2.5	2.1	1.9
Euro area	2.1	1.5	0.2	1.5	1.8	1.8	1.7
Germany	1.7	1.4	0.4	1.7	1.9	1.9	1.8
France	1.8	1.3	0.3	1.2	2.1	1.8	1.7
Italy	1.8	1.4	0.0	1.3	1.3	1.5	1.5
Portugal	3.0	1.3	0.6	1.6	1.3	1.5	1.8
Spain	3.2	1.5	−0.2	2.0	1.7	1.8	1.8
Japan	−0.3	0.4	−0.1	0.5	1.0	1.1	1.2
United Kingdom	1.9	2.6	0.7	2.7	2.5	2.2	2.0
Emerging countries	*6.8*	*6.0*	*4.2*	*4.3*	*4.9*	*5.0*	*4.4*
China	1.7	2.7	2.0	1.6	2.1	2.4	2.4
India	4.5	9.0	4.9	3.3	4.0	3.5	4.6
Indonesia	8.4	6.0	3.5	3.8	3.2	3.1	2.7
Brazil	7.3	6.2	8.8	3.5	3.7	4.1	4.1
Mexico	5.2	4.1	2.8	6.0	4.8	4.1	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	4.4	4.0
Turkey	27.2	8.1	7.8	11.1	15.8	18.7	12.0
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	4.7	5.1	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	2.8	2.5	2.4	1.9	1.9
Government consumption	5.0	0.8	1.0	1.9	2.0	1.2	1.1
Gross fixed capital formation	6.0	−4.1	2.9	4.8	5.5	3.7	2.8
Capital goods	5.3	−0.3	5.3	6.0	6.7	4.3	2.8
Construction	6.2	−7.0	1.1	4.6	5.7	3.7	2.8
Domestic demand (vs. GDP Δ)	4.6	−1.6	2.4	2.9	3.0	2.1	1.9
Exports of goods and services	4.8	2.4	5.2	5.2	2.0	3.3	4.0
Imports of goods and services	7.1	−1.5	2.9	5.6	3.6	3.5	4.1
Gross domestic product	**3.8**	**−0.4**	**3.2**	**3.0**	**2.5**	**2.1**	**2.0**
Other variables							
Employment	3.4	−1.9	3.1	2.8	2.5	2.1	1.9
Unemployment rate (% of labour force)	10.5	21.0	19.6	17.2	15.3	13.6	12.0
Consumer price index	3.2	1.5	−0.2	2.0	1.7	1.8	1.8
Unit labour costs	3.3	0.3	−0.6	0.2	0.9	2.1	2.5
Current account balance (cum. % GDP)	−6.0	−2.1	2.3	1.8	0.8	0.6	0.6
External funding capacity/needs (cum., % GDP)	−5.3	−1.7	2.5	2.1	1.0	0.8	0.8
Fiscal balance (cum., % GDP)[1]	0.4	−7.3	−4.3	−3.1	−2.7	−2.0	−1.4

Note: *1. 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	2.4	2.3	2.3	2.1	1.8
Government consumption	2.3	−0.8	0.8	0.2	0.7	0.6	0.3
Gross fixed capital formation	−0.3	−4.2	2.4	9.2	4.2	4.3	4.5
Capital goods	1.3	−1.0	7.6	13.7	7.0	6.5	5.5
Construction	−1.6	−7.0	−1.3	8.3	3.7	6.2	5.5
Domestic demand (vs. GDP Δ)	1.5	−1.4	2.1	3.1	2.4	2.2	2.1
Exports of goods and services	5.2	3.4	4.4	7.8	3.9	5.0	4.3
Imports of goods and services	3.6	1.2	4.7	8.1	4.9	3.4	4.3
Gross domestic product	**1.5**	**−0.6**	**1.9**	**2.8**	**2.1**	**1.9**	**1.9**
Other variables							
Employment	0.4	−1.4	1.2	3.3	2.4	0.9	0.5
Unemployment rate (% of labour force)	6.1	12.3	11.1	8.9	7.0	6.5	6.2
Consumer price index	3.0	1.3	0.6	1.6	1.3	1.5	1.8
Current account balance (cum. % GDP)[1]	−9.4	−4.9	0.6	0.5	0.0	−0.2	−0.2
External funding capacity/needs (cum., % GDP)[1]	−7.9	−3.4	1.6	1.4	0.9	0.6	0.5
Fiscal balance (cum., % GDP)[1]	−4.4	−6.8	−2.0	−3.0	−0.7	−0.6	−0.5

***Note:*** *1. Four-quarter cumulative total.*

　　　　　Forecasts

The financial markets end a year marked by volatility

The year ends with concern among investors. The financial markets have experienced an intense 2018, with various episodes of stock market corrections, a gradual increase in risk premiums on corporate debt, repeated spikes in sovereign risk premiums in the euro area periphery, the strengthening of the dollar against the main advanced currencies and, especially, the main emerging currencies, as well as significant volatility in the oil price. All of this has taken place in an environment of heightened geopolitical and trade tensions, coupled with the withdrawal of monetary policy stimulus, resulting in the environment of very low volatility of recent years being left behind. This change of panorama has been particularly noted in the equity markets, where the major stock market indices have suffered their worst year since 2009-2011, with cumulative declines of close to –15% for the year as a whole. In the fixed-income markets, meanwhile, sovereign interest rates have also been highly volatile, driven by political tensions, the Fed's trend of rate hikes and fears that the global economy could slow down more than expected in 2019. These dynamics were particularly felt in December, when the Fed's fourth rate hike in the year combined with the end of the ECB's QE, further losses in the stock markets, a marked decline in sovereign interest rates (with investors barely anticipating any new reference rate hikes by the Fed in 2019) and a renewed decline in the oil price.

Volatility persists in the international stock markets. In December, the international stock markets suffered a new surge of risk aversion and closed the last month of the year in negative. The main trading floors began the month with a somewhat hesitant tone, but it turned pessimistic after the Fed confirmed the fourth rate rise of the year. As such, the VIX index (a volatility indicator) surged to levels not seen since the corrections of February, while the stock markets of the advanced economies suffered widespread and significant losses. In particular, the main US indices lost almost 9%, while in the euro area the falls amounted to around 6%. On the other hand, the MSCI index for the emerging economies as a whole fell more moderately, although losses in the emerging bloc were also widespread across the Asian and Latin American trading floors (with declines of close to 3% and 1.5%, respectively).

The Fed raises interest rates for the fourth time in 2018 and the ECB confirms the end of QE. As expected, at its last meeting of the year, the Fed increased the target reference rate by 25 bps, bringing it up to the 2.25%-2.50% range. Thus, with the four rate rises accumulated in 2018, in addition to the three that took place in 2017, US monetary policy has ceased to be accommodative and is entering into a more neutral territory in relation to the business cycle, where it is likely
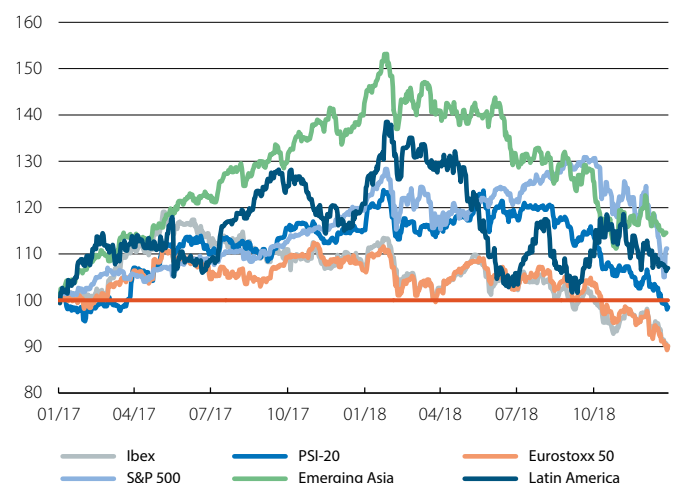
Implicit volatility in the financial markets
Index   *Index*
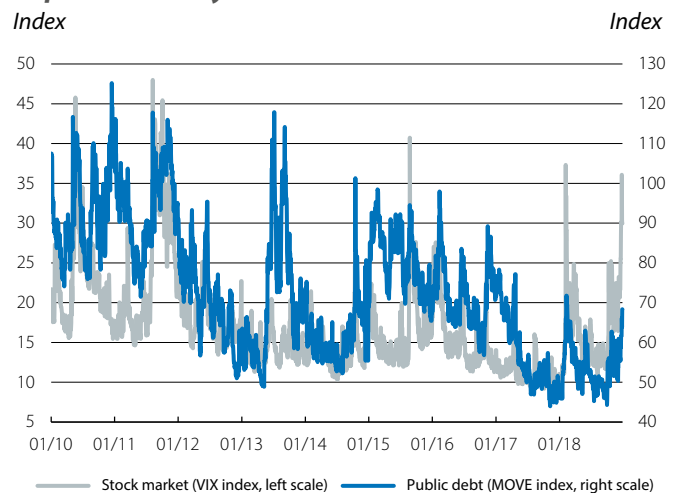
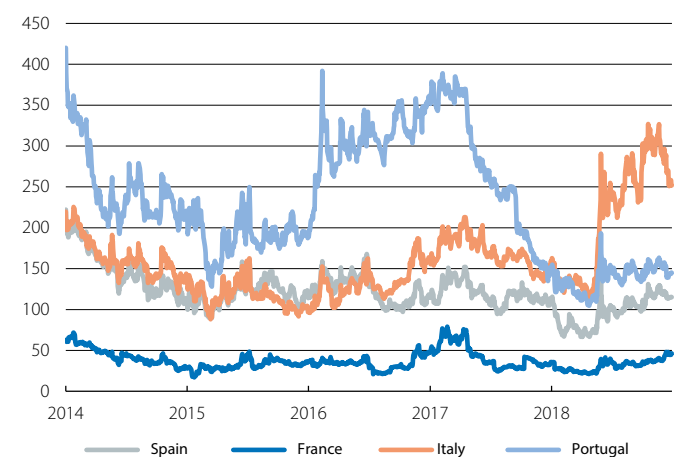*Source: CaixaBank Research, based on data from Bloomberg.*

Main international stock markets
Index (100 = January 2017)

Source: CaixaBank Research, based on data from Bloomberg.

Euro area: risk premiums of 10-year sovereign bonds
(bps)

Source: CaixaBank Research, based on data from Bloomberg.

to remain in 2019: according to their latest forecasts, the members of the Fed expect two rate hikes in 2019, in line with the scenario foreseen by CaixaBank Research. The ECB, meanwhile, confirmed the end of its net purchases of assets and reiterated its intention to keep interest rates unchanged until, at least, after the summer of 2019. In addition, it recalled that it will remain present in the markets for a long time by reinvesting the assets on its balance sheet as they reach maturity. This is a strategy that, according to the ECB, will continue to be governed by the so-called capital key (each country's relative contribution to the ECB's internal capital) and the principle of market neutrality (such that the reinvestments match the average maturity profile that exists in the secondary market). In this way, despite the net purchases of assets coming to an end, the ECB will maintain an accommodative monetary policy throughout 2019.

Sovereign interest rates fall, while the dollar remains strong. The turmoil in the stock markets, together with a certain scepticism among investors in relation to the Fed's future reference rate hikes, pushed sovereign interest rates down in the US and Germany. In addition, of particular note in the US was the flattening of the sovereign yield curve, with the differential between 10-year and 3-month rates lying below 40 bps for the first time since 2007. On the other hand, in the euro area, the peripheral risk premiums reacted with optimism to the agreement reached between Italy and the European Commission on the Italian budget for 2019 (see the section on International Economy), and in the case of Spain and Portugal, the risk premiums fell back to the levels seen at the beginning of the year. This improvement in sentiment was also noted in the foreign exchange market, where the euro appreciated against most of the advanced economy currencies over the course of the month. In the United Kingdom, meanwhile, the accentuation of the uncertainty surrounding Brexit penalised the exchange rate of the pound (−1.3% against the euro). Finally, in the emerging economies, the currencies fluctuated moderately – and somewhat disparately – against the dollar.

OPEC and its partners agree on a joint cut in oil production. Following the collapse in the price of a barrel of Brent oil in November, on 7 December OPEC member countries and their partners (such as Russia, Kazakhstan and Mexico) announced a joint reduction of 1.2 million barrels a day in their crude oil production (compared to the levels produced in October 2018). The production cut is part of a deal that will begin to be implemented in January 2019 and will initially last for six months. However, the announcement was received with ambiguity in the markets. After a few sessions of indecision, the price of a barrel of Brent oil ended up falling in December for the third consecutive month, reflecting investors' fears that there will still be an excess supply of crude oil in 2019.
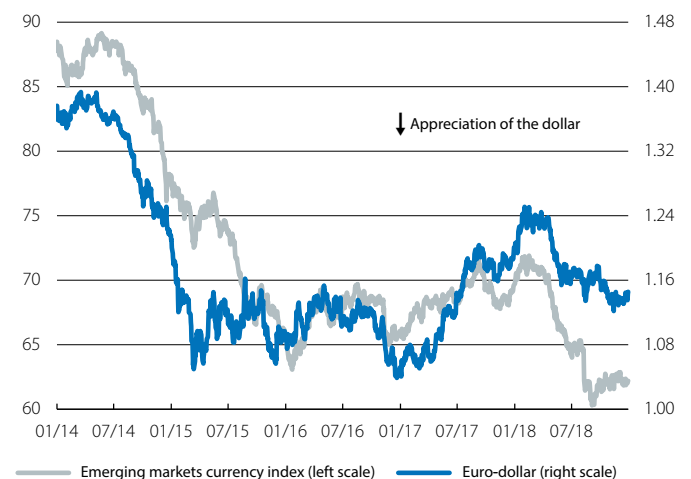
Yields on 10-year sovereign bonds
(%)
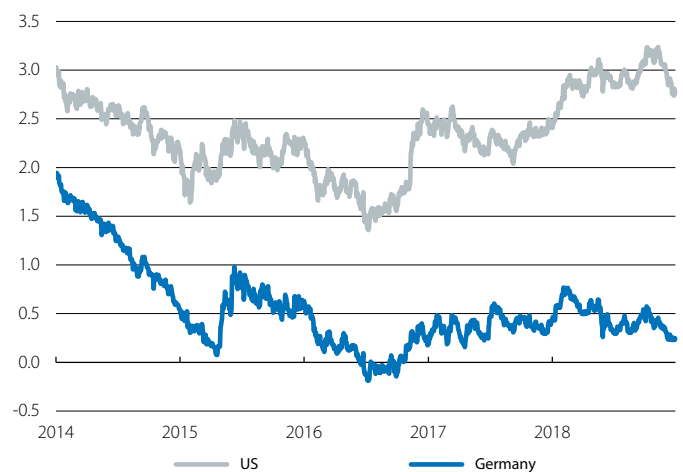
Source: CaixaBank Research, based on data from Bloomberg.

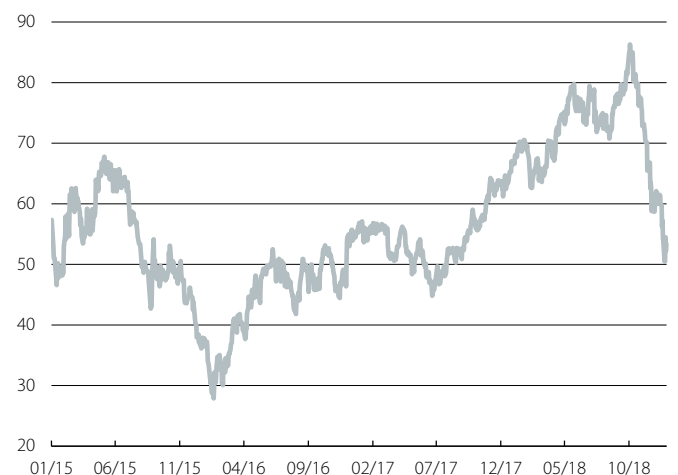*International currencies against the US dollar*
(Index) *(Dollars per euro)*

Source: CaixaBank Research, based on data from Bloomberg.

Brent oil price
(Dollars per barrel)

Source: CaixaBank Research, based on data from Bloomberg.

An Italian fiscal expansion

The Italian economic outlook has deteriorated considerably in recent months. This is largely due to the tensions generated by the Italian Coalition Government's programme in the financial markets and with Brussels. Specifically, the cabinet hopes to stimulate the economy with a fiscal expansion, but this plan raises doubts about the sustainability of Italy's public finances and has tightened the country's financial conditions. In this Focus, we analyse the negative impact that a tightening of financial conditions could have on the Italian economy and whether this impact could offset the positive effect on GDP of the fiscal stimulus.

Indeed, as the first chart shows, since the Italian general election that took place last March, interest rates on Italian sovereign debt have risen considerably. For example, the interest rate on the 10-year bond has gone from 1.9% to 3.2% in just nine months. In addition, tensions in the financial markets and the deterioration of the outlook for the public finances have led the credit rating agencies to downgrade Italy's credit rating.[1]

These events could have important implications for the Italian economy. First of all, a significant and sustained increase in sovereign bond interest rates will inevitably lead to a higher cost of financing public debt, forcing Italy to allocate more resources to the payment of interest on debt and limiting its fiscal capacity to cope with adverse shocks in the future. We expect this impact to be minor in the short term (given that the average maturity of Italian debt is relatively high, at 6.9 years). However, our estimates indicate that a permanent increase in the interest rate of the 10-year bond to 3.5% would cause the debt ratio to rise from 2021 on, if the primary surplus (which excludes interest payments) were to remain at around 1.5% (i.e. only slightly below its current level) and with a nominal GDP growth of approximately 2.5%.

