MR12

MONTHLY REPORT • ECONOMIC AND FINANCIAL MARKET OUTLOOK

NUMBER 440 | DECEMBER 2019

ECONOMIC & FINANCIAL ENVIRONMENT

DOSSIER: 2020 OUTLOOK

CaixaBank Research

MONTHLY REPORT - ECONOMIC AND FINANCIAL MARKET OUTLOOK
December 2019

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

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Date this issue was closed:
30 November 2019

INDEX

Balance, outlook and New Year wishes

The balance of 2019 cannot be described as positive. Before the start of the year, we thought that the global economy could grow above 3.5%. As we approach its end, it seems that we will end up below 3.0%. In the last 20 years, the only years with lower growth were 2009, the year of the Great Recession, and 2001, marked by the terrorist attacks in the US. The average growth rate in the last decade, which includes 2009, is 3.4%, half a point more than in 2019. The trade war between the US and China, Brexit, the problems in the automotive sector in Europe and the impact on emerging economies of the interest rate hikes implemented by the Fed in 2018 have weighed down growth more than expected.

Compared to expectations, growth has been disappointingly low in the euro area, the United Kingdom and large emerging economies such as India, Brazil, Mexico and Turkey. Interestingly, the US and China have grown in line with expectations, despite them being the protagonists of a conflict that has done much damage – especially to the euro area, which is very open to trade. Spain has endured the storm reasonably well and will close the year growing around 2.0%, only slightly below what we envisaged. There is no doubt that, with a more favourable external environment and greater political stability, the Spanish economy would have left the forecasts trailing behind.

For 2020, we expect that global growth will only improve slightly, reaching above the 3.0% mark thanks to the rebound of the emerging economies that have performed worse this year. In the advanced economies, we expect the euro area to maintain a similar rate of growth to that of this year, at around 1%, while the US could lose some steam, since the effect of the fiscal stimulus has now dissipated and the economy is in a very mature phase of the cycle. In this context, it is foreseeable that the maturity of the cycle could also cause a slowdown in the pace of growth of the Spanish economy down to around the 1.5% mark.

This scenario of forecasts is based on a number of assumptions, mainly: the support of monetary policy – in particular in the US –, after the three interest rate cuts implemented in the second half of 2019; some support from fiscal policy in certain countries in the euro area, and, finally, an assessment that the uncertainties that have gripped demand will go no further, although they will by no means dissipate entirely.

As for the trade war, we think that the most likely scenario is that it will not get any worse, because risking a sudden slowdown in the US economy during an election year would be unwise for President Trump. However, it is also true that the struggle with China, which goes beyond the trade war, makes him gain popularity, giving him some incentives to keep it alive. With regard to Brexit, the other great source of uncertainty, the elections this December could serve to clarify the picture if, as suggested by the polls, Boris Johnson manages to win a majority in Parliament. In this case, one would expect a rapid ratification of the agreement and the commencement of negotiations for the future relationship framework between the United Kingdom and the EU, a process which could also prove complex.

As the end of the year is also a time for expressing wishes, I will dare to ask for three related to the economy: firstly, a return to multilateralism as a basis for international relations, something that is essential in order to tackle challenges such as climate change and to avoid falling into a process of deglobalisation, which would pose an enormous cost for the world economy. Secondly, a strengthening of the institutional architecture of the euro area, completing the banking union and the capital markets union, and moving toward fiscal union, something that is necessary in order to promote growth and stability in the Economic and Monetary Union. Finally, at the national level in particular, the launch of ambitious reforms to improve productivity and social cohesion, something which is key to alleviating the dependency on monetary policy – the only game in town – and curbing populism.

I also wish everyone one of you, dear readers, a happy festive period and a prosperous and happy 2020.

Enric Fernández
Chief Economist
30 November 2019

Chronology

NOVEMBER 2019

10 General elections are held in Spain.

SEPTEMBER 2019

1 The US implements a tariff increase on 112 billion dollars of Chinese imports and China imposes tariffs on around 2,000 US products.
12 The ECB announces a new stimulus package, with a 10-bp cut in the deposit facility interest rate (–0.50%), a tiered system for deposit remuneration and the resumption of net purchases of assets (20 billion per month).
18 The Fed cuts its reference interest rates by 25 bps, down to the 1.75%-2.00% range.
20 The rating agency S&P improves Spain's credit rating from A– to A.

JULY 2019

16 As proposed by the European Council, the European Parliament elects Ursula von der Leyen as President of the European Commission.
24 Boris Johnson takes over from Theresa May as the British Prime Minister.
31 The Fed cuts its reference interest rates by 25 bps to 2.00%-2.5%.

OCTOBER 2019

11 The US and China work on phase one of a trade deal, and the US suspends the implementation of a tariff increase due to take effect on 15 October.
17 The United Kingdom and the EU reach a new withdrawal agreement.
28 The EU extends the Brexit deadline to 31 January 2020.
31 The Fed cuts its benchmark interest rates by 25 bps down to the 1.50%-1.75% range.
Mario Draghi's mandate as ECB president comes to an end.

AUGUST 2019

1 The US announces a new tariff increase on 300 billion dollars of Chinese imports not previously subject to tariffs.
5 The US calls China a «currency manipulator» after the Central Bank of China allowed the yuan to depreciate to levels not seen since 2008.
23 China announces the introduction of tariffs on 75 billion dollars of US imports.

JUNE 2019

7 Theresa May resigns as leader of the Conservative Party in the United Kingdom and remains as interim prime minister until a new leader is chosen at the end of July.
30 Donald Trump and Xi Jinping agree to resume trade negotiations between the US and China following their meeting at the G-20 summit.

Agenda

DECEMBER 2019

2 Portugal: public debt (October).
3 Spain: registration with Social Security and registered unemployment (November).
10-11 Federal Open Market Committee meeting.
12 Governing Council of the European Central Bank meeting.
12-13 European Council meeting.
13 Portugal: tourism activity (October).
17 Spain: quarterly labour cost survey (Q3).
23 Spain: loans, deposits and NPL ratio (October and Q3).
State budget execution (November).
Portugal: housing prices (Q3).
Portugal: state budget execution (Q3).
26 Spain: balance of payments and NIIP (Q3).
30 Spain: quarterly national accounts (Q3).
Spain: household savings rate (Q3).
Spain: CPI flash estimate (December).
31 Portugal: CPI flash estimate (December).

JANUARY 2020

2 Portugal: economic climate indicator (December).
3 Spain: registration with Social Security and registered unemployment (December).
9 Portugal: international trade (November).
Portugal: turnover in industry (November).
15 Spain: financial accounts (Q3).
Portugal: tourism activity (November).
22 Spain: loans, deposits and NPL ratio (November).
23 Governing Council of the European Central Bank meeting.
28 Spain: labour force survey (Q4).
29 Portugal: employment and unemployment (December).
28-29 Federal Open Market Committee meeting.
30 Euro area: economic sentiment index (January).
US: GDP (Q4 and 2019).
31 Spain: GDP flash estimate (Q4).
Spain: CPI flash estimate (January).
Euro area: GDP of the euro area (Q4).

2019, between unease and hope

Unease, surely, is the word that best captures the collective mood of the past few years. 2019 has been no exception, although as economists we have continued to record generally positive macroeconomic indicators. To understand why unease appears to be becoming the defining mood of our times, the so-called *zeitgeist*, we have to look beyond the main macroeconomic figures. Behind them lies a more complex reality that is proving difficult for us economists to tie down. I am referring to phenomena such as technological change, the crisis in which economic policy is currently immersed and the political crisis.

If we look at the trend in the major macroeconomic figures, we note that economic activity continues to grow. Nevertheless, over the course of the year it has slowed down more than expected, especially in several European and emerging countries. Thus, the year as a whole will end up closing with growth of 2.9%. This is a relatively low figure and around half a percentage point lower than our predictions a year ago, although it is unlikely to go down in history.

However, the impact that technological change is having on society and business surely will go down in history. In 2019, for example, it has been particularly felt in the automotive sector. At the beginning of the year, it appeared to us economists that the sector was going through a temporary rough patch due to a tightening of the environmental regulations. However, with the passage of time it has become apparent that the crisis is deeper and longer-lasting than initially thought, and that is occurring against a backdrop of the difficulties experienced across much of the sector in responding to the challenge of technological change.