Secondly, a tightening of the financing costs for the public sector usually entails a deterioration of the financing conditions of companies in the market. Indeed, as the second and third charts show, since last March, interest rates on (senior) corporate bonds issued by Italy's largest non-financial companies have increased by between 30 and 190 bps, while the rates on bonds issued by the country's major banks have increased by 133 bps (on average, for bonds that generally have a five-year maturity period). In this context, a higher cost of financing for banks usually results in an increase of

Italy: sovereign debt yield curve
(%)
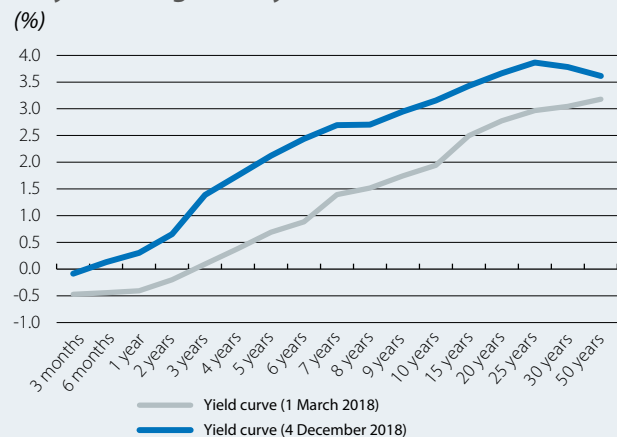
Source: CaixaBank Research, based on data from Bloomberg.

interest rates on loans and lower availability of credit to the private sector. This, in turn, affects companies' and households' spending decisions.

Likewise, tensions in the Italian sovereign debt market could lead to a weakening of Italian banks' and other financial institutions' balance sheets, with consequences for their capital position. In particular, these entities (on average) have a high exposure to domestic sovereign debt – 10% of their assets are made up of sovereign bonds issued by the Italian Government –,[2] and they are required to reflect any change in these bonds' market value in their capital.[3] Therefore, when sovereign bond yields increase significantly (i.e. a sharp fall in bond prices), these institutions may see their capital eroded through the negative adjustments in the valuation of these bonds. In fact, the ECB estimates that in Q2 2018 alone, the revaluation of sovereign bonds had a significant negative impact (of between 25 and 84 bps) on CET1 capital ratios[4] – the primary measure of financial solvency used by the banking regulator[5] – of the main Italian banks.

For the moment, however, the impact on the supply of bank lending has not been visible. As such, new bank lending and interest rates, both to businesses and to households, remain at levels similar to those of April.[6] Furthermore, in the last ECB bank lending survey,[7] Italian financial institutions did not report any significant

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1. In October, Moody's downgraded Italy's credit rating to just one category above speculative grade. Fitch and S&P, meanwhile, kept Italy's credit rating unchanged, but downgraded the rating outlook to negative.

2. For the euro area as a whole, the average is 4.0% of assets.
3. In particular, changes in the (fair) value of financial instruments that are classified as «Available-for-sale financial assets» must be recognised directly in the company's equity.
4. The Common Equity Tier 1 capital ratio is calculated by dividing the highest-quality capital (composed primarily of shares and reserves) by the risk-weighted assets.
5. ECB (2018), «Financial Stability Review», November.
6. ECB data up to October 2018.
7. Conducted in Q3.

changes in the conditions of financing provided to companies and households, although they did point out that the cost of financing and balance sheet restrictions had gained prominence as factors that could contribute to a tightening of lending criteria. The lesser impact on bank lending may be due to the fact that the pass-through is slower than on previous occasions,[8] that banks are now better capitalised,[9] and that there is abundant liquidity in the market. This liquidity, in particular, allows banks to access other less costly sources of financing, such as the ECB's targeted longer-term refinancing operations (TLTROs), while also making other traditional sources of financing cheaper, such as deposits.[10]

However, if tensions persist, the negative impact of the tighter financial conditions on bank lending (and, therefore, on consumption and investment decisions) will become more evident. In addition, a continued weakening of capital positions would force Italian banks to find alternative ways to strengthen their solvency, for instance by reducing the risk of their assets, by reducing lending, or by going to the market to raise capital – but to do this, the conditions in the equity market need to be favourable.

In this context, it is worth asking what effect can the tightening of financial conditions have on the aggregate economic activity. To address this question, we estimated the impact of a shock to the risk premium of a 10-year Italian bond on the economy's real growth, on the basis of the historical relationship between the two variables.[11] Our estimates suggest that a 100-bp increase in the 10-year sovereign bond yield over a four-quarter period could reduce annual real GDP growth by 0.47 pps. This implies that the increase in rates observed since Q2 2018 may have had a detrimental impact on growth in the second half of 2018 and could continue to weigh on growth in 2019.

On the other hand, the fiscal expansion envisaged by the Italian Government amounts to 0.9 pps of GDP.[12] Since

Italy: non-financial company senior bond yields
(%)

■ March 2018 ■ November 2018

Source: CaixaBank Research, based on data from Bloomberg.

Italy: banking sector senior bond yields
(%)

■ March ■ November

Source: CaixaBank Research, based on data from Bloomberg.

several estimates place Italy's fiscal multiplier[13] between 0.5 and 0.8, the fiscal boost could have a positive impact on GDP of 0.5 pps in 2019. However, this effect depends on the specific measures that are implemented[14] and it also relies on maintaining investor confidence (otherwise, private investment could be reduced beyond what the rise in the cost of capital would suggest). Therefore, in net terms, if the tightening of financial conditions were to persist, any expansionary effect that fiscal policy might have on the economy will be easily diluted and could even cause a growth slowdown in 2019.

8. See, for example, U. Albertazzi *et al.* (2014), «The impact of the sovereign debt crisis on the activity of Italian banks», where it is estimated that a 100-bp increase in Italy's risk premium usually translates, after three or four months, into a 20-bp rise in bank interest rates.
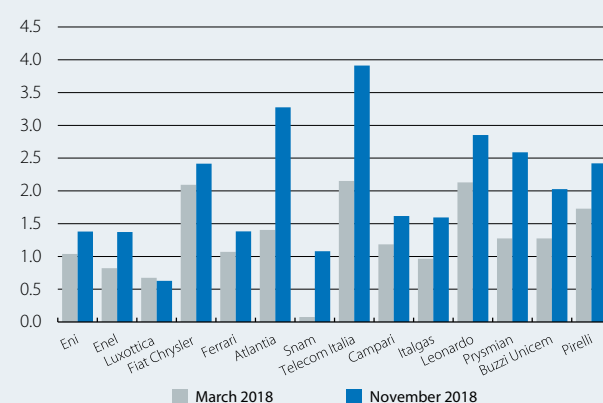9. At the end of 2014, the average CET1 capital ratio for the sector stood at 11.7%, versus 13.9% at the end of Q2 2018. The better capitalisation makes the banks less susceptible to increases in financing costs and to changes in the value of sovereign bonds.
10. The main source of financing for Italian banks remain residents' deposits – which represent approximately 63% of the banks' total financing – and these, for the time being, continue to grow at a healthy rate (3% year-on-year).
11. In particular, the relationships are modelled using a VAR formula, using data covering the period between 2000 and 2018.
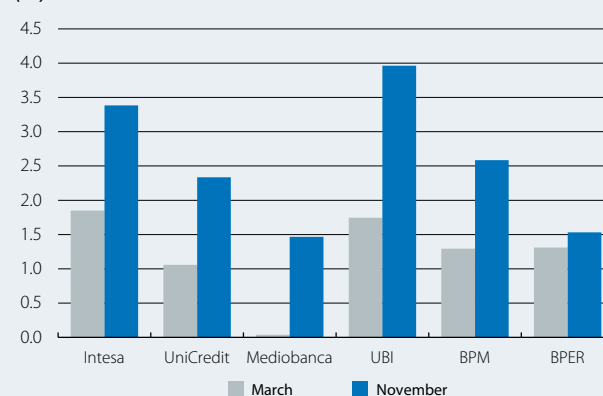12. According to the deterioration of the structural balance – the budgetary balance adjusted for the business cycle, one-off factors and other temporary measures – foreseen in the budget plan sent to Brussels on 13 November 2018.

13. The increase in GDP as a result of fiscal expansion.
14. In mid-December, the Italian cabinet revised its deficit target for 2019 downwards. The specific measures that are to be implemented and the size of the fiscal expansion remain to be seen.

Interest rates (%)

	31-Dec	30-Nov	Monthly change (bp)	Year-to-date (bp)	Year-on-year change (bp)
Euro area					
ECB Refi	0.00	0.00	0	0.0	0.0
3-month Euribor	−0.31	−0.32	1	2.0	2.0
1-year Euribor	−0.12	−0.15	3	6.6	6.6
1-year government bonds (Germany)	−0.57	−0.63	6	6.8	6.8
2-year government bonds (Germany)	−0.61	−0.60	−1	1.7	1.7
10-year government bonds (Germany)	0.24	0.31	−7	−18.7	−18.7
10-year government bonds (Spain)	1.42	1.50	−8	−14.7	−14.7
10-year government bonds (Portugal)	1.72	1.83	−11	−22.3	−22.3
US					
Fed funds	2.50	2.25	25	100.0	100.0
3-month Libor	2.81	2.74	7	111.6	111.6
12-month Libor	3.01	3.12	−11	90.3	90.3
1-year government bonds	2.60	2.68	−8	86.8	86.8
2-year government bonds	2.49	2.79	−30	60.7	60.7
10-year government bonds	2.68	2.99	−31	27.5	27.5

Spreads corporate bonds (bps)

	31-Dec	30-Nov	Monthly change (bp)	Year-to-date (bp)	Year-on-year change (bp)
Itraxx Corporate	89	81	8	43.9	43.9
Itraxx Financials Senior	109	104	4	64.7	64.7
Itraxx Subordinated Financials	228	211	18	123.8	123.8

Exchange rates

	31-Dec	30-Nov	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
EUR/USD (dollars per euro)	1.147	1.132	1.3	−4.5	−4.5
EUR/JPY (yen per euro)	125.830	128.440	−2.0	−7.0	−7.0
EUR/GBP (pounds per euro)	0.899	0.887	1.3	1.2	1.2
USD/JPY (yen per dollar)	109.690	113.570	−3.4	−2.7	−2.7

Commodities

	31-Dec	30-Nov	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
CRB Commodity Index	409.2	416.2	−1.7	−5.4	−5.4
Brent ($/barrel)	53.8	58.7	−8.4	−19.5	−19.5
Gold ($/ounce)	1,282.5	1,222.5	4.9	−1.6	−1.6

Equity

	31-Dec	30-Nov	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
S&P 500 (USA)	2,506.9	2,760.2	−9.2	−6.2	−6.2
Eurostoxx 50 (euro area)	3,001.4	3,173.1	−5.4	−14.3	−14.3
Ibex 35 (Spain)	8,539.9	9,077.2	−5.9	−15.0	−15.0
PSI 20 (Portugal)	4,731.5	4,914.1	−3.7	−12.2	−12.2
Nikkei 225 (Japan)	20,014.8	22,201.8	−9.9	−12.1	−12.1
MSCI Emerging	965.7	994.7	−2.9	−16.6	−16.6

# Heading towards a widespread global slowdown

A temporary pause in the global slowdown? Following a few difficult quarters with declining momentum in the global economic sentiment indicators, the latest available data show that some representative confidence indicators, such as the global composite PMI, have rebounded. A similar reading can be drawn from economic activity indicators in the emerging markets, such as the so-called IIF Growth Tracker, which seeks to estimate these countries' contemporary growth and which registered two consecutive months of increases in November. Besides this representing a pause in the economic slowdown, the length of which remains to be seen, the global indicators still suggest a slower pace of economic activity compared to a few quarters ago. Furthermore, if we review the factors that lie behind this moderation, the indicators suggest that the slowdown observed over the past year seems likely to continue.

The factors hindering growth remain active. The slowdown in the global economy witnessed in recent quarters has been brought about by a combination of factors that are acting simultaneously and which are expected to continue to (moderately) restrict global growth in the near future. Firstly, the global financial conditions have become less accommodative due to the measures of certain central banks (mainly the Fed's normalisation of monetary policy, as is well known), as well as due to the surge in financial volatility in many stock markets and, in some cases, sovereign debt yields. In addition, geopolitical uncertainty (particularly the rise of US protectionism, which has led to a spiral of trade tensions with China and, to a lesser extent, with the EU) is already taking a toll on international trade flows. As such, in September, year-on-year trade growth stood at 2.4%, compared to 5.6% at the beginning of 2018. Finally, the trend in commodity prices, not only oil but in a broader sense, has experienced a downturn in the second half of the year: the CRB index, which measures a wide range of commodity prices, has fallen by 7% since last June. Given that this is a key source of growth for many emerging markets, it is logical that they are losing momentum.

## US

Economic activity remains buoyant, but the pockets of risk show no sign of dissipating. The consumer confidence index developed by the Conference Board stood at 135.7 points in November, well above the average for 2017 (120.5). On the other hand, the business sentiment index (ISM) rebounded to 59.3 points, thus remaining at historically high levels. Similarly, the second GDP estimate for Q3 confirmed the strong momentum of the US economy (with quarter-on-quarter growth of 0.9% and year-on-year growth of 3.0%). In this context of strong economic activity data, the US and

Global economic activity indicators
Level

Composite PMI   Manufacturing PMI   Services PMI
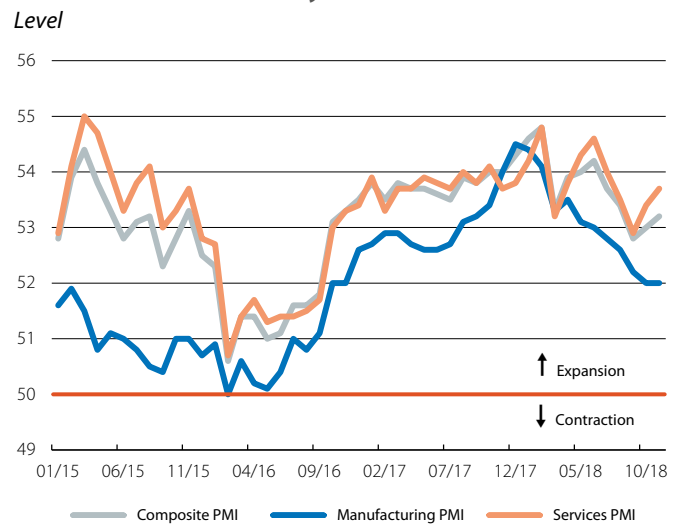
Source: CaixaBank Research, based on data from IHS Markit.

International trade in goods *
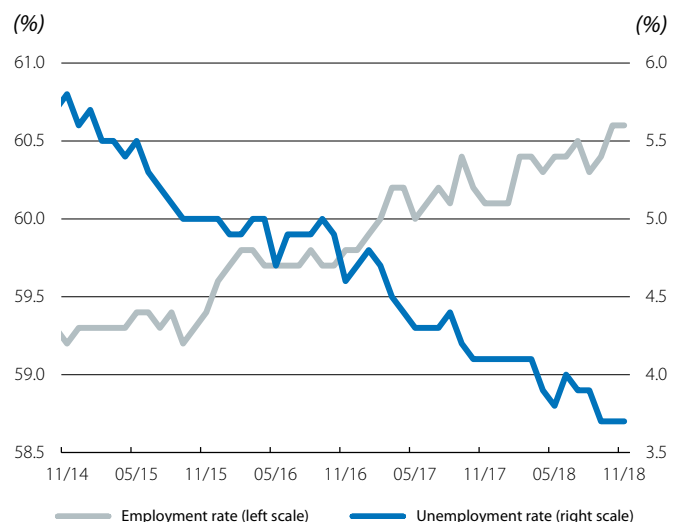*Year-on-year change (%)*
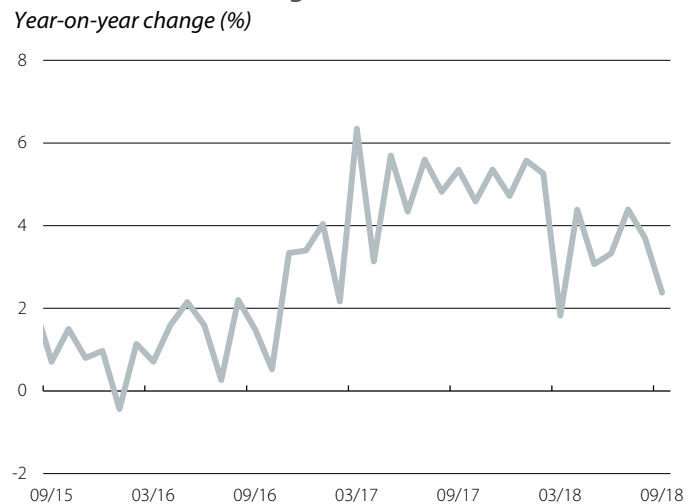
*Note: * In volumes.*
Source: CaixaBank Research, based on data from the CPB World Trade Monitor.

US: labour market
(%)   *(%)*

Employment rate (left scale)   Unemployment rate (right scale)

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

China agreed to halt the imposition of new trade tariffs for 90 days while they negotiate the nature of their future bilateral relations. Despite this so-called «trade truce» having provided some relief, there is still a long way to go before a definitive solution to the conflict is reached.

In a context of cyclical maturity, the Fed raises rates once again. The US economy therefore remains buoyant, despite being in a mature phase of the cycle. This situation is particularly reflected in the strength of the labour market, which managed to create 155,000 jobs in November (a high figure, if we consider the economy's situation of virtually full employment). In this context, and as expected, the Fed once again rose the reference rate up to 2.25%-2.50%. Nevertheless, with regards to the future tightening of financial conditions, the Fed has communicated to the market the possibility of a slower pace of rate hikes in 2019, which reflects the doubts surrounding the pace of growth in the US this year as the expansionary effects of fiscal policy are diluted.
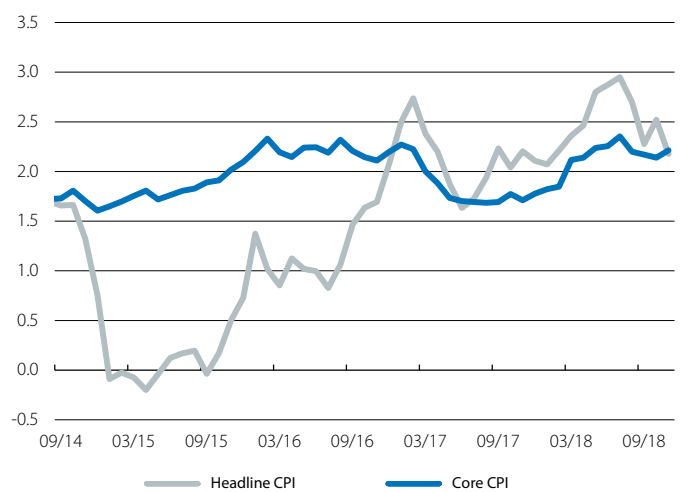
EURO AREA

Economic activity slows down, but the trend could be temporary. The latest economic activity indicators for the euro area suggest that the economic slowdown continues, which has increased concerns over the actual rate of growth that can be expected over the coming quarters. All in all, the breakdown of GDP for Q3 2018 confirmed that domestic demand remains the main driver of growth in the euro area. Given the inertia that this component generally has, this leads us to think that the growth of the euro area will reach healthier levels over the next few quarters (for more details, see the Focus «Euro area growth: neither very fast nor particularly slow» in this *Monthly Report*). This is also the ECB's reading, which highlights the temporary nature of the current slowdown and is being accepted as a consensual and reasonable view.

The United Kingdom and Italy remain sources of uncertainty. As the official date of the United Kingdom's departure from the EU approaches, certainty over how the process will be carried out is decreasing, rather than increasing. In December, we witnessed the withdrawal of the parliamentary vote on the preliminary Brexit agreement and a motion of no confidence in Theresa May, which, eventhough she survived it, also served to confirm the fragmentation within the Conservative Party itself. A new attempt at ratifying the preliminary agreement in the House of Commons has now been announced and is due to take place before 21 January 2019. Although the British Government is expected to ratify the agreement, the difficulties in achieving a majority in the House of Commons increase the chances of the United Kingdom deferring its departure from the EU, or of the day of Brexit arriving without an agreement having been reached, which would lead to a
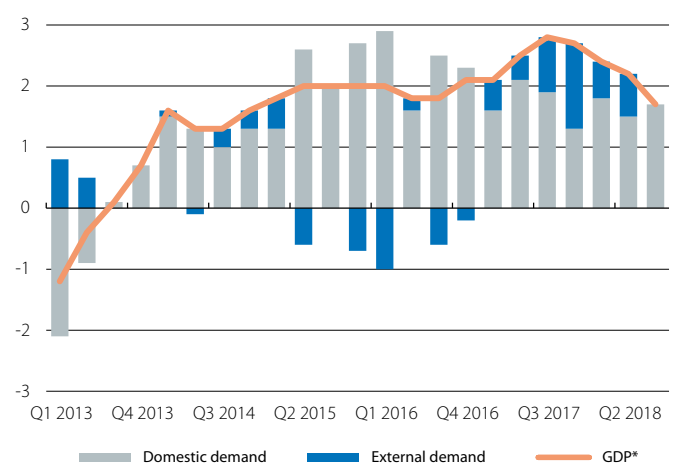
US: CPI
Year-on-year change (%)

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

Euro area: GDP
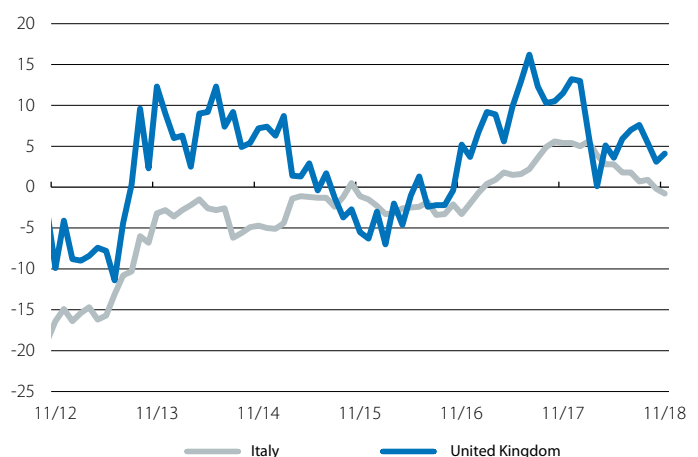*Contribution to year-on-year growth (pps)*

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

Italy and the United Kingdom: business confidence indicator
Level

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

disorderly exit for the United Kingdom. Developments in the budgetary conflict between Italy and the EU, on the other hand, are somewhat more positive. After the European Commission kick-started the process to implement a so-called «excessive deficit procedure» against Italy, the Italian Government has conceded and has announced a downward revision of its deficit target for 2019 (2.04% of GDP, compared to the 2.4% initially proposed). Despite this representing a step in the right direction and the European Commission announcing that the procedure could be called off, Italy's public finances are unlikely to cease being a source of risk.

EMERGING MARKETS

(Temporary) relief in the emerging markets. The state of several emerging economies (those known as «fragile emerging economies», characterised by the presence of macroeconomic imbalances) has been a source of concern for analysts and investors at least since last summer. In October and November, the underlying tone of economic activity has been more favourable, albeit with some exceptions such as Turkey (more on that further below). One of the highlights of this improvement in economic sentiment and in investors' risk tolerance has been the recovery of capital inflows in the aforementioned two months, both of debt and equity. However, that same measure has shown signs of erosion in December, reflecting the heightened global financial volatility seen in recent weeks. Beyond this short-term view, and as we have already commented, the emerging slowdown is expected to continue over the next few quarters in light of the set of three factors affecting these economies. These include a context of tighter global financial conditions, continued uncertainty over trade tensions and declining commodity prices.

The Chinese economy continues to slow down, both in its internal and external components. In November, industrial output grew by just 5.4% year-on-year (5.9% in October), the lowest rate since the beginning of 2016. Retail sales also slowed to 8.1% (8.6% in October). In addition, Chinese exports (in dollars) rose by just 5.4% in November, a significant slowdown following the impressive figure for October (15.6%). As such, China's export sector is beginning to show somewhat less margin for manoeuvre in the face of the trade tensions with the US, and the indicators point towards growth of less than 6.5% in Q4.

Notable economic slowdown in Turkey. In Q3, GDP growth stood at 1.6% year-on-year, a far cry from the 5.3% registered in the previous quarter, as well as being lower than expected. The breakdown by component shows that the abrupt halt of inflows of international capital experienced in the summer put a sudden stop to financing for investment and private consumption (a component that was also affected by inflationary shock). In addition, the negative trend in growth is likely to continue over the coming quarters.

Emerging markets: net capital inflows *
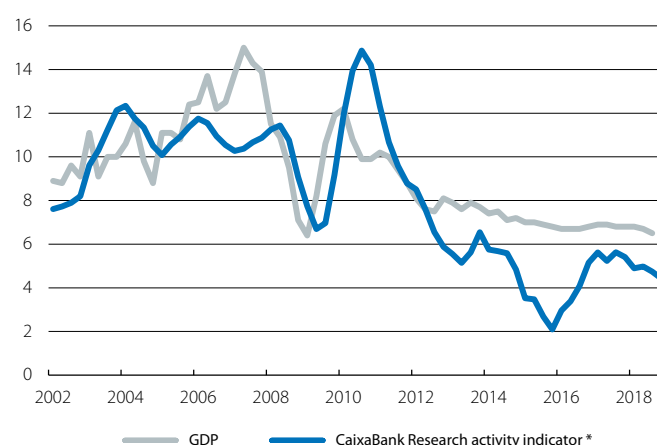*(USD millions, 28-day moving average)*
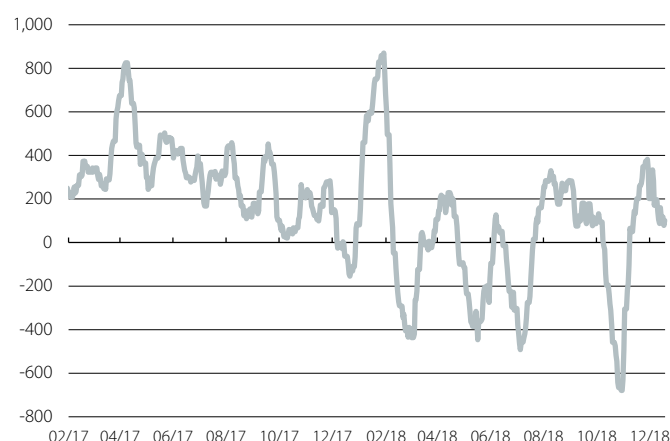
Note: * Portfolio flows (debt and equity). Countries included: Indonesia, India, Korea, Thailand, South Africa, Brazil, Turkey, Hungary and Mexico.
Source: CaixaBank Research, based on data from the IIF.

China: GDP compared to the CaixaBank activity indicator
Year-on-year change (%)

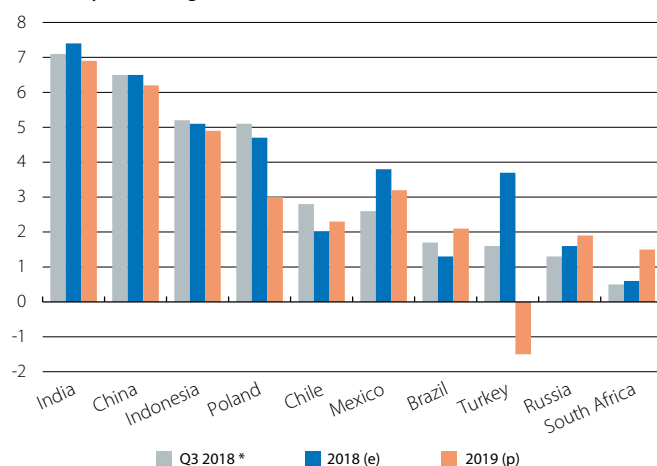

GDP | CaixaBank Research activity indicator *

Note: * Moving average of the economic activity indicator for the last four quarters.
Source: CaixaBank Research, based on data from the People's Bank of China and the National Statistics Office of China.

Emerging markets: GDP
Year-on-year change (%)

Q3 2018 * | 2018 (e) | 2019 (p)

Note: * Year-on-year change. (e) Estimate. (p) Forecast.
Source: CaixaBank Research, based on data from Bloomberg.

Euro area growth: neither very fast nor particularly slow

Following a truly exceptional 2017, the growth of the euro area dropped down a gear in the first half of 2018. Although this raised some suspicion, it was attributed to temporary factors (colds, strikes, meteorology, etc.). However, the pace of growth in Q3 was much lower, and this has already triggered some alarms. To what extent should we be worried? In this article, we will study this issue in detail: we will start by analysing the data for Q3 to settle the question of what failed, before exploring the outlook for the European economy over the next few quarters.

When we look at the breakdown of GDP in Q3, the elements of most concern are the modest growth in private consumption (+0.1% quarter-on-quarter) and the decline in exports (–0.1% quarter-on-quarter). However, when we delve deeper into the causes, we see that both components have been partially affected by significant temporary factors.

In particular, two temporary factors have weighed down household consumption. Firstly, the price of oil rose more than expected in Q3, which reduced households' purchasing power (real consumption slowed down but nominal consumption remained stable, such that households failed to offset the rise in prices with greater expenditure on this occasion). According to our estimates,[1] the rise in oil prices shaved 0.2 pps off growth in consumption in Q3, which in turn would have reduced quarter-on-quarter GDP growth by 0.1 pp.

Secondly, on 1 September a new EU-wide protocol on vehicle emissions came into force. The new regulation caused major disruption to economic activity: as can be seen in the second chart, in August vehicle manufacturers were able to sell the stock of vehicles that would not fulfill the new requirements, but this was more than offset by the fall in production in September – when manufacturers had to slow down their production to adjust their vehicles to the new regulatory framework. We estimate that this second factor also reduced GDP growth by 1 decimal point,[2] as the lower levels of car production eroded economic growth. In addition, the reduced production of vehicles dragged down exports, which we estimate reduced growth by an additional 0.2 pps.[3] As such, the temporary factors deducted

Euro area: nominal consumption and real consumption
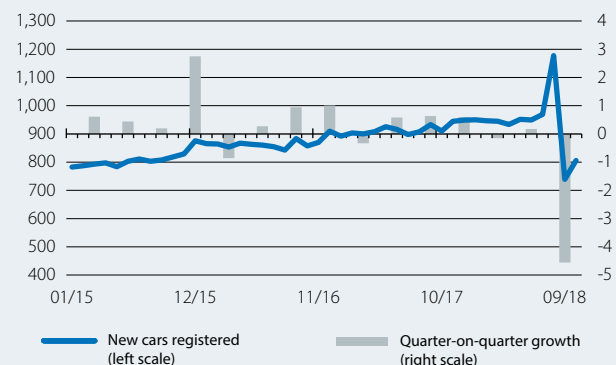Year-on-year change (%)
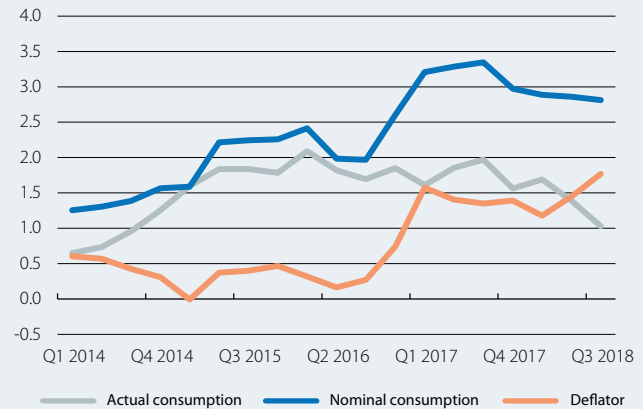
Source: CaixaBank Research, based on data from Eurostat.

Euro area: new passenger car registrations *
Level (thousands)   Quarter-on-quarter change (%)

Note: ** Seasonally-adjusted data.*
Source: *CaixaBank Research, based on data from the ECB.*

0.4 pps from growth (see the third chart), meaning that if they had not been present, growth could have reached a solid 0.6% quarter-on-quarter.

These results are reassuring, but we also want to analyse the economic outlook for the euro area over the coming months. On the one hand, the moderation in oil prices witnessed in Q3, the automotive sector's return to normal levels of activity observed in October and the buoyancy of the labour market[4] point towards a significant upswing in consumption in Q4 and set the stage for an encouraging 2019. On the other, the persistence of accommodative macrofinancial conditions

1. We compared real consumption with the oil prices recorded (68 euros a barrel at the end of Q3) against a scenario with oil prices at around 60 euros a barrel (the average for the first nine months of the year).
2. The quarter-on-quarter growth of new vehicles registered was 4.5 pps lower than expected, and 4% of household expenditure in the EU goes on cars, resulting in a decline in consumption of almost 0.2 pps.
3. The growth in car production was more than 8 pps lower than expected in Q3. Given that European car exports account for 7% of total exports, this unexpectedly low figure reduced European exports by almost 0.6 pps.

4. According to data from the ECB, the remuneration per worker grew by 2.5% year-on-year in Q3, the highest rate since 2008.

will continue to bolster consumption and investment. The element that is of most concern is the weakness of the external sector (even if car exports had not fallen in Q3, the contribution of external demand would have been −0.1 pps in quarter-on-quarter terms), which has been affected by uncertainty, the slowdown of the global economy and trade tensions. We expect that the external sector will continue to go through a rough patch over the coming quarters, but thanks to internal demand, this should not prevent us from seeing reasonable economic growth rates for the euro area as a whole.

Following this qualitative vision, we end the article with a quantitative analysis that offers some figures to help us determine the magnitude of the somewhat positive developments we expect to see over the coming months. To do this, we construct a stylized model for predicting GDP growth over the coming quarters, based on the records of the Purchasing Managers' Index (PMI) and estimates of the main economic activity indicators (retail sales and industrial production)[5] in Q4.[6] This predictive exercise indicates a quarter-on-quarter GDP growth of 0.4% over the coming quarters. This is a significant growth rate and similar to that indicated by our forecasts (0.5% over the coming quarters).

In short, our estimates suggest that there are enough ingredients present for the European economy to regain its buoyancy over the coming quarters. All in all, we must be very cautious in relation to the closing stretch of 2018 and the beginning of 2019, given that a new factor has emerged that is having a detrimental impact on the economy. Specifically, the disruptions to economic activity in France after the demonstrations of the yellow vests have reduced the PMI in December and could represent a new obstacle for economic growth in the euro area.

Euro area: temporary factors and quarter-on-quarter growth in Q3
(p. p.)
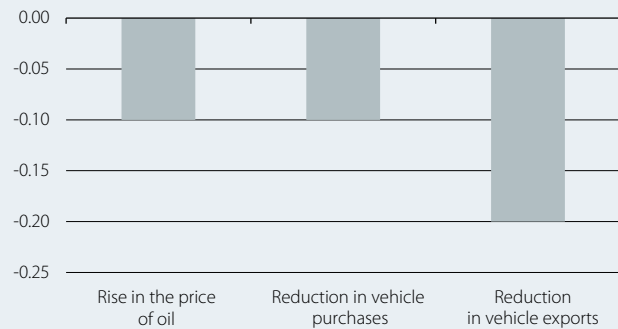
Note: *Impacts estimated according to the methodology developed in footnotes 1, 2 and 3.*
Source: *CaixaBank Research.*

Euro area: GDP predictive model
Quarter-on-quarter change (%)

Note: *Predictions based on PMI data and on estimates of retail sales and industrial production for Q4. The dotted lines represent 95% confidence intervals.*
Source: *CaixaBank Research.*

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5. We plotted GDP growth against economic activity and business sentiment indicators. The main specification is: growth of $GDP_t = \beta_0 + \beta_1 * PMI_t + \gamma * retail\ sales_t + \alpha * industrial\ production_t + \varepsilon_t$, with quarterly data beginning in the year 2000.
6. We used the observed retail sales and industrial production figures in October, and an estimate of the figures for November and December based on the PMI observed in Q4.