Technological change and digitisation have been revolutionising various sectors for some years now. However, the automotive sector is special, because of its size and because its development has played a fundamental role in defining the modern era. Beyond the sector's importance and historical symbolism, the experience it has endured in 2019 serves to remind us that, in order to tackle the technological revolution that is taking place, companies must do more than simply incorporate the latest technological advances into their products to improve their performance or their customers' experience. The magnitude of the technological change that is taking place is such that it is forcing businesses to rethink their entire business model.

In the case of the car, for instance, some companies that to date only produced cars are now considering whether, in addition to improving their innovation policy, they need to expand their range to include other products in order to remain competitive. Such an expansion might include scooters or electric motorbikes, or even a move into the services that are being developed around mobility. There are many doors that are opening, and the implications of choosing each one are quite different. It seems clear that resting on one's laurels is not an option, and yet not all companies are in the same position to tackle the challenge that lies ahead of them. All this leads to unease, among workers both in the automotive sector and in other sectors that have not yet been revolutionised but feel the pressure drawing ever closer.

As if this were not enough, adding to the unease in 2019 is the fact that the economic policy instruments that have traditionally been used to revive the economy are running out of ammunition. Indeed, during the year it has become evident that neither monetary policy nor fiscal policy have much scope to act decisively in the event of a downturn. The need to find ways to have some margin to act, and to do so in an effective and sustainable manner, is particularly acute in the euro area.

In this context, the pressure on political action is increasing, and the elections taking place in developed countries are becoming increasingly tense because there is an awareness of just how important the results could be. And yet, in most cases the result ends up being a source of unease. Just when broad social consensus is needed to implement far-reaching measures in order to address the challenges posed by technological change and the ageing of the population, polarisation increases. This ends up translating into more fragile governments, often with more extreme positions. It is not surprising that in 2019 the political uncertainty indices have once again spiked in most countries.

And yet, there is reason for hope. The experience of the sectors that are being revolutionised by technological change can serve as a warning to all workers to prepare ourselves. It may also kick companies into designing more flexible structures that allow them to gradually steer their efforts towards areas with the greatest potential, while also providing a boost for their innovation strategies.

In terms of economic policy, it should be noted that the new president of the ECB has already announced that she will conduct a thorough review of the objectives and instruments of monetary policy. Above all, in the political sphere, we can feel reassured that most developed countries have the best system for coping with the challenges we face - a mature and consolidated liberal democracy. It may not be the fastest system in times of disruptive change like the present, when the political debate runs deep and there can be a sense of paralysis. However, the speed with which other countries with authoritarian systems take decisions should not lead us to doubt. We have to be patient and, above all, maintain a more empathetic and constructive attitude. That way, in the medium term, the consensus we will end up generating will be much more robust than that which any other system could achieve. **We have no shortage of reasons to hope**.

Oriol Aspachs
Head of Research

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

Financial markets

	Average 2000-2007	Average 2008-2016	2017	2018	2019	2020	2021
INTEREST RATES							
Dollar							
Fed funds (upper limit)	3.43	0.48	1.50	2.50	1.75	1.50	1.75
3-month Libor	3.62	0.70	1.61	2.79	1.75	1.73	1.90
12-month Libor	3.86	1.20	2.05	3.08	1.80	1.88	2.20
2-year government bonds	3.70	0.73	1.84	2.68	1.65	1.85	2.00
10-year government bonds	4.70	2.61	2.41	2.83	1.85	2.00	2.20
Euro							
ECB depo	2.05	0.40	–0.40	–0.40	–0.50	–0.50	–0.25
ECB refi	3.05	1.00	0.00	0.00	0.00	0.00	0.25
Eonia	3.12	0.65	–0.34	–0.36	–0.45	–0.45	–0.25
1-month Euribor	3.18	0.79	–0.37	–0.37	–0.43	–0.43	–0.20
3-month Euribor	3.24	0.98	–0.33	–0.31	–0.40	–0.40	–0.15
6-month Euribor	3.29	1.14	–0.27	–0.24	–0.35	–0.35	–0.05
12-month Euribor	3.40	1.34	–0.19	–0.13	–0.30	–0.30	0.05
Germany							
2-year government bonds	3.41	0.69	–0.69	–0.60	–0.60	–0.40	–0.10
10-year government bonds	4.30	1.98	0.35	0.25	–0.30	0.30	0.67
Spain							
3-year government bonds	3.62	2.30	–0.04	–0.02	0.05	0.48	0.81
5-year government bonds	3.91	2.85	0.31	0.36	0.20	0.71	1.05
10-year government bonds	4.42	3.82	1.46	1.42	0.50	1.10	1.37
Risk premium	11	184	110	117	80	80	70
Portugal							
3-year government bonds	3.68	4.42	–0.05	–0.18	0.14	0.79	1.25
5-year government bonds	3.96	5.03	0.46	0.47	0.32	1.03	1.42
10-year government bonds	4.49	5.60	1.84	1.72	0.40	1.20	1.52
Risk premium	19	362	149	147	70	90	85
EXCHANGE RATES							
EUR/USD (dollars per euro)	1.13	1.30	1.18	1.14	1.10	1.15	1.21
EUR/JPY (yen per euro)	129.50	126.36	133.70	127.89	118.64	121.90	128.26
USD/JPY (yen per dollar)	115.34	97.50	113.02	112.38	107.85	106.00	106.00
EUR/GBP (pounds per euro)	0.66	0.83	0.88	0.90	0.91	0.90	0.89
USD/GBP (pounds per dollar)	0.59	0.63	0.75	0.79	0.83	0.78	0.73
OIL PRICE							
Brent ($/barrel)	42.3	85.6	64.1	57.7	60.0	61.5	63.0
Brent (euros/barrel)	36.4	64.8	54.2	50.7	54.5	53.5	52.1

Forecasts

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

International economy

	Average 2000-2007	Average 2008-2016	2017	2018	2019	2020	2021
GDP GROWTH							
Global	**4.5**	**3.3**	**3.8**	**3.6**	**2.9**	**3.2**	**3.4**
Developed countries	***2.7***	***1.2***	***2.5***	***2.3***	***1.7***	***1.5***	***1.6***
United States	2.7	1.4	2.4	2.9	2.3	1.8	1.8
Euro area	2.2	0.4	2.7	1.9	1.1	1.1	1.3
Germany	1.6	1.1	2.8	1.6	0.6	0.7	1.5
France	2.0	0.6	2.4	1.7	1.3	1.4	1.5
Italy	1.5	–0.7	1.8	0.7	0.2	0.5	0.7
Portugal	1.5	–0.3	3.5	2.4	1.9	1.7	1.6
Spain	3.7	0.0	2.9	2.4	1.9	1.5	1.5
Japan	1.5	0.4	1.9	0.8	0.9	0.6	0.9
United Kingdom	2.8	1.1	1.9	1.4	1.3	1.2	1.4
Emerging countries	***6.6***	***5.1***	***4.8***	***4.5***	***3.8***	***4.4***	***4.6***
China	11.7	8.4	6.9	6.6	6.0	5.8	5.7
India	9.7	6.9	6.9	7.4	5.3	6.1	6.5
Indonesia	5.5	5.7	5.1	5.2	5.0	4.8	4.7
Brazil	3.6	1.7	1.1	1.1	1.0	1.8	2.1
Mexico	2.4	2.1	2.1	2.0	0.4	1.3	2.1
Chile	5.0	3.2	1.3	4.0	2.2	2.8	2.8
Russia	7.2	1.0	1.6	2.2	1.2	1.9	1.8
Turkey	5.4	4.8	7.4	3.1	–1.3	2.5	3.1
Poland	4.0	3.2	4.9	5.2	3.8	2.9	2.4
South Africa	4.4	1.8	1.5	0.7	0.7	1.6	1.9
INFLATION							
Global	**4.2**	**3.8**	**3.2**	**3.6**	**3.4**	**3.5**	**3.5**
Developed countries	***2.1***	***1.5***	***1.7***	***2.0***	***1.4***	***1.6***	***1.8***
United States	2.8	1.6	2.1	2.4	1.8	2.1	2.0
Euro area	2.1	1.4	1.5	1.8	1.1	1.2	1.7
Germany	1.7	1.3	1.7	1.9	1.3	1.3	1.8
France	1.8	1.2	1.2	2.1	1.2	1.4	1.8
Italy	1.9	1.5	1.3	1.2	0.6	1.0	1.5
Portugal	3.0	1.2	1.4	1.0	0.4	0.7	1.0
Spain	3.2	1.3	2.0	1.7	0.7	1.0	1.4
Japan	–0.3	0.3	0.5	1.0	0.5	1.1	1.2
United Kingdom	1.9	2.3	2.7	2.5	1.9	1.8	2.1
Emerging countries	***6.8***	***5.8***	***4.3***	***4.8***	***4.8***	***4.7***	***4.6***
China	1.7	2.6	1.6	2.1	2.5	2.4	2.6
India	4.5	8.5	3.3	3.9	3.4	4.1	5.1
Indonesia	8.4	5.7	3.8	3.2	3.0	2.7	2.9
Brazil	7.3	6.4	3.5	3.7	3.8	3.6	3.8
Mexico	5.2	3.9	6.0	4.9	3.7	3.7	3.5
Chile	3.1	3.5	2.2	2.7	2.2	2.8	3.1
Russia	14.2	9.3	3.7	2.9	4.6	3.7	4.0
Turkey	27.2	8.1	11.1	16.2	16.1	13.1	10.0
Poland	3.5	2.1	1.6	1.2	2.1	2.5	2.5
South Africa	5.3	6.2	5.3	4.6	4.3	4.8	4.9