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

UNITED STATES

	2016	2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	10/18	11/18	12/18
Activity									
Real GDP	1.6	2.2	2.5	2.6	2.9	3.0	–	...	–
Retail sales (excluding cars and petrol)	3.4	4.1	5.3	4.4	5.2	5.4	4.9	4.6	...
Consumer confidence *(value)*	99.8	120.5	126.0	127.1	127.2	132.6	137.9	136.4	128.1
Industrial production	−1.9	1.6	3.0	3.4	3.4	5.0	3.8	3.9	...
Manufacturing activity index (ISM) *(value)*	51.4	57.4	58.7	59.7	58.7	59.7	57.7	59.3	...
Housing starts *(thousands)*	1,177	1,208	1,259	1,317	1,261	1,234	1,217	1,256	...
Case-Shiller home price index *(value)*	189	200	205	209	211	212	214	...	...
Unemployment rate *(% lab. force)*	4.9	4.4	4.1	4.1	3.9	3.8	3.7	3.7	...
Employment-population ratio *(% pop. > 16 years)*	59.7	60.1	60.1	60.3	60.4	60.4	60.6	60.6	...
Trade balance [1] *(% GDP)*	−2.7	−2.8	−2.8	−2.9	−2.9	−2.9	−3.0	...	...
Prices									
Headline inflation	1.3	2.1	2.1	2.2	2.7	2.6	2.5	2.2	...
Core inflation	2.2	1.8	1.8	1.9	2.2	2.2	2.1	2.2	...

Note: 1. Cumulative figure over last 12 months. Billion dollars.
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	Q4 2017	Q1 2018	Q2 2018	Q3 2018	10/18	11/18	12/18
Activity									
Real GDP	0.6	1.9	2.0	1.2	1.4	0.1	–	...	–
Consumer confidence *(value)*	41.7	43.8	44.5	44.4	43.7	43.4	43.0	42.9	...
Industrial production	0.2	2.9	2.7	2.0	1.3	−0.1	2.5	0.5	...
Business activity index (Tankan) *(value)*	7.0	19.0	25.0	24.0	21.0	19.0	–	19.0	–
Unemployment rate *(% lab. force)*	3.1	2.8	2.7	2.5	2.4	2.4	2.4	2.5	...
Trade balance [1] *(% GDP)*	0.7	0.5	0.5	0.4	0.4	0.1	0.0	−0.2	...
Prices									
Headline inflation	−0.1	0.5	0.6	1.3	0.6	1.1	1.4	0.9	...
Core inflation	0.6	0.1	0.3	0.4	0.3	0.3	0.4	0.3	...

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

CHINA

	2016	2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	10/18	11/18	12/18
Activity									
Real GDP	6.7	6.9	6.8	6.8	6.7	6.5	–	...	–
Retail sales	10.4	10.3	9.9	9.9	9.0	9.0	8.6	...	...
Industrial production	6.1	6.6	6.2	6.6	6.6	6.0	5.9	5.4	...
PMI manufacturing *(value)*	50.3	51.6	51.7	51.0	51.6	51.1	50.2	50.0	49.4
Foreign sector									
Trade balance [1] *(value)*	512	420	420	404	377	349	347	353	...
Exports	−8.4	7.9	9.6	13.7	11.5	11.8	15.5	5.4	...
Imports	−5.7	16.3	13.4	19.4	20.6	20.4	20.8	3.0	...
Prices									
Headline inflation	2.0	1.6	1.8	2.2	1.8	2.3	2.5	2.2	...
Official interest rate [2] *(value)*	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4
Renminbi per dollar *(value)*	6.6	6.8	6.6	6.4	6.4	6.8	6.9	6.9	6.9

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

EUROPEAN UNION

Activity and employment indicators
Values, unless otherwise specified

	2016	2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	10/18	11/18	12/18
Retail sales *(year-on-year change)*	1.6	2.3	2.0	1.6	1.7	1.1	1.7	...	...
Industrial production *(year-on-year change)*	1.6	3.0	4.2	3.1	2.4	0.8	1.2	...	...
Consumer confidence	−7.8	−2.5	−0.2	0.5	0.0	−1.8	−2.7	−3.9	−6.2
Economic sentiment	104.2	110.8	114.3	114.0	112.5	111.5	109.7	109.5	...
Manufacturing PMI	52.5	57.4	59.7	58.3	55.5	54.3	52.0	51.8	51.4
Services PMI	53.1	55.6	55.9	56.4	54.6	54.4	53.7	53.4	51.4
Labour market									
Employment (people) *(year-on-year change)*	1.4	1.6	1.6	1.5	1.5	1.3	–	...	–
Unemployment rate: euro area *(% labour force)*	10.0	9.1	8.7	8.5	8.3	8.1	8.1	...	...
Germany *(% labour force)*	4.2	3.8	3.6	3.5	3.4	3.4	3.3	...	...
France *(% labour force)*	10.1	9.4	9.1	9.2	9.0	9.0	8.9	...	...
Italy *(% labour force)*	11.7	11.3	11.0	11.0	10.7	10.3	10.6	...	...
Spain *(% labour force)*	19.6	17.2	16.5	16.2	15.4	15.0	14.8	...	...

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

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

	2016	2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	10/18	11/18	12/18
General	0.2	1.5	1.4	1.3	1.7	2.1	2.2	2.0	...
Core	0.8	1.1	1.1	1.2	1.2	1.2	1.2	1.1	...

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	Q4 2017	Q1 2018	Q2 2018	Q3 2018	10/18	11/18	12/18
Current balance: euro area	**3.4**	**3.4**	**3.4**	**3.6**	**3.8**	**3.4**	**3.3**	**...**	**...**
Germany	8.5	8.0	8.0	8.0	8.2	7.8	7.7	...	...
France	−0.8	−0.6	−0.6	−0.4	−0.3	−0.6	−0.6	...	...
Italy	2.5	2.8	2.8	2.8	2.8	2.7	2.7	...	...
Spain	2.3	1.8	1.8	1.8	1.4	1.1	1.0	...	...
Nominal effective exchange rate[1] *(value)*	94.3	96.5	98.6	99.6	98.5	99.2	98.9	98.3	98.4

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.

Credit and deposits of non-financial sectors
Year-on-year change (%), unless otherwise specified

	2016	2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	10/18	11/18	12/18
Private sector financing									
Credit to non-financial firms[1]	1.8	2.5	3.0	3.3	3.7	4.2	3.9	...	...
Credit to households[2,3]	1.7	2.6	2.8	2.9	2.9	3.1	3.2	...	...
Interest rate on loans to non-financial firms[4] *(%)*	1.4	1.3	1.3	1.2	1.2	1.2	1.2	...	...
Interest rate on loans to households for house purchases[5] *(%)*	1.8	1.7	1.7	1.6	1.6	1.6	1.6	...	...
Deposits									
On demand deposits	10.0	10.1	10.2	9.2	8.0	7.3	7.3	...	...
Other short-term deposits	−1.9	−2.7	−2.4	−2.2	−1.5	−1.4	−1.0	...	...
Marketable instruments	2.7	1.1	−1.6	−5.7	−2.9	−5.1	−4.8	...	...
Interest rate on deposits up to 1 year from households *(%)*	0.5	0.4	0.4	0.4	0.4	0.3	0.3	...	...

Notes: 1. Weighted by flow of foreign trade. 2. Data adjusted for sales and securitization. 3. Including NPISH. 4. Loans of more than one million euros with a floating rate and an initial rate fixation period of up to one year. 5. 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.

A year of transition towards more sustainable levels of growth

The outlook for the Spanish economy remains favourable. The latest available data suggest that the Spanish economy closed 2018 with a growth rate of 2.5%, while for 2019 we expect the economy to continue to grow at a high rate, albeit somewhat more moderate than in the previous year. More specifically, we expect growth of 2.1%, a figure similar to the forecasts of other financial institutions, such as the Bank of Spain, which in its latest quarterly report places growth for 2019 at 2.2%. This moderation in the pace of expansion is due to the fading of the support factors that have provided a boost to growth in recent years (low oil price, low interest rates and acceleration in global growth) and less cyclical momentum. All in all, growth will stabilise at high rates that are more in line with the economy's potential, which we estimate at around 1.8%. By component, we expect that domestic demand will continue to be the main driver of growth, thanks to the encouraging developments in the labour market and the positive climate of confidence. We also expect exports to recover, at least partially, after a few quarters of lower-than-expected growth. Nevertheless, the pressure that domestic demand will exert on imports leads us to predict that the external sector's net contribution to growth will be very limited.

**The economic activity indicators point towards a good end to the year**, and CaixaBank Research's GDP forecast model predicts quarter-on-quarter growth of 0.61% in Q4 2018, similar to that of Q3. The balance of the various indicators as a whole is positive, and this has been reflected in a growth forecast that has improved over the course of the month. More specifically, the latest indicators have shown an upswing in sentiment (in November, the manufacturing PMI rose by 0.8 points to 52.6 points and consumer confidence rose by 0.6 points up to −6.6 points), as well as in economic activity in the manufacturing sector (industrial production grew in October by 0.8% year-on-year in seasonally-adjusted terms, +1 pp compared to the previous month) and in consumption (in October, retail sales picked up, growing by a healthy 4.5% in seasonally-adjusted terms, 3 pps higher than the figure for September). In addition, this positive trend has not been hampered by the slowdown in exports (3.0% year-on-year in September, −2 pps compared to the previous month).

The labour market continues to generate employment and the recovery in wages is confirmed. The number of workers affiliated to Social Security grew by 2.9% in November. Therefore, since November 2017 the number of affiliated workers has risen by 527,869 people, a very significant figure that helps to explain the trend in domestic demand and the positive climate of confidence in the economy. Nevertheless, compared to the 3.1% growth registered in October, the figure for November was solid but remains in line with our expectation that job creation will gradually moderate over the coming

Spain: GDP
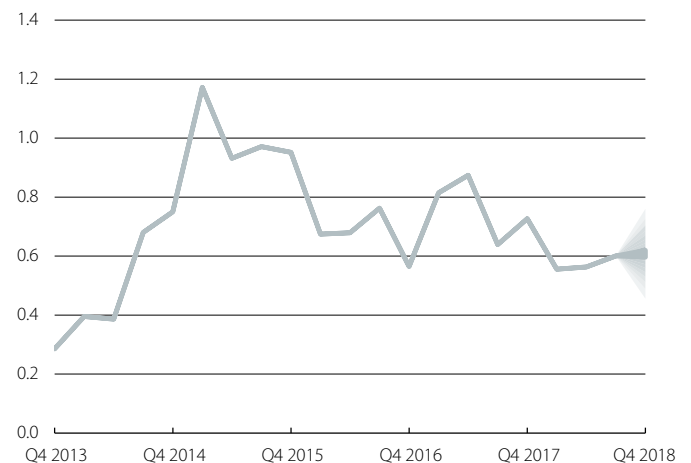Contribution to year-on-year growth (pps)
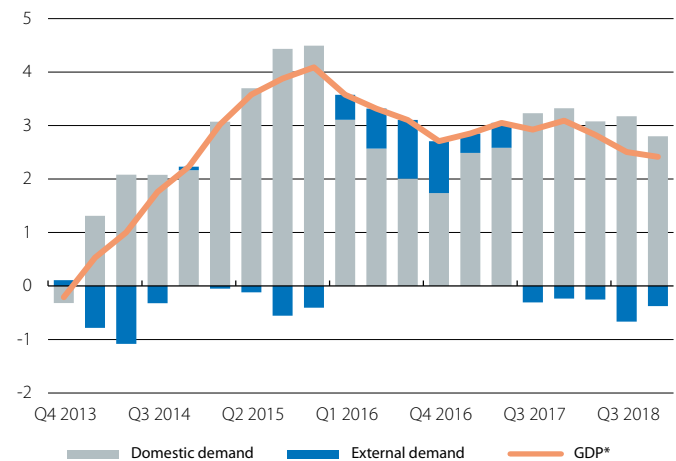
Note: * Year-on-year change (%).
Source: CaixaBank Research, based on data from the National Statistics Institute.

Spain: GDP
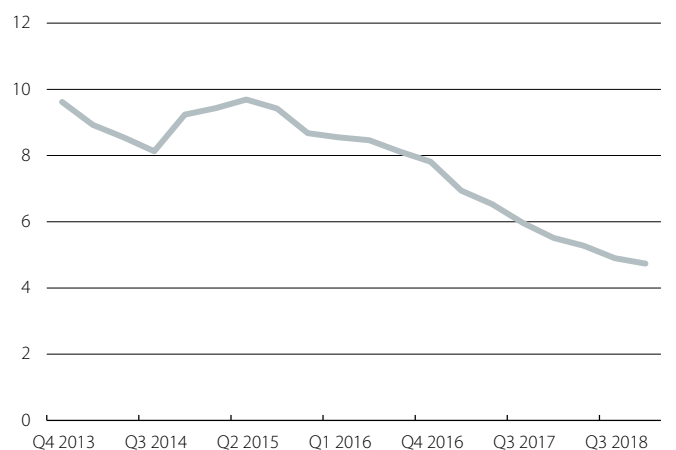Quarter-on-quarter change (%)

Note: 90% confidence interval.
Source: CaixaBank Research, based on data from the National Statistics Institute.

Spain: gross household savings over disposable income
Four-quarter cumulative figures (%)

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

quarters. The latest data from the National Statistics Institute, meanwhile, show that labour costs per effective hour picked up, growing by 2.5% year-on-year in Q3. This figure clearly exceeds the 1.2% registered in Q2 and the average for 2017 (0.0%), and it is relatively in line with the figure for Q3 for the euro area as a whole (2.2%). These figures thus confirm a gradual recovery in wages, which we expect to continue over the coming quarters. What is more, at the last Council meeting of Ministers, the Government approved an increase to the minimum wage, up to 900 euros (+22.3%). It also approved a fixed salary increase for public sector employees in 2019 of 2.25% (with an additional 0.25% for central government employees), to which a further 0.25% could be added if GDP growth were to rise above 2.5%.

The savings rate fell slightly in Q3 and stood at 4.7% of gross disposable income (GDI), 0.2 pps below the figure for the previous quarter. The trend in savings reflects the positive developments in private consumption, which grew by 4.0% in Q3 in nominal terms. All in all, the gradual recovery of GDI, which grew by 2.7% year-on-year, 0.6 pps above the figure for Q2, allowed the drop in the savings rate to be less significant than in previous quarters. As for the coming quarters, we expect that households will moderate their growth in consumption slightly and will use the expected growth in income, driven by the increase in employment and wages, to begin to rebuild their savings buffer.

Energy goods continue to weigh down the current account surplus. The current account balance stood at 12,254 million euros in October (1.02% of GDP), lower than the figure for October 2017 (1.80% of GDP). This difference, which amounts to –8,522 million euros, is almost entirely due to the deterioration in the trade balance of energy goods, which once again had a negative contribution and fell in October by 0.12 pps of GDP compared with the previous month. As for the year end, the decline in the oil price in November and December could provide some relief to the deterioration of the trade balance.

Housing prices continue to grow steadily in Q3, with a 7.2% year-on-year increase (based on sale prices per the National Statistics Institute, or NSI), 0.4 pps above the previous quarter and higher than the average for 2017 (6.2%). This is in line with the strong indicators of supply (residential investment) and demand (sale transactions) that are available for Q3, suggesting some buoyancy in the housing market. However, this indicator contrasts with the price growth figure published by the Ministry of Public Works (a series based on appraisal values) for Q3, which showed a moderation in the growth of housing prices. These divergent trends should not come as a surprise, considering that the two series are based on separate data sources. That said, it should be noted that since the NSI's indicator uses transaction prices based on data from public notaries, rather than appraisal values, it ought to be a more reliable indicator of price trends in the real estate market. Looking ahead to the next few quarters, we expect that prices will continue to grow at a steady rate, thanks to the strength of demand and the accommodative financial conditions, albeit at a somewhat slower rate than the levels reached in recent quarters.

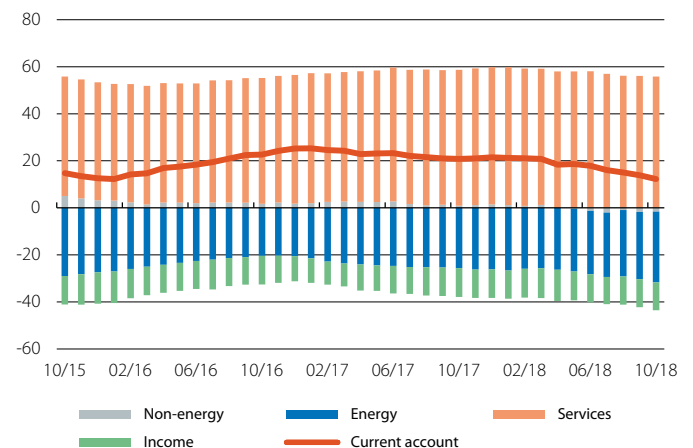*Spain: total labour cost per hour **
Year-on-year change (%)
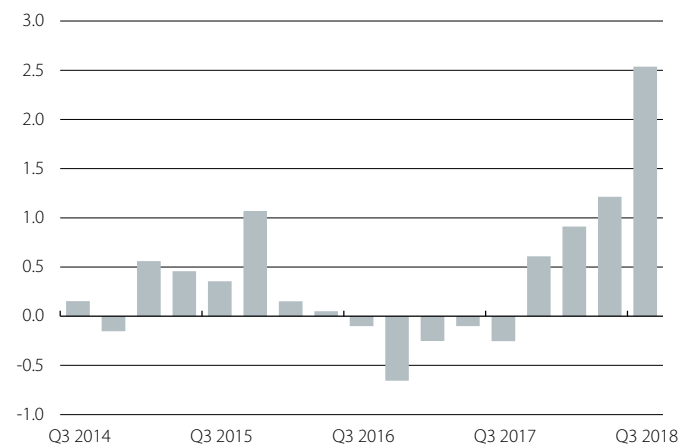
Note: **Series seasonally-adjusted and adjusted for calendar effects.*
Source: *CaixaBank Research, based on data from the National Statistics Institute (ETCL).*
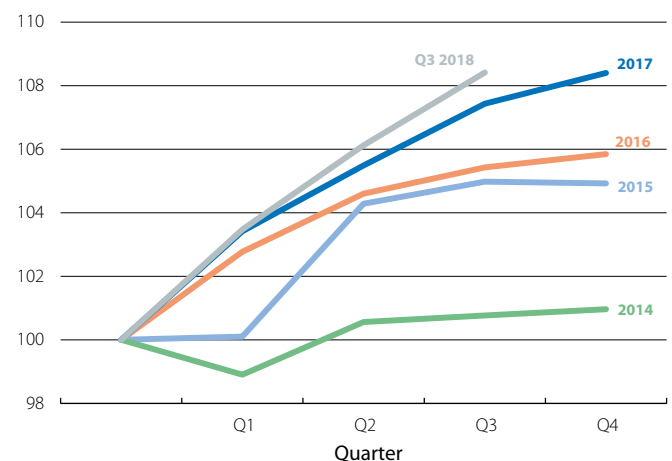
Spain: current account balance
12-month cumulative balance (EUR billions)

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

Spain: housing prices based on sales
Index (100 = previous year)

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

Will greater wage growth lead to higher inflation in Spain?

During 2018, core inflation has remained stable despite the buoyancy of the labour market. This has been partly due to wages still not seeing significant growth. For the next few years, however, all the indicators suggest that the recovery in wages will gain momentum, which could put pressure on inflation. With this in mind, below we explore the link between wage recovery and inflation.

Recent inflationary dynamics

Spain will end 2018 with an inflation rate of around 2%, in a year marked by a rise after starting at around 1% in Q1. However, much of this increase is due to the trend in energy prices, which are highly volatile as well as highly dependent on the price of oil. On the other hand, core inflation, which excludes the volatile components (energy and unprocessed foods) and better reflects the underlying inflationary trends, has remained relatively stable and at contained levels (around 1% for most of the year).

The stability of core inflation at these low rates contrasts with the buoyancy of the labour market. Between 2013 and 2018, the unemployment rate has been declining steadily at a rate of 2 pps per year, such that today there are nearly 2 million more people in employment than in 2013. The Phillips curve, which shows the relationship between the labour market and inflation, provides a good illustration of the contrast between these two dynamics in recent years. As shown in the second chart, the Phillips curve of the Spanish economy suggests that, given the current level of unemployment, we should see notably higher core inflation (slightly above 1.5%).
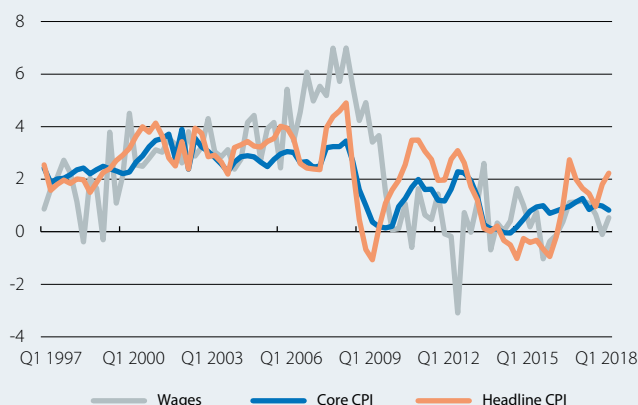
The decoupling between the labour market and inflation

This apparent decoupling between inflation and the labour market is a widespread phenomenon among the world's major economies. Academic studies indicate three major types of explanations for this trend: the stability of inflation expectations, structural changes related to globalisation and new technologies, and measurement issues.[1] In greater detail, one possible explanation is that inflation expectations (which are

Spain: trend in prices and wages
Year-on-year change (%)

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

Spain: Phillips curve
Core inflation (%)

Note: Each point marks a different quarter from Q1 2002 to Q3 2018. In blue are the first three quarters of 2018.
Source: CaixaBank Research, based on data from the National Statistics Institute.

an important factor in determining the inflation that is subsequently observed) have become more stable (and, therefore, less sensitive to the business cycle) thanks to the credibility of monetary policy in achieving inflation objectives. Secondly, globalisation[2] and digital technologies facilitate the relocation of production and increase the global component of the price formation chain. Therefore, domestic inflation becomes more sensitive to the global business cycle and less sensitive to the domestic one. In addition, both the increase in companies' market power observed in recent decades[3] and technological advances that incentivise a

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1. See J. Stock and M. Watson (2018), «Slack and Cyclically Sensitive Inflation», Working Paper. In terms of the Phillips curve, these are factors that cause a flattening of the curve or its inward displacement. Another explanation for this apparent decoupling between inflation and the labour market is the non-linearity of the Phillips curve (i.e. the fact that inflation's sensitivity to the labour market increases as unemployment declines, as shown, for instance, by L. Donayre and I. Panovska (2016), «Nonlinearities in the U.S. Wage Phillips curve», Journal of Macroeconomics). As reflected in the second chart, this can also be observed in the case of Spain.

2. See S. Wei and Y. Xie (2018), «On the Divergence between CPI and PPI as Inflation Gauges: The Role of Supply Chains», NBER Working Paper n° 24319.
3. See J. Loecker and J. Eeckhout (2017), «The Rise of Market Power and the Macroeconomic Implications», NBER Working Paper n° 23687.

relatively greater use of capital also reduce the influence of the labour factor in the formation of prices. Finally, some economists argue that this loss of sensitivity between inflation and the labour market is a statistical illusion, caused by the problems of accurately measuring real levels of unemployment and inflation.[4]

The sensitivity of inflation to wages

To analyse the relationship between the labour market and inflation in greater depth, below we study one of the channels through which the recovery of the labour market is transmitted to inflation: wage growth. So far, the reduction in unemployment has translated into wage growth only discreetly. Specifically, according to the national accounts, the remuneration per full-time employee has increased at an average rate of 0.5% per year between 2013 and 2018. Nevertheless, the wages agreed through collective agreements have shown more buoyancy, with year-on-year growth increasing from 0.4% at the beginning of 2013 to 1.7% at the end of 2018. Thus, the collective agreements suggest that wage growth in the economy as a whole could be a little stronger over the coming quarters.

Will this have a notable impact on inflation? The group of benchmark prices, i.e. the consumer price index (CPI), includes a diverse range of products which, therefore, have different sensitivities to the domestic business cycle (for example, some of them are highly integrated into the global production chain, hence their prices are determined internationally). Therefore, to answer our question, we disaggregated the CPI[5] into nearly 100 components, both for Spain and for the euro area as a whole, before analysing the historical sensitivity of each of these components in relation to the trend in wages.[6]

Thus, based on the historical relationships between prices and wages, we identified the components of CPI whose prices respond positively to an increase in wages. In line with the loss of inflation's sensitivity to the labour market discussed earlier, our exercise shows that, in Spain, the weight of prices that are sensitive to wage growth has substantially reduced.

Sensitivity of inflation to wages

Weight of the prices that are sensitive to wage growth as a proportion of the HICP as a whole (%)

■ 2002-Q2 2008   ■ Q3 2008-2013   ■ 2014-Q3 2018
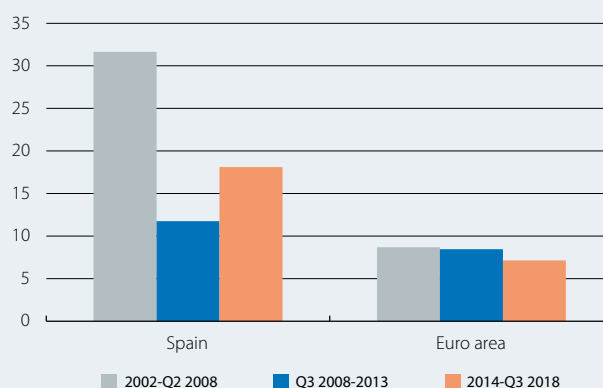
Source *CaixaBank Research, based on data from Eurostat.*

Specifically, these components have gone from representing around 30% of the total of all the prices in the index in the period between 2002 and Q2 2008 (the previous expansionary phase) to slightly less than 20% in the most recent period (see the third chart). In fact, with this trend, Spanish inflation's sensitivity to wages has moved closer to that of inflation for the euro area as a whole (where components sensitive to wage growth represent slightly less than 10% of the total), although it remains notably higher than that of the other major euro area economies.[7]

In conclusion, our analysis highlights a loss of sensitivity of Spanish inflation to wage growth. This is consistent with the decoupling between the trends in inflation and the labour market that has been observed across the major international economies. However, the loss of sensitivity of Spanish inflation has brought it closer to that of its main European partners. Therefore, the greater buoyancy in wages that is expected over the next few years is likely to have a moderate impact on Spain's inflation, especially in comparison to the previous expansionary phase. Furthermore, the pace of recovery of the underlying inflationary pressures is likely to be gradual and relatively in line with that of the euro area as a whole.

4. See, for example, the Focus «Beyond the unemployment rate», in the MR12/2017.
5. We focused the analysis on the harmonised index of consumer prices (HICP) in order to make the results comparable between different euro area economies.
6. For each component of the HICP, and in each region, the relationship is estimated as follows: $\pi_{i,t} = a + \rho\,\pi_{i,t-1} + \beta\,wages_{i,t-j} + \Omega\,oil_t + \varepsilon_{i,t}$ for $j = 0,1,...,4$. π is the inflation of the component; *wages* refers to wage growth, and *oil*, the growth in the oil price. This analysis is performed using quarterly data starting from 2002 and for three different periods: 2002-Q2 2008, Q3 2008-2013 and 2014-Q3 2018. Within each sample period, we consider a component to be sensitive to wage growth when the coefficient β is highly positive in at least one of the five estimates (i.e., $j = 0,1,...,4$).

7. The same exercise applied to Germany and France shows that the components of these economies' HICP that are sensitive to wage growth make up around 10% of the total.

Activity and employment indicators

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

	2016	2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	10/18	11/18	12/18
Industry									
Industrial production index	1.9	3.2	5.2	2.7	0.9	0.3	1.0	...	...
Indicator of confidence in industry *(value)*	−2.3	1.0	4.3	2.8	1.2	−2.6	−1.5	−0.8	...
Manufacturing PMI *(value)*	53.2	54.8	55.9	55.3	53.7	52.4	51.8	52.6	...
Construction									
Building permits *(cumulative over 12 months)*	43.7	22.9	25.1	25.1	28.1	25.8	22.4	...	...
House sales *(cumulative over 12 months)*	13.1	14.1	15.2	15.8	15.6	13.1	12.0	...	...
House prices	1.9	2.4	3.1	2.7	3.8	3.2	–	–	–
Services									
Foreign tourists *(cumulative over 12 months)*	8.2	10.0	9.2	8.2	5.3	1.5	0.8	...	...
Services PMI *(value)*	55.0	56.4	54.5	56.8	55.8	52.6	54.0	54.0	...
Consumption									
Retail sales	3.8	0.9	0.3	1.8	0.1	−0.2	2.1	1.4	...
Car registrations	11.4	7.9	10.8	11.8	9.2	17.0	−6.6	−12.6	−3.5
Consumer confidence index *(value)*	−3.8	−0.7	−1.5	−0.6	0.5	−3.3	−7.5	−6.6	...
Labour market									
Employment [1]	2.7	2.6	2.6	2.4	2.8	2.5	–	–	–
Unemployment rate (% labour force)	19.6	17.2	16.5	16.7	15.3	14.6	–	–	–
Registered as employed with Social Security [2]	3.0	3.6	3.5	3.4	3.1	2.9	3.1	2.9	–
GDP	3.2	3.0	3.1	2.8	2.5	2.4	–	–	–

Prices

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

	2016	2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	10/18	11/18	12/18
General	−0.2	2.0	1.4	1.0	1.8	2.2	2.3	1.7	1.2
Core	0.8	1.1	0.8	1.0	1.0	0.8	1.0	0.9	...

Foreign sector

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

	2016	2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	09/18	10/18	11/18
Trade of goods									
Exports *(year-on-year change, cumulative over 12 months)*	1.7	8.9	8.9	5.8	5.2	4.5	4.5	4.3	...
Imports *(year-on-year change, cumulative over 12 months)*	−0.4	10.5	10.5	6.6	6.9	6.2	6.2	6.3	...
Current balance	25.2	21.5	21.5	20.8	17.9	13.8	13.8	12.3	...
Goods and services	36.0	33.6	33.6	33.5	29.8	25.7	25.7	24.1	...
Primary and secondary income	−10.7	−12.1	−12.1	−12.7	−12.0	−11.9	−11.9	−11.8	...
Net lending (+) / borrowing (−) capacity	27.8	24.2	24.2	23.8	21.2	17.3	17.3	15.9	...

Credit and deposits in non-financial sectors[3]

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

	2016	2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	10/18	11/18	12/18
Deposits									
Household and company deposits	2.5	2.8	3.2	2.5	3.0	3.4	3.9	3.1	...
Sight and savings	16.0	17.6	15.9	12.3	11.0	10.3	10.2	9.9	...
Term and notice	−16.0	−24.2	−24.6	−23.1	−20.7	−18.7	−17.1	−17.2	...
General government deposits	−14.2	−8.7	13.1	16.7	17.6	10.4	14.1	20.6	...
TOTAL	1.2	1.9	3.7	3.2	3.8	3.8	4.5	4.2	...
Outstanding balance of credit									
Private sector	−3.6	−2.2	−1.9	−2.2	−2.8	−2.3	−2.1	−2.1	...
Non-financial firms	−5.3	−3.6	−3.3	−4.4	−6.4	−5.6	−5.3	−5.4	...
Households - housing	−3.7	−2.8	−2.6	−2.4	−2.0	−1.7	−1.5	−1.4	...
Households - other purposes	2.0	3.7	4.5	4.9	5.0	5.5	5.2	4.6	...
General government	−2.9	−9.7	−11.4	−12.5	−9.4	−8.9	−12.5	−11.2	...
TOTAL	−3.6	−2.8	−2.5	−2.9	−3.2	−2.7	−2.7	−2.7	...
NPL ratio *(%)*[4]	9.1	7.8	7.8	6.8	6.4	6.2	6.1	...	...

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.*

Portugal: consolidation of the expansive phase

Solid growth in a more mature phase of the cycle. While we await the latest data of the year, all the indicators suggest that in 2018 as a whole, the Portuguese economy will have grown by slightly more than 2%. This implies a certain deceleration compared to the 2.8% of 2017 and reflects a natural moderation of growth as the economy enters a more mature phase of the cycle (in addition to reflecting the effect of the slowdown of the major neighbouring economies, which is particularly felt by small open economies such as Portugal). As such, this trend is expected to continue in 2019, with a growth rate close to but slightly below 2%. However, the Portuguese economy enters this phase of the cycle strengthened by the improved competitiveness it has achieved in recent years. This is reflected in the latest update of the global competitiveness index prepared by the World Economic Forum, in which Portugal has climbed eight positions compared to last year, reaching 34th out of a total of 140 countries. Furthermore, Portugal has made progress in practically all areas of the index, especially those related to the skills of the workforce, the capacity for innovation and the labour market. Nevertheless, these positive prospects for the economy in the medium term are not exempt from risks, particularly in view of the fear of a less favourable external environment, which is discussed in the International Economy section in this same *Monthly Report.*

External financing capacity tempers. In particular, in Q3 2018 Portugal's external financing capacity stood at 0.5% of GDP, slightly below the 0.7% registered in Q2 and the average for 2017 (1.0%). This moderation was primarily due to the increase in the financing needs of non-financial corporations (which went from –1.2% to –1.9%) as a result of the sector's higher levels of investment, as reflected in its healthy gross fixed capital formation figures (+5.7%). On the other hand, the reduction in the external financing capacity of households (from 0.8% in Q2 to 0.4% in Q3), with private consumption increasing faster than disposable income (and keeping the savings rate low, at around 4%), also weighed down the financing capacity of the economy as a whole.