Forecasts

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

Spanish economy

	Average 2000-2007	Average 2008-2016	2017	2018	2019	2020	2021
Macroeconomic aggregates							
Household consumption	3.6	–0.6	3.0	1.8	1.2	1.6	1.3
Government consumption	5.0	0.9	1.0	1.9	2.3	1.8	1.4
Gross fixed capital formation	5.6	–3.8	5.9	5.3	2.8	2.8	2.4
Capital goods	5.0	–1.5	8.5	5.7	5.1	5.3	2.6
Construction	5.7	–6.5	5.9	6.6	1.4	1.1	2.3
Domestic demand (vs. GDP Δ)	4.5	–1.2	3.0	2.6	1.7	1.9	1.5
Exports of goods and services	4.8	2.8	5.6	2.2	1.7	2.1	3.0
Imports of goods and services	7.0	–1.0	6.6	3.3	1.0	3.3	3.1
Gross domestic product	**3.7**	**0.0**	**2.9**	**2.4**	**1.9**	**1.5**	**1.5**
Other variables							
Employment	3.2	–1.5	2.8	2.5	2.2	1.4	1.1
Unemployment rate (% of labour force)	10.5	20.8	17.2	15.3	14.2	13.6	13.2
Consumer price index	3.2	1.3	2.0	1.7	0.7	1.0	1.4
Unit labour costs	3.0	0.1	0.7	1.2	2.5	2.6	2.3
Current account balance (% GDP)	–5.9	–1.1	2.7	1.9	1.6	1.3	1.4
External funding capacity/needs (% GDP)	–5.2	–0.7	2.9	2.4	1.8	1.5	1.6
Fiscal balance (% GDP)[1]	0.4	–7.1	–3.0	–2.5	–2.3	–2.0	–1.5

Note: *1. Excludes losses for assistance provided to financial institutions.*

Forecasts

Portuguese economy

	Average 2000-2007	Average 2008-2016	2017	2018	2019	2020	2021
Macroeconomic aggregates							
Household consumption	1.7	–0.2	2.1	3.1	2.2	1.9	1.7
Government consumption	2.3	–0.7	0.2	0.9	0.5	0.2	0.2
Gross fixed capital formation	–0.3	–3.5	11.5	5.8	7.4	4.4	4.4
Capital goods	1.2	–0.1	12.5	7.5	6.9	5.9	5.9
Construction	–1.5	–6.2	12.2	4.6	7.1	2.5	2.5
Domestic demand (vs. GDP Δ)	1.3	–1.0	3.3	3.2	2.8	2.1	2.0
Exports of goods and services	5.2	3.5	8.4	3.9	2.5	2.3	2.6
Imports of goods and services	3.6	1.6	8.1	5.9	5.2	3.7	3.3
Gross domestic product	**1.5**	**–0.3**	**3.5**	**2.4**	**1.9**	**1.7**	**1.6**
Other variables							
Employment	0.4	–1.1	3.3	2.3	1.0	0.5	0.2
Unemployment rate (% of labour force)	6.1	12.2	8.9	7.0	6.3	6.1	6.0
Consumer price index	3.0	1.2	1.4	1.0	0.4	0.7	1.0
Current account balance (% GDP)	–9.2	–4.1	1.2	0.4	–0.7	–0.7	–0.4
External funding capacity/needs (% GDP)	–7.7	–2.7	2.1	1.4	0.2	0.2	0.5
Fiscal balance (% GDP)	–4.6	–6.4	–3.0	–0.4	–0.3	–0.3	0.1

Forecasts

The markets face the end of the year with a positive tone

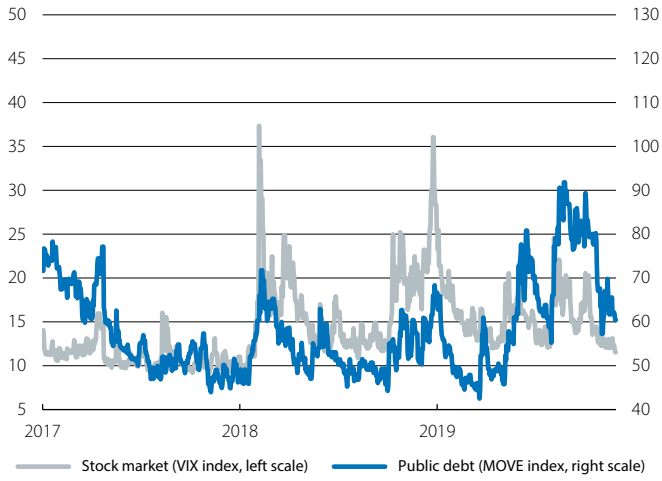
With no new catalysts, in November investors remained cautiously optimistic. If we were to look back to the beginning of the year and list the most relevant factors that have influenced the evolution of the financial markets in recent months, topping that list would be the trade dispute between the US and China, Brexit, the slowdown in global growth and the return to the stage of monetary stimuli by the Fed and the ECB. Indeed, in November some of these very same factors continued to support the improvement in investor sentiment that began in late September. Specifically, the potential signing of the first phase of a trade agreement between Washington and Beijing, coupled with the publication of macroeconomic data (which, while still mixed, in many cases were better than anticipated), bolstered investors' optimism and appetite for risk. Thus, the markets face the end of 2019 with a more optimistic sentiment, although this remains fragile and subject to political developments and the messages from the central banks.

The stock markets continue on the up. The improved expectations over the trade environment and the stabilisation of some economic activity indicators in the major economies favoured investors' risk appetite during the month of November. In this context, stock market indices on both sides of the Atlantic racked up gains of around 3%, which were widespread across the various sectors (see second chart). This optimism was also influenced by the Q3 corporate earnings campaigns. In the case of the S&P 500, 78% of companies beat analysts' forecasts (higher than the average for the past five years, which was 71%). In the euro area, companies reported earnings that were more in line with the consensus estimates, with the forecasts being exceeded in 57% of cases. Looking ahead to 2020, the expectations for earnings per share so far indicate a relative improvement in margins in the case of European companies. In the US, meanwhile, there has been a slight reduction in earnings expectations as companies feel the pressure of the trade tensions and the strength of the dollar. On the other hand, stock markets in emerging countries showed a mixed performance. While the Asian indices registered gains, driven by the improved outlook for the trade negotiations, socio-political tensions in several Latin American countries penalised this region's stock markets with losses of around –5%.

Sovereign yields remain low. The renewed appetite for risk contributed to a surge in sovereign yields in the US and Germany during the early weeks of November. However, the lack of specifics in the trade negotiations between the US and China muddied investor sentiment in the closing stages of the month. This factor, coupled with the contents of the minutes of the respective meetings of the Fed and the ECB (which reinforced the continuity of the accommodative

Implicit volatility in the financial markets

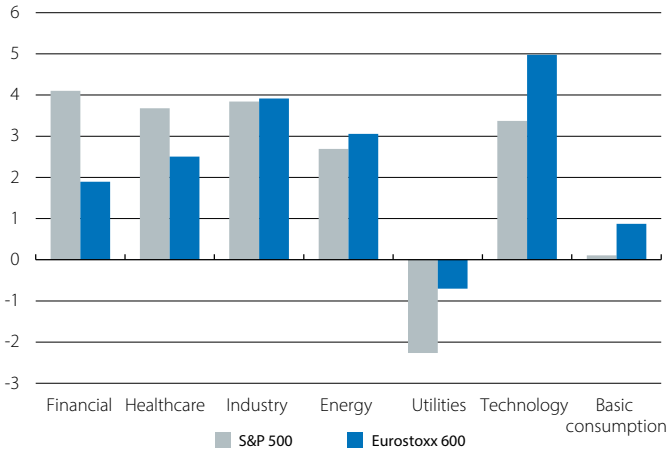
Index *Index*



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

S&P 500 and Eurostoxx 600: performance of the main sectors

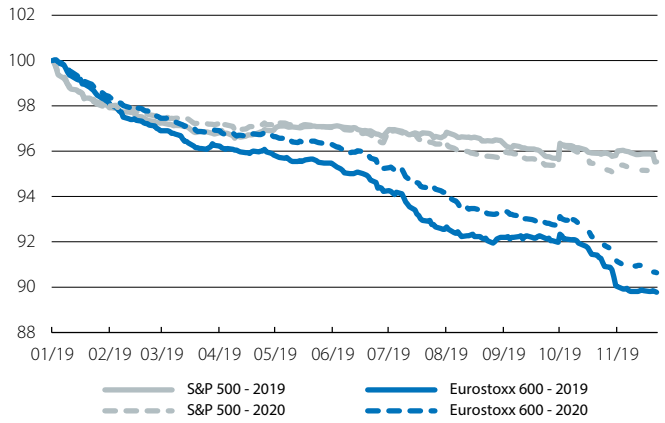
Cumulative change in November (%)



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

Evolution of expectations for corporate earnings in 2019 and 2020

Index (100 = January 2019)



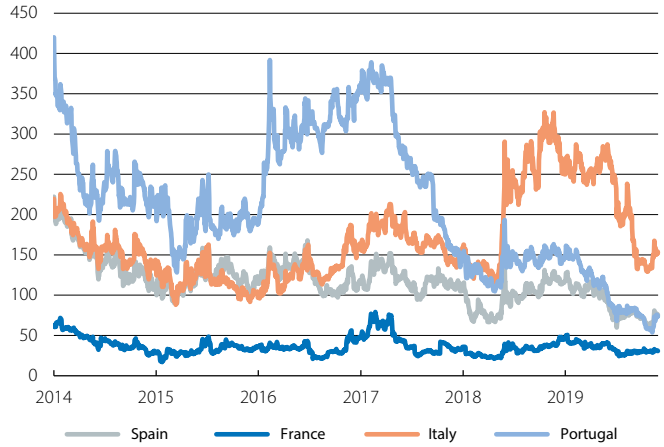
Note: *Evolution of expectations for earnings per share in 2019 and 2020.*
Source: *CaixaBank Research, based on data from Bloomberg.*

monetary environment), led to the yields on bonds considered safe-havens to moderate their rise in the second half of the month. Meanwhile, the risk premiums of the euro area periphery increased, in part due to investors' reaction to the electoral results in Spain, and in spite of Moody's, Fitch and DBRS keeping their credit ratings for Spain, Portugal and Italy unchanged, respectively.

The central banks reinforce the accommodative financial conditions. In November, the details offered by the minutes of the October meetings of the Fed and the ECB were the focus of attention in the field of monetary policy. On the one hand, at the Fed's meeting, the majority of its members agreed that the intensity of the risks affecting the outlook had reduced, though it remains high. It was also reflected that, in the view of most members of the Fed, following the 25-bp cut (down to the 1.50%-1.75% range) the current level of interest rates is appropriate for supporting moderate growth, a strong labour market and a rapprochement of inflation towards the 2% symmetrical target. The minutes of the ECB's meeting, meanwhile, reflected the concern over the persistence of risks affecting the outlook, the moderate levels of inflation and the contained economic growth of the euro area. For this reason, the institution reiterated the importance of implementing the stimulus package announced in September (cutting the depo rate down to –0.50%, resuming net purchases of assets and implementing more favourable conditions for the TLTRO). Finally, in emerging economies, China's central bank took a first step towards a more accommodative monetary policy. In particular, it lowered the 7-day *reverse repo* interest rate for the first time in four years (–5 bps, down to 2.50%), as well as the reference rate for new corporate loans (–5 bps, down to 4.15%). These reductions marked a new attempt by the country's government to support investor confidence and to reduce the financial burden of the corporate sector. Until now, the Chinese authorities had chosen to use other tools, such as reductions in the banking sector's reserves ratio. However, according to analysts' consensus, its impact fell short of the expected boost to lending and domestic consumption.

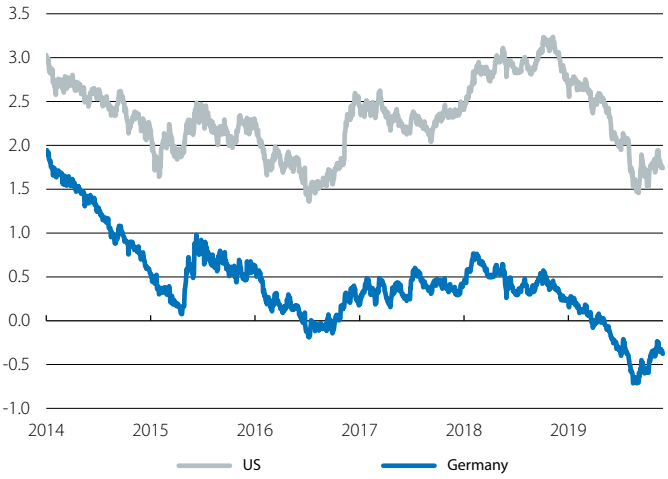
The oil price consolidates its position above 60 dollars in anticipation of OPEC's next move. The continuity of favourable investor sentiment drove up the price of several commodities linked to the business cycle. Among them, the price of a barrel of Brent crude oil rose by +3.7%, also favoured by the expectation that OPEC will once again extend its oil production cuts at its meeting in early December. In the currency market, meanwhile, the main story was the depreciation of Latin American currencies against the dollar, driven by economic indicators and heightened socio-political tensions in the region. The biggest drop in the month was registered by the Chilean peso, whose value fell to an all-time low and amassed a depreciation of around –9% against the dollar. Following behind it was the Brazilian real (–5.8%) and the Colombian peso (–5.4%).

Euro area: risk premiums of 10-year public debt
(bps)



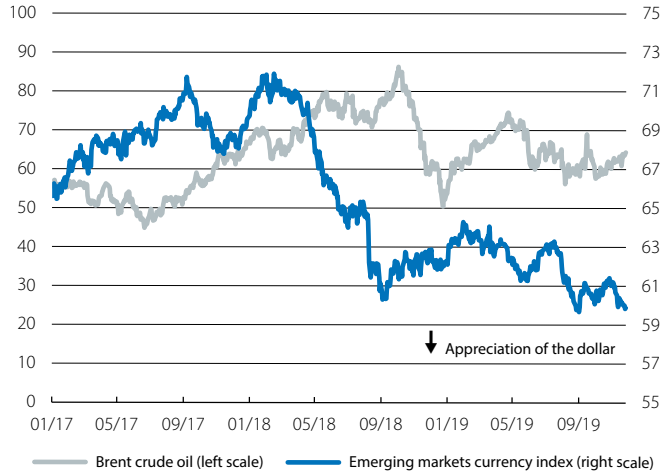
Source: *CaixaBank Research, based on data from Bloomberg.*

Yields on 10-year public debt
(%)



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

Brent oil price and emerging currencies
(Dollars per barrel) *Index*



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

Why has the Federal Reserve cut interest rates?

- **The Fed has cut interest rates in 2019 for the first time in 11 years. However, it has barely lowered its growth outlook for the US and has justified the cut with the weakness of inflation and the persistence of risks.**
- **Is it possible that the Fed has changed its reaction function? The results of the analysis in this article suggest so. However, this is not the first time that the Fed has responded more to the risks than the data themselves, and this shift could be explained by structural changes in the economy, such as the flattening of the Phillips curve.**

From forward guidance to data dependency

When the US Federal Reserve began its hiking cycle in 2015, it did so in a gradual and predictable manner, offering clear guidance on the expected evolution of rates (forward guidance). After raising them by 225 bps and reaching the level of the natural interest rate, according to the estimates of some members of the FOMC (see first chart), at the end of 2018 the Fed reported its intention to cease forward guidance and **adopt an approach more dependent on the economic and financial data**.[1]

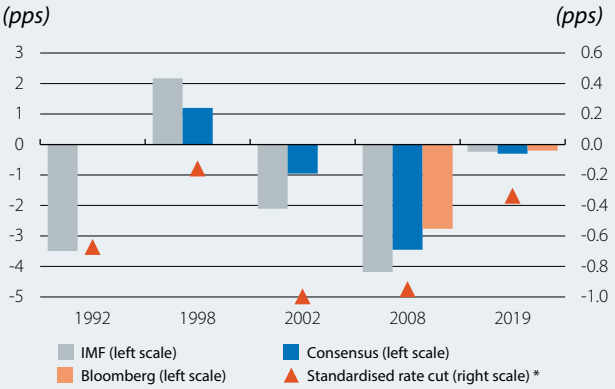
Following this change of strategy, and in an environment with a global slowdown and contained inflationary pressures, during the first half of 2019 the Fed remained patient and left interest rates uncharged, despite the strength of the labour market. However, **in July, the intensification of geopolitical uncertainty** (mainly driven by the resurgence of the trade tensions between the US and China and an apparent increase in the likelihood of a hard Brexit), **coupled with the decline in inflation expectations, led the Fed to lower rates** by 50 bps in Q3 and by 25 more in October.