A positive trend in the public accounts. According to the latest data from the national accounts, the budgetary balance of the public sector stood at +0.7% of GDP in Q3 2018. This encouraging figure reflects the positive trend in the public accounts in recent years, favoured by the economic cycle and the labour market. In this regard, revenues registered significant growth (5.4%), while the trend in expenditure was also encouraging with an increase of just 0.8% (excluding base effects related to the restructuring costs of the financial system). After adjusting these figures for the changes in how the Christmas wage was paid to public sector employees and

Portugal: GDP and coincident economic activity index
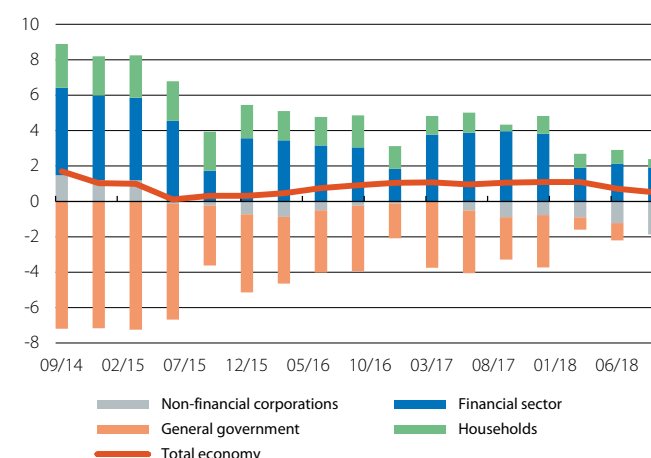*Year-on-year change (%)*
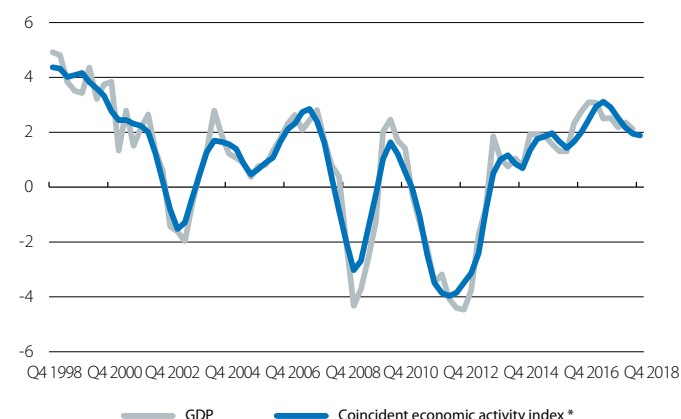
Note: * Level.
Source: CaixaBank Research, based on data from Datastream and the Bank of Portugal.
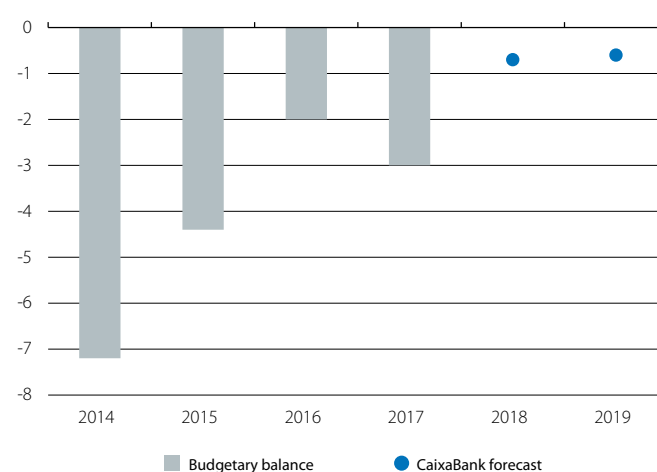
Portugal: external lending capacity/needs
(% of GDP)

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

Portugal: government balance
(% of GDP)

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

pensioners (see the Portuguese Economy section of the MR12/2018), the figures reinforce the forecast that the government balance will have ended the year at around −0.7% of GDP.

The labour market consolidates its recovery. Since employment reached a low point in early 2013 as a result of the 2008 international financial crisis and the recession that followed, Portugal's economy has created nearly 548,200 jobs in net terms and total employment is approaching the levels registered before the crisis. At the same time, the composition of job creation has been realigned over the course of 2018, with jobs associated with the public sector and manufacturing gaining weight, to the detriment of sectors associated with tourism. This recovery in the labour market continues to be reflected in the latest data, which show that in October employment increased by 1.7% year-on-year (seasonally adjusted) and the unemployment rate stood at 6.7%, the lowest level since the end of 2002.

Housing price growth moderates in Q3. In particular, the transaction-based house price index increased by 8.5% year-on-year in Q3, 2.7 pps less than in Q2, making it the second consecutive quarter with a slowdown in growth. By segment, the prices of existing homes rose by 9.2%, while those of new homes rose by 5.7%. In addition, in quarter-on-quarter terms, the price of housing grew by 1.0% in Q3 2018, its lowest rate in the past three years. Over the coming quarters, the slowdown in housing prices is expected to gradually continue. This is due to the moderation in tourist activity and the slowdown in global economic activity, forces that have contributed particularly to the buoyancy of real estate prices in recent years.

New bank lending remains strong. In October, the total balance of new lending to private individuals rose for the third consecutive month (+0.2%), something not seen since 2011. As for lending to corporations, new lending rose by 13.5%, but in net terms the stock of credit fell by 4.6% due to sales of credit portfolios. Despite these positive trends, the environment is not without risks. In this regard, in its December Financial Stability Report, the Bank of Portugal highlights the sudden surge in risk premiums (which causes a reduction in the value of assets – particularly relevant given the banking sector's exposure to public debt securities) as one of the risks to the country's financial stability over the coming quarters.

Portugal: employment and labour force
Index (100 = Q3 2008)
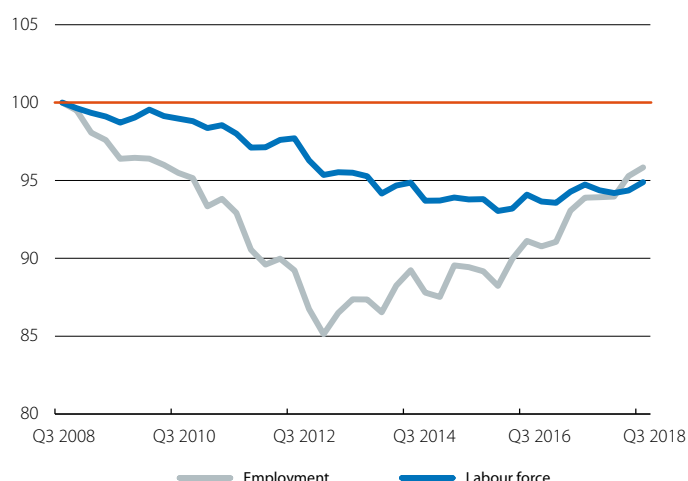
Source: CaixaBank Research, based on data from Datastream.

Portugal: price of housing
Quarter-on-quarter change (%)   *Year-on-year change (%)*
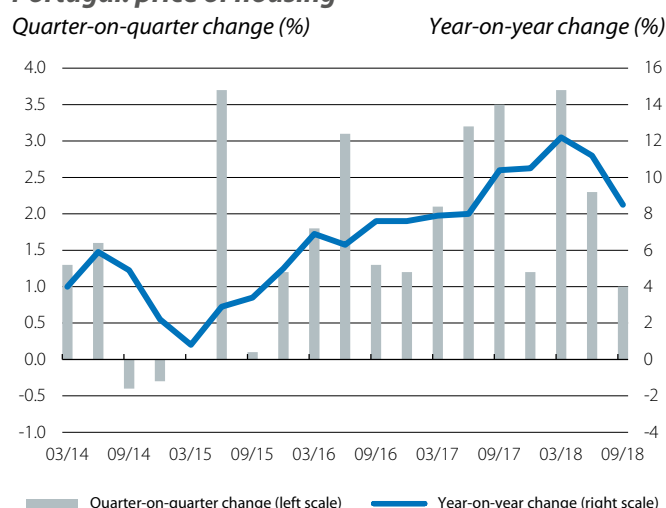
Source: CaixaBank Research, based on data from the National Statistics Institute of Portugal.

Portugal: private sector lending
October 2018

	Balance (EUR millions)	Year-on-year change (%)
Lending to individuals	120,514	0.2
Lending for housing	97,977	−1.1
Lending for consumption and other purposes	22,537	6.1
Consumption	15,278	13.2
Lending to corporations	70,849	−4.6
Non-property developers	64,733	−4.4
Property developers	6,116	−6.7
Total lending to the private sector *	191,363	−1.6

*Note: * New lending to the non-financial private sector.*
Source: CaixaBank Research, based on data from the Bank of Portugal.

Portugal: the automotive industry leads exports of goods

The importance of automotive exports[1]

In recent years, the automotive cluster in Portugal has acquired greater economic weight in terms of GDP. Today, the automotive sector is responsible for nearly 8.5% of the production of Portugal's industry and 2.1% of the production of the Portuguese economy as a whole. It also accounts for 0.7% of total employment and 4.8% of occupation in the manufacturing industry.[2] In addition, according to the Automotive Association of Portugal (ACAP, in Portuguese), in 2017, 176,000 cars were manufactured (a 22.7% increase), of which AutoEuropa (of the Volkswagen Group) was responsible for more than 60%.[3] Finally, the sector is highly orientated towards exports. This is shown by the fact that, according to the ACAP, in 2017 nearly 96% of car production was exported, a figure that rose to 99% in the light vehicle category.

With these figures, it is no wonder that the automotive sector will play a key role in the performance of Portugal's goods exports. As shown in the first chart, in the latter part of 2018, exports of the automotive industry reached 13.0% of the total exports of goods (the highest figure since the end of 2004) and 3.7% of GDP (an all-time high). In addition, as can be seen in the second chart, in October 2018 the sector's exports registered a growth of 39.4% year-on-year (reaching 7.5 billion euros for the 12-month cumulative total). Therefore, if we combine these figures with the fact that goods exports of the economy as a whole grew by 6.5%, we see that the automotive sector accounted for over 70% of the growth in total exports last October.

How does this picture of the Portuguese automotive industry compare with other economies? If we look at countries of a similar size in terms of GDP, in economies such as the Czech Republic or Hungary the automotive sector accounts for a greater proportion of the total. Specifically, according to data for 2017, the sector's exports represent around 21% and 18% of total exports, respectively. In contrast, in countries with more developed economies but a population size similar to that of Portugal, such as Belgium and Austria, the automotive industry represents a similar fraction

1. The figures discussed encompass all motor vehicles and tractors, chassis and bodywork, automotive parts and accessories, as well as trailers and semi-trailers included in the combined nomenclature NC8.
2. See the Office for Strategy and Studies of the Ministry of Economy of Portugal (2018), « A indústria automóvel na economia portuguesa », Temas Económicos, n° 61, November.
3. Most vehicles produced in Portugal are light vehicles, mainly cars (72% of total production).

Portugal: automotive sector exports *
12-month cumulative figure (%)   *12-month cumulative figure (%)*
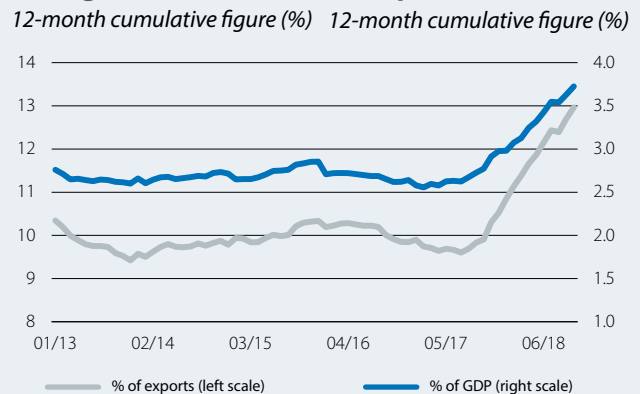
Note: * Includes all motor vehicles, chassis, bodywork, trailers and semi-trailers, car parts and accessories.
Source: CaixaBank Research, based on data from the National Statistics Institute of Portugal.

Portugal: exports of cars, parts and components
(EUR millions)   *(%)*
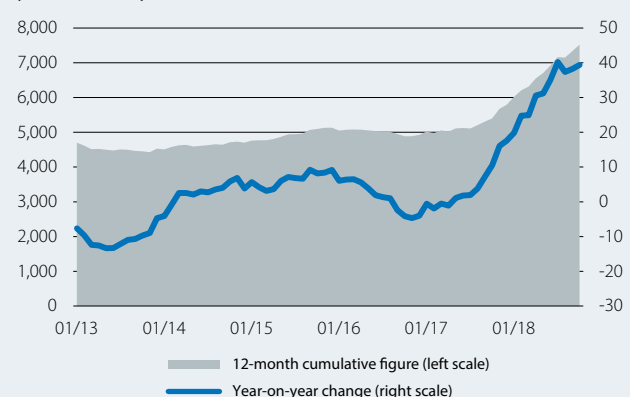
Source: CaixaBank Research, based on data from the National Statistics Institute of Portugal.

of the economy to that of Portugal. Indeed, in 2017 the sector's exports accounted for around 11% of total exports in Belgium, while in Austria the figure stood at 9%.

By sub-sector, the automotive industry is divided into three large groups: motor vehicles for all purposes, including tractors; parts and accessories; and chassis, bodywork, trailers and semi-trailers. The figures up to October 2018 (12-month cumulative figures) show that the first sub-sector represents 59% of exports; the second, nearly 40%; and the third, a little over 1%. A year ago, the two main sub-sectors were at par, with values close to 49%, but in 2018 there has been a significant recovery in the sale of motor vehicles, as a result of higher production levels.

By region, the Lisbon metropolitan area leads the automotive sector's exports with a 42% share, as it

includes the district of Setúbal, where AutoEuropa (of the Volkswagen Group) is located. It is followed by the Northern region, which represents 36% of the sector's exports and includes a large number of companies that specialise in automotive parts and accessories. In third position is the Central region, which accounts for another large part of exports amounting to 19%, through the companies PSA Peugeot Citroen de Mangualde and Renault de Cacia.

Lastly, despite the buoyancy of exports in the automotive sector as a whole, in net terms the sector's trade balance remains negative. However, this situation has improved considerably in the last year: in October 2018, the balance of the automotive sector stood at –1.3 billion euros, compared to –2.7 billion euros in October 2017. In addition, the various sub-sectors are in different situations: much of the deficit comes from the motor vehicles sub-sector, since the domestic demand for cars is almost exclusively met with high foreign imports (as we have seen, practically all of the domestic production is exported). In contrast, the parts and accessories sub-sector has generated a surplus since the end of 2015. This is because, in recent years, it has expanded at a greater rate than the supply for internal customers (specifically, to vehicle assembly and export companies, a function with which the sub-sector was initially developed), and it has expanded into exporting to supply factories abroad.

Future outlook

A car is a durable consumer good and, as such, purchasing one requires a high initial outlay from households: this is why the automotive industry is traditionally highly sensitive to changes in the business cycle. In the case of Portugal, given that the sector is highly orientated towards exports, the industry must cope with an international environment that is at the mercy of possible spikes in geopolitical tensions and the tightening of financial conditions. In this regard, it should also be noted that Portugal's automotive exports are currently concentrated in a relatively small number of countries. Specifically, based on data for October 2018, Spain leads the purchases of Portuguese automotive products, with 22.1%, followed by Germany and France with 18.5% and 18.4%, respectively, and the United Kingdom with 8.8%. In other words, these four countries together accounted for 67.8% of the total exports of the Portugal's automotive industry.

Finally, the sector also faces major challenges in the medium and long term, such as the new demands relating to emissions and the consequent introduction of alternatives to engines that run on fossil fuels, which could lead to a realignment of the sector. Faced with these and other challenges, the automotive industry has

made significant investments through programmes to increase competitiveness in sectors with a medium-high technological intensity. According to the Ministry of Economy, since the implementation of these operational programmes,[4] total investment in the sector has reached 211 million euros, of which 80.5% corresponds to the vehicle components industry. Furthermore, there are investments in R&D, mostly financed by the equity capital of the companies in the sector.[5]

In short, the automotive industry has increased its productive capacity through innovation and technology, as well as with improvements in the skills of the companies' workforce, competitiveness and internationalisation – all this in order to develop this sector, which is regarded as strategic for the Portuguese economy.

4. Between 2014 and August 2018.
5. See footnote 2.

Activity and employment indicators

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

	2016	2017	Q1 2018	Q2 2018	Q3 2018	07/18	08/18	09/18	10/18	11/18
Coincident economic activity index	1.7	2.9	2.5	2.2	1.9	2.0	1.9	1.9	1.9	1.9
Industry										
Industrial production index	2.4	4.0	2.3	0.5	−1.8	−1.0	−3.8	−0.5	−0.1	−2.9
Confidence indicator in industry *(value)*	−0.7	2.3	2.1	0.0	0.4	0.9	1.6	−1.2	−1.1	−0.7
Construction										
Building permits *(cumulative over 12 months)*	7.9	19.8	9.0	11.4	12.7	...	...	12.7	...	...
House sales	18.8	20.5	15.7	23.7	18.4	...	...	18.4	...	...
House prices *(euro/m² - valuation)*	3.8	5.0	5.4	6.1	6.2	...	...	6.2	...	...
Services										
Foreign tourists *(cumulative over 12 months)*	10.9	12.3	11.2	7.6	3.8	5.0	4.0	2.5	1.2	...
Confidence indicator in services *(value)*	7.3	13.8	13.2	14.4	16.5	18.3	14.5	16.7	8.6	11.7
Consumption										
Retail sales	2.7	4.1	5.9	2.6	2.3	2.4	3.5	0.9	5.7	4.5
Coincident indicator for private consumption	1.9	2.6	2.7	2.4	1.8	2.0	1.8	1.6	1.4	1.2
Consumer confidence index *(value)*	−11.1	0.5	2.0	2.8	−1.4	−1.4	−1.3	−1.5	−0.4	−3.4
Labour market										
Employment	1.2	3.3	3.2	2.4	2.1	2.2	2.0	2.1	1.7	...
Unemployment rate (% labour force)	11.1	8.9	7.9	6.7	6.7	6.8	6.9	6.6	6.7	...
GDP	1.9	2.8	2.2	2.4	2.1	...	...	2.1	...	...