From data dependency to risk management

The most discerning readers will have noticed that the Fed cut interest rates not only due to the trends in the economic data (weakness in inflation and its outlook) but **also due to changes in the balance of risks**. In fact, analysts' forecasts for economic growth (and those of the members of the Fed itself) have not changed significantly since October 2018, which suggests that the Fed's reaction should have been less aggressive. In particular, according to the historic relationship between changes in the official interest rates and in the growth forecasts that accompanied them, the Fed should have cut interest rates by 15 bps in 2019, rather than by 75.[2]

Furthermore, we must bear in mind that lowering interest rates by 75 bps in 2019 substantially depletes the Fed's margin to implement further rate cuts compared to that which it had in, say, the year 2000. The fall in the natural rate reduces the Federal Reserve's margin (and that of other central banks) to stimulate the economy through conventional measures. After all, **cutting interest rates by 2 bps is relatively more expensive for a central bank when the natural rate is 1% compared to when it is 5%**. For this reason, if we adjust the cumulative decline in the interest rate[3] to account for the level of the nominal natural interest rate and we compare the Fed's reaction with that seen in other cycles of rate cuts, we see that the Fed's reaction has been somewhat excessive: **while the revision of forecasts in the Great Recession was 17 times greater than the current one, the monetary policy response was only 3 times more reactive**. It is true that, at that time, the Fed also sought to stimulate the economy using non-conventional tools (QE and forward guidance). However, if we perform the same analysis for the cycle of rate cuts of 1992 or 2002, we note that the revision of forecasts was 15 and 9 times greater than the current one, while the monetary policy response was only 2 and 3 times more reactive, respectively. Furthermore, these rate cuts are in addition to the change in the outlook. In the second half of 2018, not only did the Fed rule out interest rate cuts, but it also

US: revisions of GDP growth forecasts



Notes: *Changes in the US GDP growth forecast around cycles of rate cuts by the Fed.*
** We divide the cumulative reduction in the official rate of the Fed by the nominal natural rate of interest estimated by Holston, Laubach and Williams (2017).*
Source: *CaixaBank Research, based on data from Bloomberg, Consensus Economics and the IMF.*

1. See «The Fed: from forward guidance to data-dependency» in the MR02/2019.
2. We estimate that $\Delta i_t = \beta_1 \Delta g^e_t + \beta_2 \Delta g^e_{t-1} + \upsilon_t$, where Δi_t is the change in the Federal Reserve's interest rate, Δg^e is the change in the IMF's GDP growth forecast in the *World Economic Outlook* compared to the previous one, and υ_t is an error term. We introduce the revisions carried out by the IMF since October 2018.
3. We divide the Fed's cumulative reduction in rates by the nominal natural rate of interest in force prior to the first cut, in order to estimate how much of the margin for conventional monetary policy has been used up.

gave indications of several rate hikes in 2019, bringing rates up to 3.1%.

The Fed's reaction function has changed, but this is not something new

This evidence suggests that **the Federal Reserve has changed its reaction function, now relying less on its baseline scenario and more on the risks affecting its forecasts**. In fact, several members of the Fed have acknowledged this to be the case,[4] advocating a monetary policy that proceeds with caution in an environment like the current one (i.e. one in which significant downside risks coexist with reasonably strong economic activity).

On the other hand, this is not the first time that the Federal Reserve has acted this way. According to the minutes of the Fed's own meetings, since 1987, uncertainty has been mentioned several times as a reason for not implementing planned changes to interest rates. For instance, in 1998, fears of a surge in inflation supported a rate hike, but faced with the risk of the Russian debt crisis of that same year having a significant impact on foreign demand, the Fed opted to do the exact opposite, cutting rates instead. At that time, the members of the FOMC interpreted that the cost of an overheating of the economy was lower than that of an overreaction of monetary policy.[5]

Is it the Fed that has changed... or the world around it?

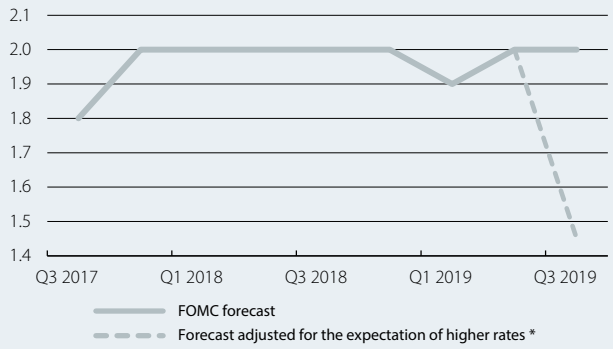
The change in the Fed's behaviour can also be explained by changes in how the economy operates. On the one hand, **inflation has remained contained and below the 2% symmetrical target for some years now**, despite the fact that the unemployment rate has been at a historic low for the past 50 years. This suggests that the Phillips curve is not acting within the same parameters as it used to, so it is natural that the Fed should act differently in order to stimulate inflation.

On the other hand, the revision of the economic outlook, both according to analysts' consensus and on the part of the IMF and the Fed itself, has been moderate. This is partly due to the expectation that a more accommodative monetary policy would partially offset the slowdown. In particular, there has been a **change in the outlook regarding monetary policy which has helped to soften what could otherwise have been a much sharper revision of the GDP growth forecasts**: in September 2018, the median member of the Fed believed that the official interest rate would be 3.4% by the end of 2020,

4. See, among others, J. Williams (2019). «Monetary Policy and the Economic Outlook» Speech at the Euromoney Real Return XIII: The Inflation-Linked Products Conference, New York. And C. Evans (2019) «Revisiting Risk Management in Monetary Policy». Speech at the Credit Suisse Asian Investment conference, Hong Kong.
5. C. Evans, J. Fisher, F. Gourio and S. Krane (2015). «Risk management for monetary policy near the zero lower bound». Brookings Papers on Economic Activity, 141-219.

Federal Reserve: GDP growth forecast for Q4 2020

(%)



Notes: *Evolution of the forecast for year-on-year growth in Q4 2020 according to the median voter of the FOMC. * We subtract from this forecast the reaction of GDP growth to a decline in the interest rate consistent with the FOMC's revision of expectations (which went from 3.4% to 1.9% in September 2019).*
Source: *CaixaBank Research, based on data from the Federal Reserve and from J. Willis and G. Cao (2015).*

whereas in the latest update in September this figure stood at 1.9%. With this revision, if we take the impact that changes in the Federal Reserve's interest rate have historically had on GDP growth, and we subtract this impact from the Fed's current growth forecast, we see that the downward revision to the forecasts would have been much greater (see last chart).[6]

What can we expect in the future?

If predicting the future path of interest rates had already been made more difficult since the Federal Reserve stopped providing forward guidance, the greater sensitivity to risks affecting the scenario only adds yet more uncertainty to the decisions of the FOMC. Furthermore, this complexity is compounded by the pressure on the independence of the Federal Reserve in a US presidential election year, in which the president and future candidate, Donald Trump, will most likely demand additional monetary stimuli. Therefore, although the Fed insists that interest rates are at an appropriate level and does not plan to alter them if their expectations for the economy are met (GDP growth of around 2%, a strong labour market and inflation approaching its target rate), it is possible that **the Fed will maintain its dovish bias throughout 2020** and it could cut interest rates even further in the event of an increase in uncertainty or further signs of a slowdown in the economy. In fact, the forecasts we present in this *Monthly Report* show precisely that.

Ricard Murillo Gili

(See an extended version of this article at caixabankresearch.com)

6. Specifically, we use the results of the autoregressive vector from J.L. Willis and G. Cao (2015), «Has the US economy become less interest rate sensitive?», Economic Review (01612387), 100(2), which they use to estimate the reaction of GDP in the US to a change in the Fed's interest rate.

Interest rates (%)

	30-Nov.	31-Oct.	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	**–0.40**	–0.39	–1	–9.2	–8.5
1-year Euribor	**–0.27**	–0.27	0	–15.6	–12.7
1-year government bonds (Germany)	**–0.62**	–0.63	1	–5.1	1.5
2-year government bonds (Germany)	**–0.63**	–0.66	3	–1.7	–3.1
10-year government bonds (Germany)	**–0.36**	–0.41	5	–60.2	–67.3
10-year government bonds (Spain)	**0.42**	0.24	18	–100.0	–108.6
10-year government bonds (Portugal)	**0.40**	0.17	24	–132.1	–142.6
US					
Fed funds	**1.75**	1.75	0	–75.0	–50.0
3-month Libor	**1.91**	1.90	0	–90.2	–83.1
12-month Libor	**1.95**	1.96	0	–105.3	–116.8
1-year government bonds	**1.59**	1.49	9	–101.1	–109.2
2-year government bonds	**1.61**	1.52	9	–87.6	–117.5
10-year government bonds	**1.78**	1.69	8	–90.8	–121.2

Spreads corporate bonds (bps)

	30-Nov.	31-Oct.	Monthly change (bp)	Year-to-date (bp)	Year-on-year change (bp)
Itraxx Corporate	**48**	52	–4	–40.9	–32.8
Itraxx Financials Senior	**57**	60	–4	–52.0	–47.8
Itraxx Subordinated Financials	**118**	125	–7	–110.1	–92.5

Exchange rates

	30-Nov.	31-Oct.	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
EUR/USD (dollars per euro)	**1.102**	1.115	–1.2	–3.9	–2.6
EUR/JPY (yen per euro)	**120.610**	120.490	0.1	–4.1	–6.1
EUR/GBP (pounds per euro)	**0.852**	0.862	–1.1	–5.2	–4.0
USD/JPY (yen per dollar)	**109.490**	108.030	1.4	–0.2	–3.6

Commodities

	30-Nov.	31-Oct.	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
CRB Commodity Index	**386.4**	389.5	–0.8	–5.6	–7.1
Brent ($/barrel)	**62.4**	60.2	3.7	16.0	6.3
Gold ($/ounce)	**1,463.9**	1,512.9	–3.2	14.2	19.7

Equity

	30-Nov.	31-Oct.	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
S&P 500 (USA)	**3,141.0**	3,037.6	3.4	25.3	13.8
Eurostoxx 50 (euro area)	**3,703.6**	3,604.4	2.8	23.4	16.7
Ibex 35 (Spain)	**9,352.0**	9,257.5	1.0	9.5	3.0
PSI 20 (Portugal)	**5,127.4**	5,119.6	0.2	8.4	4.3
Nikkei 225 (Japan)	**23,293.9**	22,927.0	1.6	16.4	4.2
MSCI Emerging	**1,040.1**	1,042.0	–0.2	7.7	4.6

2019: a year of uncertainty

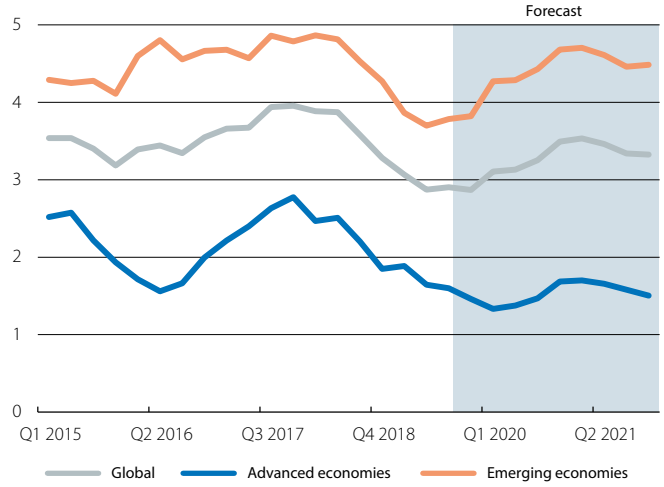
Global economic activity stepped down a notch in 2019, a year marked by the general slowdown of the economy. Following two years of high growth in which the global economy grew by 3.8% (2017) and 3.6% (2018), the data suggest a significant reduction in the pace of growth down to levels of around 3% for 2019 as a whole (specifically, 2.9% according to our estimates). The main culprit of this slowdown of the international economy is uncertainty, the key word of 2019. Without a doubt, uncertainty has risen primarily because of the trade tensions between the US and China, the political complexities of the EU (Italy, Brexit) and the global geopolitical situation (with the unrest in Hong Kong, Iran and Chile, among others). As such, an economy that was already affected by the maturity of the business cycle (and in which, therefore, a certain slowdown was to be expected) has also suffered the impact of uncertainty. This, in turn, has weighed down on foreign trade, investment and consumption: in short, economic growth itself. Despite the fact that the risks remain, at CaixaBank Research we expect that these pressures will recede in 2020 and 2021 and that the global economy will recover, although it will probably maintain lower growth rates than in recent years.

The trade tensions between the US and China intensified in 2019 following the temporary truce agreed between Washington and Beijing in December 2018. After applying tariff hikes in June and September, the US now has high tariffs on approximately 360 billion dollars of Chinese imports. China, in turn, has implemented them on some 60 billion dollars of US imports. These protectionist measures, and in particular the uncertainty over the future relationship between the two countries, can explain much of the decline in trade flows seen during 2019 (a decline which, on the other hand, has not occurred since the global financial crisis of 2008). Ironically, although the main trade conflict is between the US and China, for the time being it is other countries that appear to be taking the brunt of the heightened uncertainty, such as those in the EU, which are more sensitive to changes in global confidence and are more integrated internationally.

The manufacturing sector in advanced countries has suffered most notably due to the global uncertainty, but it has also been affected by a shock in the automotive industry (see the Focus «The difficulties of the global manufacturing sector» in this same *Monthly Report*). For the past six months, the global manufacturing PMI has stood below 50 points, the threshold that separates the expansive and contractive territories. Of particular note is the difference between emerging countries, where the sector bottomed out in mid-2019 and is already showing signs of a recovery (with a PMI of 51 in October), and advanced countries, where the manufacturing PMI remains well below 50 points (48.6 in October). Thus, these numbers point towards moderate growth in Q4 2019.

GDP growth

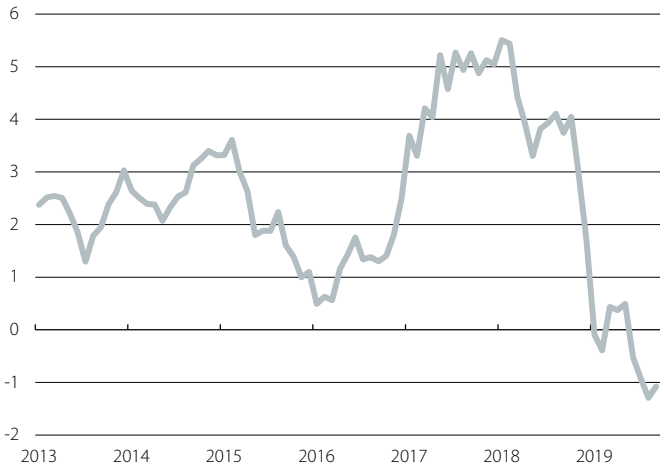
Year-on-year change (%)



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

International trade (volume)

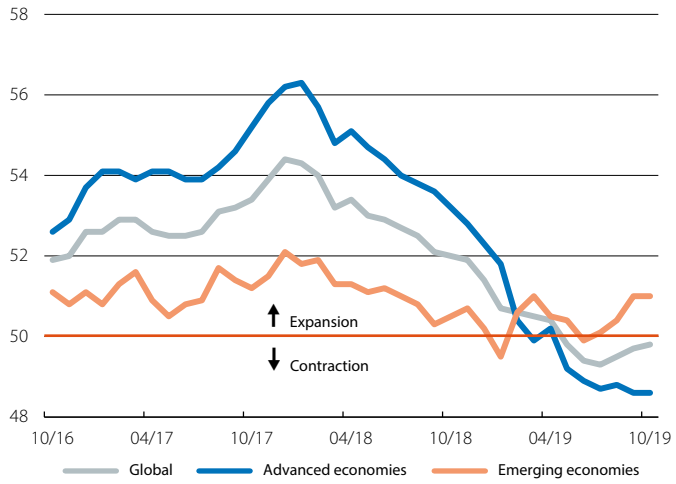
Year-on-year growth (%, 3-month moving average)



Source: *CaixaBank Research, based on data from the CPB World Trade Monitor (Merchandise).*

Economic activity indicators: manufacturing PMI

Index



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

EURO AREA

Europe has been the main victim of the deteriorating global environment in 2019, due to its openness to trade and its integration into the global economy. In November, the European Commission revised its growth forecasts for 2019 down in 11 of the 19 countries of the euro area, and in 17 countries for 2020. The underlying situation is one of a general slowdown in the European economy in 2019, with no signs of showing greater momentum in the coming quarters. Among the major countries, the most significant downward revisions were in Germany (–0.1 pp in 2019 and –0.5 pps in 2020) and Spain (–0.2 pps and –0.4 pps). According to the Commission, the main reason for this change is that, despite the fact that the risks of recession remain low, the factors that are hindering European growth will persist. Most notably, these include moderate growth in the global economy, the weakness of international trade and the problems in the global industrial sector.