Prices [1]

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

	2016	2017	Q1 2018	Q2 2018	Q3 2018	07/18	08/18	09/18	10/18	11/18
General	0.6	1.6	0.9	1.2	1.8	2.2	1.3	1.8	0.8	0.9
Core	0.8	1.3	0.9	0.9	1.3	1.8	0.7	1.4	0.3	0.5

Foreign sector

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

	2016	2017	Q1 2018	Q2 2018	Q3 2018	07/18	08/18	09/18	10/18	11/18
Trade of goods										
Exports *(year-on-year change, cumulative over 12 months)*	0.8	10.0	6.5	7.4	7.0	8.3	7.4	7.0	6.5	...
Imports *(year-on-year change, cumulative over 12 months)*	1.5	13.5	11.0	9.8	8.6	9.8	9.4	8.6	7.3	...
Current balance	1.1	0.9	0.9	0.0	−0.4	0.0	−0.4	−0.4	−0.2	...
Goods and services	3.8	3.5	3.2	3.1	3.1	3.2	2.9	3.1	3.2	...
Primary and secondary income	−2.7	−2.6	−2.3	−3.1	−3.5	−3.2	−3.3	−3.5	−3.4	...
Net lending (+) / borrowing (−) capacity	3.0	2.7	2.7	1.9	1.6	1.9	1.6	1.6	1.8	...

Credit and deposits in non-financial sectors

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

	2016	2017	Q1 2018	Q2 2018	Q3 2018	07/18	08/18	09/18	10/18	11/18
Deposits [2]										
Household and company deposits	3.7	1.7	2.6	4.3	4.4	3.6	4.7	4.7	3.8	...
Sight and savings	19.5	15.7	13.6	15.3	13.6	11.4	14.6	14.9	13.5	...
Term and notice	−3.2	−5.8	−4.1	−2.9	−2.1	−1.8	−2.1	−2.3	−2.9	...
General government deposits	−17.9	1.3	1.9	−0.8	1.0	−1.2	3.0	1.4	2.2	...
TOTAL	2.3	1.6	2.6	4.0	4.2	3.4	4.6	4.5	3.7	...
Outstanding balance of credit [2]										
Private sector	−3.9	−4.0	−1.8	−1.8	−1.4	−1.5	−1.4	−1.3	−1.6	...
Non-financial firms	−5.6	−6.5	−3.1	−3.7	−3.7	−3.8	−3.9	−3.5	−4.6	...
Households - housing	−3.3	−3.1	−1.9	−1.6	−1.2	−1.3	−1.2	−1.1	−1.1	...
Households - other purposes	−0.5	0.9	3.0	4.1	5.8	5.6	6.1	5.7	6.1	...
General government	−9.4	9.3	19.0	14.8	−12.4	−13.9	−12.2	−11.2	−11.2	...
TOTAL	−4.2	−3.5	−1.0	−1.1	−1.9	−2.1	−1.9	−1.8	−2.1	...
NPL ratio *(%)* [3]	17.2	13.3	12.8	11.7	...	...	...	...	...	...

Notes: 1. Harmonized indexes. 2. Aggregate figures for the Portuguese banking sector and residents in Portugal. 3. Period-end figure.
Source: CaixaBank Research, based on data from the National Statistics Institute, Bank of Portugal and Datastream.
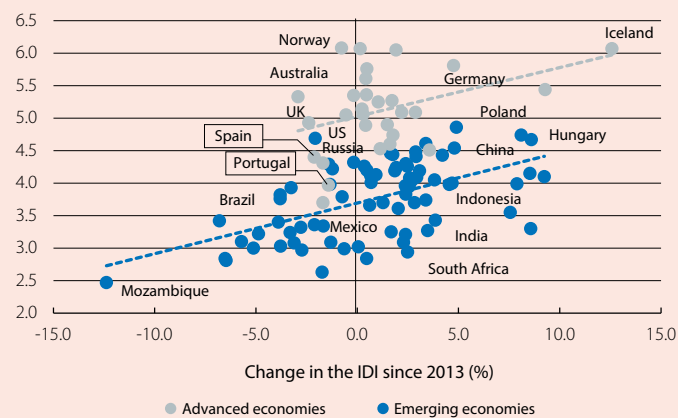
Inclusive growth: the forces of the future

According to the OECD, an economy's growth is inclusive when it is distributed equitably among society and creates opportunities for all. This is a complex concept and requires a detailed analysis in order to determine how inclusive growth has evolved over time, but the growing income inequality in most advanced economies already indicates that the trend is not exactly favourable.

In order to better assess the extent to which a country's economic growth is inclusive, the World Economic Forum has developed an index that takes into account other variables besides income inequality that are indicative of the level of inclusion, such as life expectancy, poverty rates and the dependency ratio. Although there are notable differences between countries, the final message is not very encouraging: following the deterioration in the index during the financial crisis, it has barely recovered in recent years. In fact, the persistent deterioration in the inclusive growth indices in many countries fuels fears that we have entered a phase of secular exclusion (see the chart).

In this situation, it is not surprising that inclusive growth is one of the priorities in the agendas of most international institutions. In recent decades, several factors have arisen as possible causes of the deterioration in the inclusiveness of growth, but the most prominent candidates are technological change and globalisation. Specifically, while these factors should be capable of improving the well-being of the population as a whole, their benefits and costs do not appear to have been distributed fairly or equitably among different individuals. Another factor to add to the list is the slow adaptation of regulation to the new economic context, which implies that there are significant asymmetries in the degree of regulatory control in particular sectors or economic areas.

The Inclusive Development Index (IDI)*
2018 index

Note: * The Inclusive Development Index of the World Economic Forum. This is an aggregate measure of 12 indicators distributed across three key areas: economic development, social inclusion and sustainability. Each area is given the same relative importance in order to obtain the general index. The values are distributed on a scale from 1 to 7, where 7 is the highest inclusiveness score.
Source: CaixaBank Research, based on data from the World Economic Forum.

Technological change: from computers to AI and machine learning

The appearance of computers and the first wave of robotic automation of manufacturing plants greatly favoured economic growth, but not in a very inclusive manner. In particular, in many advanced countries (such as the US and the United Kingdom), the wage gap between workers with higher levels of education («skilled» workers, according to the economic jargon) and those with a lower level of educational («unskilled» workers) increased significantly.[1] Furthermore, workers with a more basic education endured higher unemployment rates. The robotic automation of manufacturing plants had a negative impact on the demand for workers with a relatively low level of educational, as well as on their wages, since the new robotic machines served as good substitutes for the tasks they performed. In contrast, computers increased the productivity of workers with a higher level of education, which also had a (positive) impact on their wages. In summary, these technological changes clearly favoured skilled jobs, while being detrimental, therefore, to those on lower incomes (were skilled biased).

The technologies of the future (some of which are already of the present) will also effect workers, although on this occasion it seems that the impact is going to be less linked to people's level of educational. For instance, artificial intelligence (AI) has the potential to affect workers with a wide range of skill levels: from telephone operators or people who provide support and help to the elderly (through the development of chatbots, for example), to taxi drivers, translators and doctors (such as radiologists). We do not have to look very far to see that we already have the first driverless cars and programs that analyse medical images, and there is no doubt that translation applications are getting better all the time.

In this regard, some of the results reached by the director of MIT's Initiative on the Digital Economy, Erik Brynjolfsson, together with other co-authors, suggest that the phenomenon of machine learning will not directly lead to an increase in polarisation. This is because there is no clear relationship between occupations that could be more easily replaced by machine learning techniques

1. See Feenstra, R. C. , and Gordon, H. (1999), «The Impact of Outsourcing and High-Technology Capital on Wages: Estimates for the United States, 1979-1990», The Quarterly Journal of Economics 114.3: 907-940. Also see Canals, C. (2006), «What Explains the Widening Wage Gap? Outsourcing vs. Technology», CaixaBank Research, Working Papers.

and the level of wages that these jobs currently have.[2] Nevertheless, this and other technologies that are being developed could end up causing the destruction of many jobs although they can also generate new ones. Therefore, a labour framework that protects workers who lose their jobs and helps them to successfully rejoin the labour market will be key (see the article «Employment policies for inclusive growth» in this Dossier), as will be education policies that prepare future workers for the changes to come (see the article «Education as a lever for inclusive growth» in this same Dossier).

The view from the emerging countries is somewhat different, since in this case information and communication technologies appear to have a high potential to improve the level of inclusion. This is because these technologies considerably help workers in the primary sector, who are on lower incomes, to gain better access to the markets where they sell their products, thus substantially increasing their income.[3]

Offshoring: from manufacturing to services and back again

Over the past few decades, one of the most visible faces of globalisation has been the rise of offshoring (either via companies moving their operations abroad or through outsourcing), particularly in the manufacturing sector. Much like the technological change was biased in favour of skilled labour, the offshoring of manufacturing jobs has fuelled economic growth but has also made it less inclusive. In particular, in advanced countries, many companies have fragmented their production process and transferred part of it to other economies, mostly emerging ones, in order to take advantage of lower costs (specifically, labour costs). This has had an especially adverse effect on less skilled workers in developed countries (in the form of lower wages and higher unemployment rates).[4]

Nevertheless, in the future, offshoring could have different implications for the inclusiveness of economic growth. According to a recent study by Branstetter, Glenon and Jensen, US companies have considerably increased the level of offshoring of R&D to emerging countries such as India and China. The reason for this is the increasing role of information technologies and software in developing business innovation, together with the increase in the number of specialists in these two fields that exist in emerging countries.[5] These dynamics suggest that the offshoring of services will affect skilled workers to a much greater extent than the offshoring of manufacturing.

On the other hand, the sharp decline in the price of industrial robots[6] could lead to a certain degree of reshoring of some of the manufacturing processes that companies had previously moved to emerging countries (i.e. reintroducing domestic manufacturing). This, without a doubt, will have positive effects on the labour market in advanced countries, since robots require maintenance and repairs, among other complementary tasks.

In short, although the future is uncertain, what is clear is that artificial intelligence, machine learning, the co-existence of the offshoring of manufacturing with that of services and, possibly, reshoring will influence the inclusiveness of economic growth in a very different way to in the past. And we must be ready.

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2. See Brynjolfsson, E., Mitchell, T. and Rock, D. (2018), «What Can Machines Learn, and What Does It Mean for Occupations and the Economy?» AEA Papers and Proceedings, vol. 108.
3. The example of the use of mobile phones by fishermen in India's Kerala region is one of the most obvious cases. See Jensen, R. (2007), «The Digital Provide: Information (Technology), Market Performance, and Welfare in the South Indian Fisheries Sector», The Quarterly Journal of Economics 122.3: 879-924.
4. See the references of note 1.
5. See Branstetter, L. G., Britta, M. G. and Jensen, J. B. (2018), «The IT Revolution and the Globalization of R&D», n° w24707, National Bureau of Economic Research.
6. According to data from ARK Invest, the cost of industrial robots has fallen from 131,000 dollars in the mid-1990s to 31,000 dollars today.
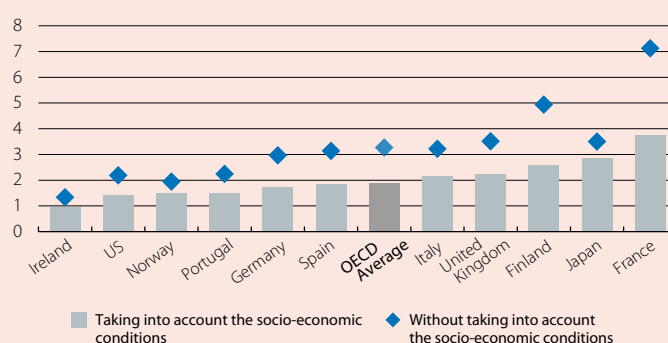
Education as a lever for inclusive growth

The importance of education for people's well-being throughout all stages of their lives is beyond any doubt. At the economic level, individuals with higher levels of education tend to enjoy higher employment rates and income levels. What is more, all the indicators suggest that in the years to come, the role of education will be even more important. The challenges posed by technological change and globalisation have a profound effect on the educational model.

Generally, the educational level of a person or society is analysed in terms of «quantity» – in other words, the number of years of formal education (the extensive margin). In this dimension, the empirical evidence leaves no doubt: the more the better, especially in early childhood.[1] Specifically, education in early childhood (from 0 to 5 years) is associated with better educational results throughout the formative period. In addition, from a strictly economic point of view, several studies document that the public return on investing in preschool education for vulnerable households is very high.[2]

Therefore, policies aimed at achieving a greater participation in preschool education can make a very significant contribution to eliminating the effect of families' socio-economic conditions on children's education outcome in the longer term. Following on from this, providing this education free of charge is a promising avenue: a recent study by UCLA[3] estimates that countries which offer a year of free preschool education have, on average, a 16% higher schooling rate at these ages than in countries that do not provide it free of charge. However, according to this same study, only 45% of countries worldwide offer one or more years of free preschool education, although this figure rises to 62% for advanced economies. In Spain, for instance, there is public provision of preschool education between the ages of 3 and 6 years, although it is not mandatory. However, there are countries where education is already mandatory in early childhood, such as Israel (from 3 years of age) and Luxembourg (from 4 years).

Compulsory education and results in mathematics
Odds ratio *

Taking into account the socio-economic conditions

Without taking into account the socio-economic conditions

Note: ** The odds ratio indicates how many times the probability of a student getting bad results in mathematics is multiplied by when they have not completed at least one year of pre-compulsory education. Values greater than 1 indicate that the probability of obtaining bad results in mathematics increases for students without pre-compulsory education compared to those having studied for at least one year in early childhood.*
Source: *CaixaBank Research, based on data from the OECD.*

On the other hand, lengthening the years of education once compulsory education ends does not usually provide such good results as having good education services during early childhood. This is illustrated by various studies in which it is observed that around 20% of workers in OECD countries are overqualified for their jobs, while around 15% are underqualified.[4]

For this reason, it can be very useful to have a high-quality service for providing guidance on the various educational and professional pathways available at the end of the compulsory studies, so that students are better equipped to consider their next steps and to align their skills and concerns with the supply of education and the labour market. Of course, this information should be accessible to all students throughout the formative period and it should be provided proactively in order to reach all students.

A good example of this policy can be found in Scotland, where a government agency in permanent contact with businesses and schools provides information to students on the needs of the labour market and on what educational path could be more useful to each student, also based on their motivations. This agency provides guidance within the schools themselves, as well as through its various offices, in order to reach all students regardless of their age and socio-economic status.

1. OECD (2016), «Low-Performing Students», chapter 2.
2. In a study conducted in the 1960s in the US, it was noted how children from vulnerable households who were randomly offered free pre-compulsory education enjoyed higher employment rates, better wages and lower crime rates after 40 years. The main benefits of such investment for the public funds lies in the greater collection of taxes and, above all, the savings in criminal costs. See Schweinhart, L. *et al.* (2005), «The High/Scope Perry Preschool Study Through Age 40», High/Scope Press.
3. See Milovantseva, N., Earle, A. and Heymann, J. (2018), «Monitoring Progress Toward Meeting the United Nations SDG on Pre-primary Education: An Important Step Towards More Equitable and Sustainable Economies», International Organisations Research Journal, vol. 13.
4. To be precise, 13%. See, for example, Quintini, G., «Right for the job», OECD Social, Employment and Migration Working Papers.

But in education, quantity is not everything. In fact, the content and the type of education (intensive margin) are becoming increasingly decisive. Educational policies should aim to provide all people with the skills they will need in the future. Furthermore, all the indicators currently suggest that the future economic context will be more changeable, primarily due to the speed of technological change, and even more globalised. Adapting education policy to this new environment is by no means trivial.

Technological change, for example, helps make it much easier to obtain information, but the key lies in knowing how to select the most relevant and truthful information and how to communicate it successfully. Furthermore, technological change is enabling the automation of many tasks, which means that the work we perform as people requires greater non-cognitive skills (so-called soft skills), such as the ability to concentrate and to plan, perseverance, self-control and relationships. Finally, given the speed of technological change and the uncertainty over where it is heading, the education system must also help us to develop an attitude that is open to change and to continuous learning.

Globalisation will also affect the type of work that will be carried out in developed countries. In recent decades, globalisation has above all affected industry, but there are signs that in the years to come it will also reach the services sector. In this regard, the prestigious Princeton economist Alan Blinder believes that jobs in the manufacturing sector, as well as in non-customised services, will continue to lose weight in advanced economies, to the benefit of more personalised services such as advisory services based on trust and personal attention. In these kinds of jobs, personal interactions tend to be very important and, therefore, they require communication skills and the ability to be spontaneous and creative. It is for this reason that Blinder advocates a profound reform of the education system, placing less importance on memorisation and standardised testing, instead prioritising teamwork and the ability to argue and offer imaginative solutions to complex problems that do not necessarily have a right or wrong answer.[5]

In short, educating the future population has always been a major challenge. From now on, faced with an uncertain and ever-changing future, this challenge will not only be significant but also essential to address, and the cost of failing to undertake continuous education and training will be much higher. For this reason, it seems that the education system will have to be re-educated. Besides, it is no longer a matter of more education (although this will also help) but, above all, better education.

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5. See Blinder, A. (2008), «Offshoring, Workforce Skills, and the Educational System», Global Economic Symposium.

Employment policies for inclusive growth

Technological change, globalisation and demographic change are major global trends that are changing the pattern of growth, and the labour market will be an area in which its impact will be felt sharply. Technological change is accelerating changes in the productive structure by automating processes, destroying occupations and creating new ones, which will change the labour requirements and the skills necessary to perform new tasks. It interacts with globalisation, which facilitates the formation of global supply chains for goods and, increasingly, for services, as well as facilitating greater competition, which affects prices and wages. Finally, the ageing of the population reduces the labour force and changes its composition, as older workers make up a larger proportion of the total. Nevertheless, the productivity gains that this new pattern of growth can provide will not necessarily be transferred to the whole of society if the structure and regulation of the labour market are not adjusted accordingly. Employment policies must be adapted in many areas in order to achieve inclusive growth.

An indispensable condition for employment growth is achieving sustained economic growth. The major trends mentioned above increasingly require greater flexibility in the economy and in labour relations in order to grow, since the productive factors (labour and capital) need to be constantly reallocated. This reallocation towards more productive companies and sectors is what allows productivity to increase and, therefore, wages and living standards to improve. On the other hand, labour protection policies play a key role in strengthening the labour markets by fixing the conditions for dismissal, thus preventing an excessive level of job destruction. However, overprotection can hinder job creation by reducing incentives for hiring.