GDP growth in the euro area remained at moderate levels in Q3 2019. In particular, GDP grew by 1.2% year-on-year (0.2% quarter-on-quarter), almost the same as the figure for the previous quarter, confirming that the European economy has got stuck at low growth rates. Nevertheless, domestic demand continues to support economic activity, with an impressive 2.2-pp contribution to year-on-year growth driven by consumption and investment. The decrease in the unemployment rate in October (down to 7.5%) tells us that the labour market has, for now, been resistant to the decline in activity that occurred in 2019. By country, growth has been particularly moderate in Italy (0.3% year-on-year and 0.1% quarter-on-quarter) and Germany (0.5% year-on-year and 0.1% quarter-on-quarter). The latter narrowly avoided a technical recession, defined as two consecutive quarters of negative growth. As for Q4, the behaviour of the economic activity indicators at the beginning of the quarter and the economic sentiment index for the euro area (ESI) point towards a similar growth to that of Q3.

Germany, the focus of various shocks. The German economy, which is very open and dependent on the industrial sector, has been particularly affected by the factors behind the slowdown in the global economy: the trade tensions between the US and China, the uncertainty surrounding Brexit and the problems in industry and in the automotive sector in particular. The tensions between the EU and the US also played a role, although the decision on whether to increase tariffs on imports of European cars will most likely be postponed until 2020. Signs that this uncertainty is affecting the German economy include the fact that some producers of German cars have already announced that they would increase their production in the US. The services sector, meanwhile, remains strong, with a PMI index above the 50-point threshold (51.3 in November). Nevertheless, there is still a risk that its ties with the industrial sector could end up holding it back more than at present. All in all, the latest economic activity indicators point towards a growth in

European Union: GDP forecasts by the European Commission

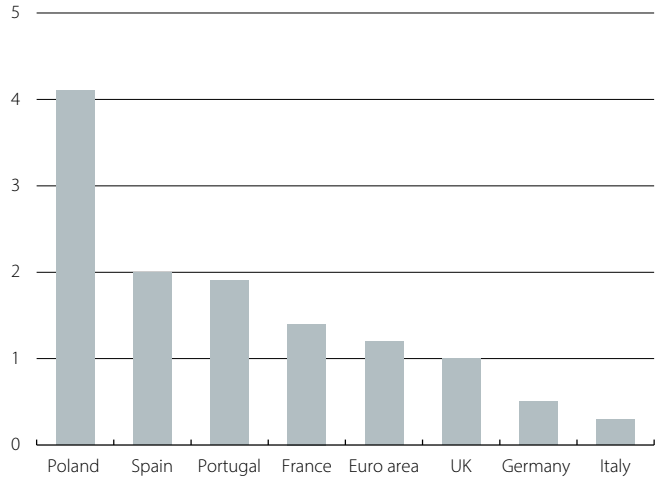
Annual change (%)

	Forecast		Change compared to the spring 2019 forecast *			
	2019	2020		2019		2020
Euro area	1.1	1.2	▼	–0.1	▼	–0.3
Germany	0.4	1.0	▼	–0.1	▼	–0.5
France	1.3	1.3	=	0.0	▼	–0.2
Italy	0.1	0.4	=	0.0	▼	–0.3
Spain	1.9	1.5	▼	–0.2	▼	–0.4
Portugal	2.0	1.7	▲	0.3	=	0.0
United Kingdom	1.3	1.4	=	0.0	▲	0.1

Note: ** Change in percentage points.*
Source: *CaixaBank Research, based on data from the European Commission (European Economic Forecast, autumn 2019).*

European Union: GDP in Q3 2019

Year-on-year change (%)



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

German economic activity indicators: PMI

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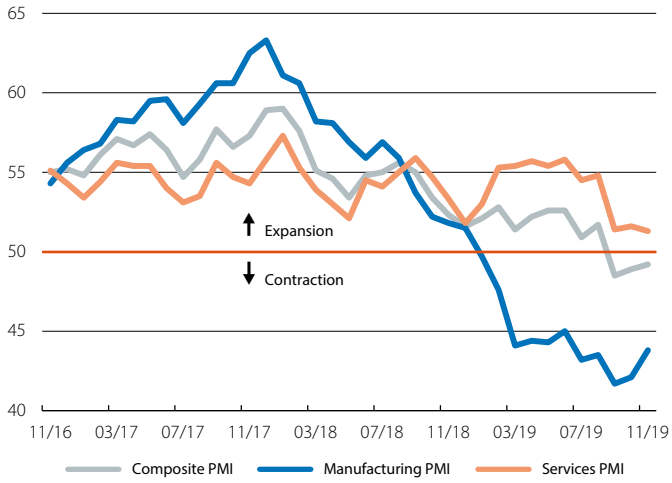


Source: *CaixaBank Research, based on data from Markit.*

Q4 similar to that of Q3 (0.1% quarter-on-quarter), thus suggesting that the German economy will grow by around 0.6% in 2019 (1.6% in 2018).

US

The US economy continues to grow at a steady pace. The GDP of the US remained strong in Q3, in spite of the trade tensions surrounding the economy. In particular, US economic activity grew by 0.5% quarter-on-quarter (2.1% year-on-year), slightly above the forecasts of analysts' consensus and those of CaixaBank Research. This is a similar rate of growth to that of the previous quarter and remains high, especially taking into account the protectionist measures and the trade tensions that have surrounded the country in recent times. However, for Q4 the available indicators suggest a somewhat more restrained growth. Specifically, industrial production fell by 1.1% in October (–0.1% in September) and retail sales registered a slowdown (3.7% in October compared to 4.5% in September). All in all, the strength of private consumption, together with the healthy performance of the labour market, points to a certain inertia in the US economy's growth which should continue over the coming quarters.

Business investment, on the other hand, contracted again for the second consecutive quarter, and shows a marked slowdown in 2019. In Q3, business investment fell by 0.1% compared to the previous quarter, driven by the fall in investment in structures and capital goods. However, this drop is qualified by the base effect of the strong performance of investment in 2018, boosted by the tax reform of the Trump Administration (for more details, see the Focus «Good outlook for the US economy, with the permission of investment» in this same *Monthly Report*).

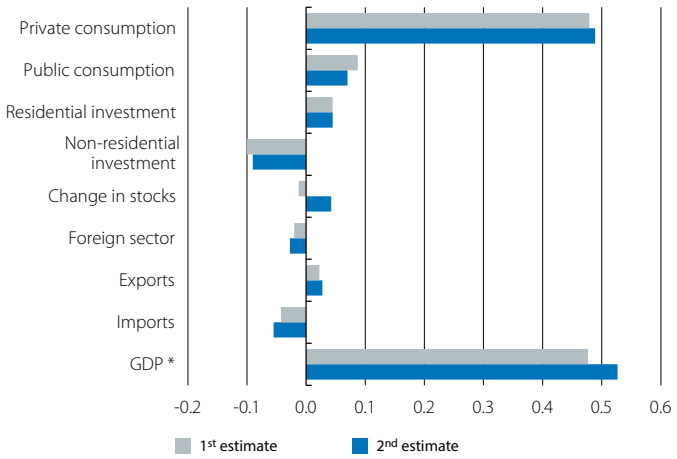
EMERGING MARKETS

The pace of economic activity continues to yield in the emerging markets. Despite the fact that the manufacturing sector is already recovering in the bloc of emerging countries (as attested by the trend in the manufacturing PMI discussed earlier), the synthetic economic activity indicator developed for these countries by the Institute of International Finance (IIF) once again fell in October. As such, the brief recovery in the pace of economic activity registered in the first part of 2019 may have been cut short. Besides idiosyncratic factors, the emerging markets are facing a complex set of circumstances, with worsening expectations, real data on the decline and financial pressure in response to the surge or persistence of various «headwinds» that affect them (in particular, geopolitical uncertainty, the slowdown in global trade and the decline in the price of many commodities).