It is also important to note the negative consequences that can result from different types of contracts having significantly different levels of protection. As an example, a much higher level of protection for permanent contracts than for temporary ones encourages greater use of the latter, causing higher-than-optimal staff rotation. In order to achieve a better balance between the flexibility and stability of labour, the OECD recommends reducing the asymmetries between different types of contracts.[1] This also makes it possible to stimulate employment in the most productive sectors by encouraging investment in the human capital of both companies and workers.

On the other hand, companies will increasingly use contract types that allow for more flexible relationships in order to reduce the costs of adapting to this changing environment, driven by technological change and globalisation. The older population, meanwhile, may also require more flexible relationships, such as part-time work, in order to prolong their working life. All of this points towards an increase in temporary and part-time contracts, self-employed workers and new types of contracts, such as on-demand employment. To varying degrees, these new contracts offer fewer labour rights than permanent contracts, and the increase in their use could reduce the social protection of a growing portion of the population. To counteract this trend, their social security coverage could be extended, particularly for on-demand employment which generally lacks basic social protection – something that some countries are already beginning to consider.[2]

Employment gap of groups with higher risk of exclusion
Difference compared to the benchmark group *
(%)   *(pps)*

■ Labour gap (2016) (left scale)   ◆ Change in the labour gap (2006-2016) (right scale)

Note: *The employment gap is defined as the difference between the employment rate for men between 30 and 54 years of age and that of the group in question, expressed as a percentage of the employment rate for men aged 30 to 54. Mothers with young children refers to working-age mothers with at least one child between 0 and 14 years of age. Non-natives refers to all those born abroad, regardless of nationality. Data on changes in the employment gap are not available for people with disabilities.*
Source: *CaixaBank Research, based on data from the OECD (2018), «Good Jobs for All in a Changing World of Work: The OECD Jobs Strategy».*

1. OECD (2018), «Good Jobs for All in a Changing World of Work: The OECD Jobs Strategy», OECD Publishing.
2. See the article «The sharing economy and the labour market» in the Dossier of the MR07/2018.

The changing needs of the labour market may also increase the risk of exclusion in more sectors of society. At present, several groups such as young people, women with children, immigrants, disabled people and the elderly participate less in employment than native men aged between 30 and 54 (see first chart). Therefore, it is important to promote equal opportunities and to eliminate any form of discrimination. Exclusion from the labour market may even be costlier now, since a diverse workforce allows organisations to tackle an increasingly changing environment with greater guarantees. In addition, the ageing of the population will increase the proportion of older workers who are at risk of exclusion. The benefits of diversity arise from the complementary nature of different workers. As an example, the IMF estimates that if the participation gap between men and women were to be completely closed, GDP could increase substantially (by 14% in Europe and Central Asia, and by over 58% in North Africa and the Middle East). This is partly due to the greater productivity that gender diversity would entail.[3] Another form of complementarity that could benefit other groups would involve integrating into the workforce millennials who have a better understanding of the new demands of the market, immigrants who can facilitate a company's internationalisation, or older workers with plenty of experience.

*Participation in continuous education and training according to prior education level ***
(%)

■ Lower secondary education or less   ◆ University education

Note: Population between 25 and 64 years of age that has participated in continuous education and training activities in the past four weeks (2017).
Source: CaixaBank Research, based on data from the OECD (2018), «Economic Survey of Spain».

In addition, changes in the needs of the labour market will increase the likelihood of job losses. For older workers, by extending their working life, they will be less likely to be able to retire directly after their unemployment benefit subsidy expires, hence they may be at greater risk of long-term unemployment.[4] In addition, the growing number of transitions between jobs will make it more necessary for them to occur smoothly. To this end, the labour legislation should focus on protecting workers, rather than job positions. The example to follow is Denmark, with its so-called «flexicurity»: a labour legislation model that is highly flexible but also has relatively generous unemployment benefits and strong support from active policies to facilitate a successful reintegration into the labour market.

Finally, we want to emphasise that a fundamental element of active policies will increasingly involve preparing workers for the changes related to technological change and globalisation, which they will be exposed to for a longer period of time due to their longer working lives. Active training policies, complementing the education policies described in the preceding article, should help workers to undertake continuous education and training and to adapt to the new skills that are required – something that happens less than would be desirable, particularly for those with less education (see second chart). Education and training to enhance these new skills will pay off in the job market with greater employability and higher wages, but it will require some effort. A useful tool to facilitate this process is the creation of personal accounts that accrue rights throughout a person's working life and which workers can use to receive an unemployment allowance in the event of losing their job, as well as to pay for training courses – the latter facilitates the adoption of new skills necessary to change jobs or sector.

In addition to devoting more resources to active policies, it will be necessary to ensure their effectiveness. Several analyses suggest that their effectiveness in the short term is limited, but that in the medium term it increases, particularly those aimed at boosting human capital.[5] In any case, their impact will depend on each individual's specific needs and profile, and an accurate and early diagnosis will be key. Fortunately, new technologies come to the rescue: algorithms can play an important role in discerning what action is most beneficial for someone who is out of work. Countries such as Australia and the Netherlands are already using automated diagnostic techniques to determine jobseekers' employability, while in Spain, pilot projects have already been conducted.[6]

In summary, what is required is an in-depth rethink of labour policies, and for that, every little helps, even if it comes from a robot.

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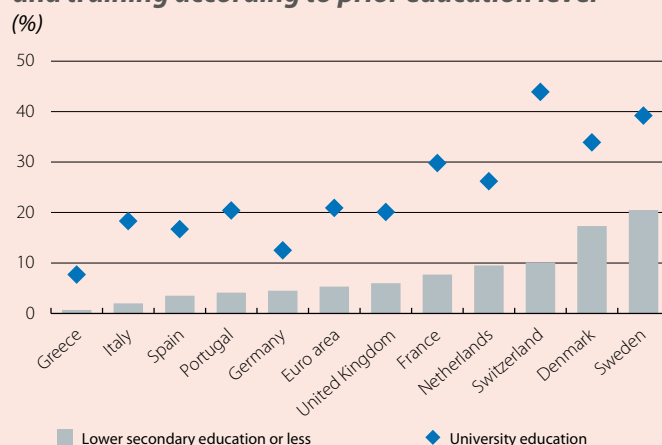
3. See Lagarde, C. and Ostry, J. D. (2018), «The macroeconomic benefits of gender diversity», VoxEU blog.
4. OECD (2017), «Preventing Ageing Unequally», OECD Publishing.
5. See Card, D., Kluve, J. and Weber, A. (2017), «What Works? A Meta Analysis of Recent Active Labor Market Program Evaluations», Journal of the European Economic Association, vol. 16(3).
6. See Felgueroso, F., García Pérez, J. I. and Jiménez-Martín, S. (2018), «Perfilado estadístico: un método para diseñar políticas activas de empleo», Fundación Ramón Areces, Fedea.

Social cohesion and inclusive growth: inseparable

Social cohesion and inclusive economic growth are two inseparable concepts that mutually feed back into each other. Therefore, in a country where growth is more inclusive, it is easier for social cohesion to increase. Similarly, it seems easier to implement measures that foster a more inclusive form of growth in a country with a higher level of social cohesion. Social cohesion, in the end, is one of the factors that allow economic growth to be inclusive. Nevertheless, the same relationship also applies in the opposite direction. So when growth becomes less inclusive, for instance because the regulatory environment does not adapt to changes in the productive structure arising from technological change or globalisation, there is a risk of damaging social cohesion, with everything that this entails. In the current context, analysing a country's social cohesion is key for being able to determine its capacity to cope with the challenges we face.

Before diving in, it is worth pointing out that when we talk about social cohesion in this article, we are referring to the state of the various types of interaction between members of a society.[1] These types of interaction include, for instance, trust, the sense of belonging, the willingness to participate, the willingness to help and all behaviours derived from these.

Equipped with a good definition, we can now analyse the state of social cohesion in the main developed countries and its relationship with inclusive economic growth. To do this, we developed an index, the aggregate social cohesion indicator (ASCI), which allows us to aggregate and synthesise the information contained in the 33 social cohesion indicators of the OECD in a single measure. It should be noted that these indicators cover all aspects of the social interactions that make up the concept of social cohesion, and they can be grouped into five categories according to the type of interaction: personal satisfaction, social environment, trust, political participation and levels of crime. To build our index, we classified the different variables gathered by the OECD into each of the five areas for each country. Most of these variables quantify the state of social interactions based on national surveys (some examples include the percentage of people who have someone close to them whom they can rely on, trust in institutions and insecurity relating to job loss). Subsequently, we calculated an average for all the different countries. We assigned a weight of 20% to each of the categories, although we also checked that the results obtained hold up with different weight allocations.

One revealing conclusion is that the Nordic countries, which tend to have a high level of institutional quality,[2] are at the top of the list. On the other hand, emerging economies, whose institutions are less robust and consolidated, have the lowest levels of social cohesion. This is because social cohesion is partly determined by the level of development of each country's institutions.[3]

In Spain, the degree of social cohesion lies somewhere in the middle of the ranking, albeit below the OECD average according to the ASCI. On a positive note, there are high levels of personal satisfaction and a buoyant social environment, while on the flip side of the coin we find low levels of trust in institutions.[4] Portugal, meanwhile, lies somewhat below Spain as a result of significantly lower levels of personal satisfaction and political participation. It is interesting to note that countries such as Germany, Finland and the US enjoy much higher levels of trust than Spain or Portugal, hence they serve as important benchmarks.

Aggregate social cohesion index (ASCI) *
Index
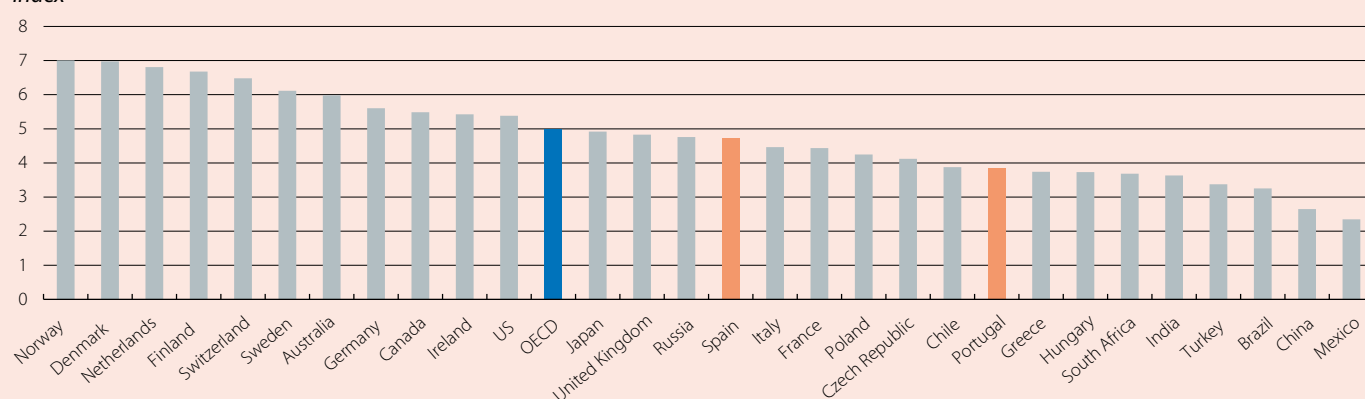
Note: * The ASCI is calculated on the basis of a set of 33 indicators, by country. Firstly, we group the indicators according to the category to which they relate (satisfaction, trust, political participation, criminality and social structure). To aggregate the indicators, we standardise them with mean 0 and variance 1. Then, the average for each category is calculated. Finally, the values obtained are aggregated by assigning a weight of 20% to each category. The benchmark score is 5, which corresponds to the average of all OECD countries.
Source: CaixaBank Research, based on data from the OECD.

1. See Chan, J., To, H. P. and Chan, E. (2006), «Reconsidering Social Cohesion: Developing a Definition and Analytical Framework for Empirical Research», Social Indicators Research, 75(2), 273-302.
2. According to the Global Competitiveness Index for 2018 (WEF), all the Nordic countries are in the top 15 of the ranking of economies with the highest institutional quality.
3. See Easterly, W., Ritzen, J. and Woolcock, M. (2006), «Social Cohesion, Institutions, and Growth», Economics & Politics, 18(2), 103-120.
4. Among other variables, the trust category encompasses the society's level of trust in public institutions and the degree of insecurity relating to job loss, variables in which Spain has relatively low levels.

Social cohesion: main components
Index (5 = OECD)

Germany — Spain — Portugal

Finland — US — Brazil
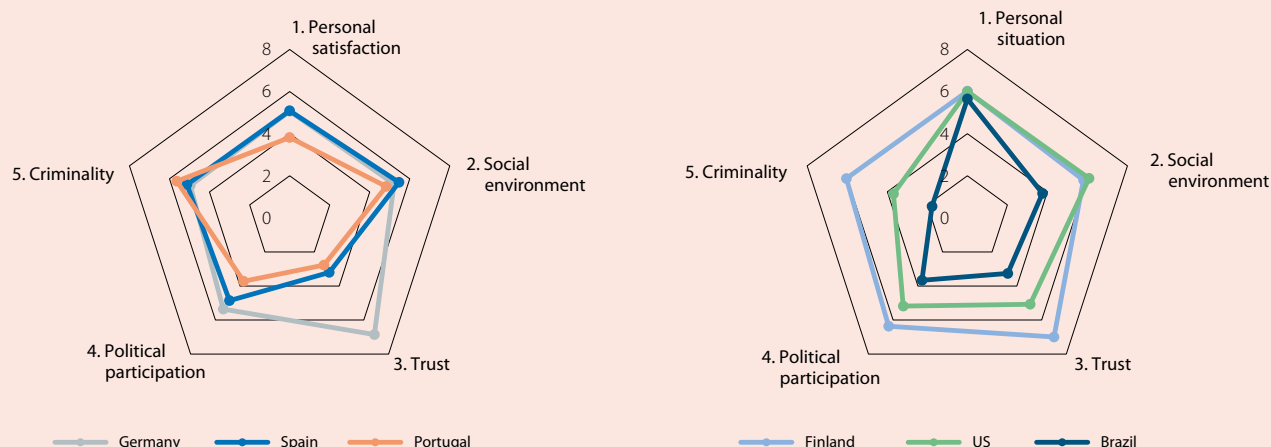
Specifically, the Nordic labour model that combines worker protection with flexibility in optimal doses, the high quality of government in Germany[5] or the system of checks and balances of the US system all serve as examples of good practices that shore up the level of trust within the society.

When we perform a comparison between countries for the different categories, we obtain some interesting results. As an example, if we focus on the area of criminality, we note that European countries score better, while both the US and emerging countries show a perception of greater criminality. Bearing in mind that measures of criminality could be capturing the degree of social unrest, it seems natural that societies with more developed and generous welfare states, such as those in Europe, come out in better shape in this area than emerging countries or the US.

It is also of interest to analyse the behaviour of the category relating to political participation. This area informs us about the degree of public interest in politics, as well as the degree of public participation in it. According to our results, the Nordic countries have very high scores, while Latin American countries, many of whose democratic institutions are still in the process of maturing after long dictatorships, have the lowest scores. Spain and Portugal, meanwhile, fall below the OECD average in this area, suggesting that there is room for improvement to achieve a more fluid relationship between society and the main political institutions.

Social cohesion and inclusive growth
Inclusive development index * (value)

Finally, we used our social cohesion index to study its relationship with inclusive growth. Our results confirm that the two concepts are inseparable. As can be seen in the third chart, there is a close relationship between the ASCI and the Inclusive Development Index (IDI) prepared by the World Economic Forum.[6] In particular, an increase of a point in the ASCI is linked with a 0.47-point increase in the IDI, illustrating that social cohesion (ASCI) does indeed have a strong and positive correlation with inclusive growth.

In short, faced with the major transformation of the productive system brought about by technological change and globalisation, as well as the challenges posed by an ageing population, it is important to take action to strengthen social cohesion – an indispensable element if we are to carry out reforms that foster an inclusive and sustained form of growth.
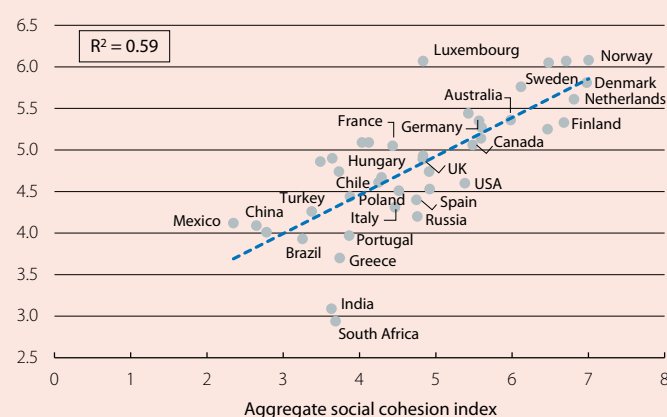
Javier Ibáñez de Aldecoa Fuster
CaixaBank Research

5. According to data from Bertelsmann Stiftung, Germany is the fifth highest country in the world in terms of democratic quality and the eighth highest in terms of quality of government.
6. This is an aggregate measure of 12 indicators distributed across three key areas: economic development, social inclusion and sustainability. Each area is given the same relative weight in order to obtain the general index. The values are distributed on a scale from 1 to 7, where 7 is the highest inclusiveness score.

Through our studies, we aim to stimulate debate and the exchange of views among all sectors of society, as well as to promote the dissemination of the major themes of the socio-economic environment of our time. Both the *Monthly Report* and the rest of CaixaBank Research's publications are available at: **www.caixabankresearch.com**

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