The slowdown in India is becoming more acute. In Q3, the Indian economy grew by 4.5% year-on-year (5.0% in Q2), a figure that is lower than expected and which marks the sixth consecutive quarter with a slowdown. The notable slowdown in investment and the loss of buoyancy in exports, affected by a more adverse global environment, were the main factors behind the decline in the Asian country's pace of economic activity.

US: components of GDP in Q3 2019

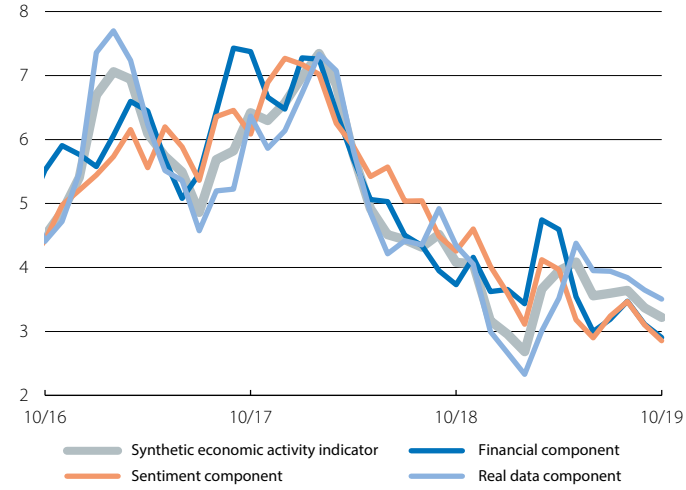
Contribution to non-annualised quarter-on-quarter growth (pps)



Note: ** Non-annualised quarter-on-quarter change (%).*
Source: *CaixaBank Research, based on data from the Bureau of Economic Analysis.*

Emerging markets: synthetic economic activity indicator

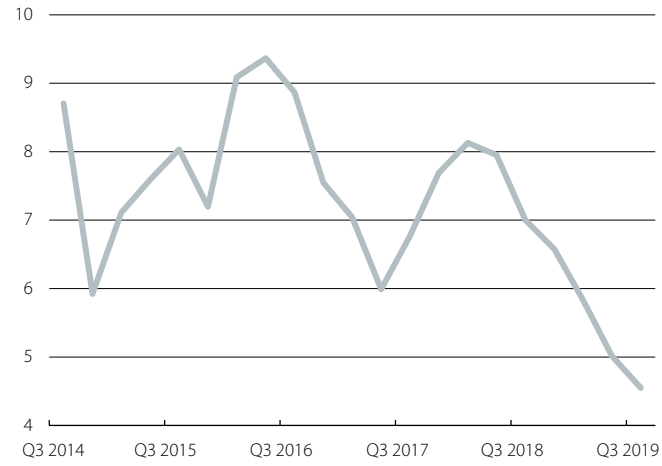
Annualised quarter-on-quarter change (%)



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

India: GDP

Year-on-year change (%)



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

The difficulties of the global manufacturing sector

- **The global manufacturing sector has entered a phase of activity contraction. The phenomenon is widespread among advanced and emerging economies, although the latter bloc is faring somewhat better, and it is particularly intense in the euro area.**
- **Behind this contraction phase lie trade tensions, the maturity of the macroeconomic cycle and disruptions in the automotive sector.**

Over the course of the year, the range of indicators pointing towards a contraction in manufacturing production has gradually expanded, especially in key economies such as Germany. Although declines in manufacturing activity are not unusual (we need go no further than 2016, when one occurred in the US), its coincidence in time with an environment of heightened uncertainty has raised doubts about the prospects for growth over the coming quarters, especially in the face of the fear that it could spread to other sectors, such as services.

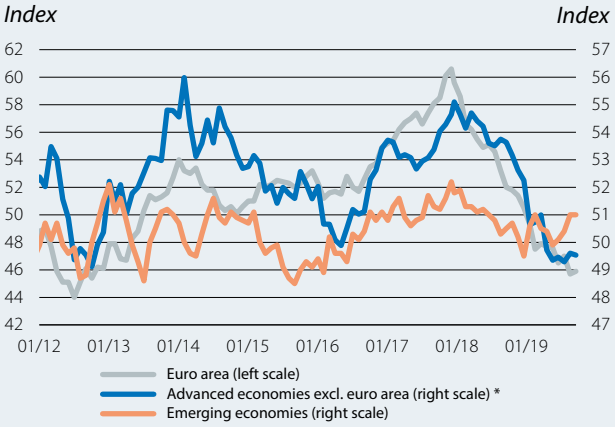
What is going on?

As shown in the first chart, the production of manufacturing firms began an expansive phase between late 2015 and mid-2016, and reached its peak towards the end of 2017. Since then, the sector's growth has seen a widespread moderation and its production has even contracted.

In the current downturn in the manufacturing cycle, various elements stand out, which we show in the first two charts:

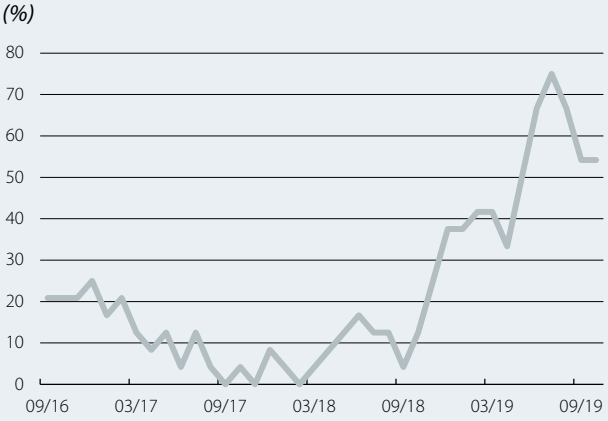
- The moderation of activity is widespread among advanced and emerging economies, although this second bloc is faring somewhat better and its manufacturing sector is showing a slight recovery in recent months.
- In particular, in August 2019, of the 24 countries for which data are available, the manufacturing PMI (a sentiment indicator that has a close correlation with economic activity growth), 21 were below the 50-point threshold, which indicates a contraction in output. Among them were the five main manufacturing economies, which represent approximately 60% of global industrial production: China, the US, Japan, Germany and South Korea.
- The weakness is reflected not only in the sentiment indicators, but the manufacturing production volumes themselves have slowed down in a widespread manner and are contracting in the major industrial economies.
- The downturn has been particularly intense in the euro area, especially in Germany.
- At the global level, for the time being at least, the drop is not larger or smaller than in other downturns in the manufacturing cycle: for instance, both the lows reached in the manufacturing PMI and the total decline in this index from its peak at the end of 2017 are similar to those observed in previous downturns (such as in 2012 and 2015) and are a far cry from what was experienced in 2008-2009.

Economic activity indicator: manufacturing PMI



Note: ** Own estimates based on the euro area's GDP share of the IMF's «Advanced economies» aggregate.*
Source: *CaixaBank Research, based on data from Markit.*

Countries with a manufacturing PMI below 50



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

On the other hand, compared to the weakness exhibited by the production of the sector, other macroeconomic elements such as investment have also suffered, but continue to grow at a steady pace. As an example, in the US, non-residential fixed investment has maintained an average quarter-on-quarter growth of 0.8% since 2018 (1.3% on average in 2017). In Europe, meanwhile, the quarter-on-quarter growth of gross fixed capital formation in France remains at around 1% on average so far this year (1.4% on average in 2017), while in Germany there has been a more notable slowdown

(0.4%, compared to 1.0%). In addition, although the growth of investment does not reveal buoyant figures (the aforementioned figures for the US contrast with an average quarter-on-quarter growth for 2003-2007 that was only slightly below 2%, the reduced buoyancy has been the rule rather than the exception since the Great Recession.

Finally, as shown in the third chart, the weakness of manufacturing production has also weighed down on employment in the sector. Nevertheless, job creation has resisted and, in the last few quarters, has even gained some momentum in economies such as the US, the United Kingdom and Germany. This is a positive sign, although the dynamics of the labour market typically exhibit a certain delay with respect to production.

What is behind the weakness of manufacturing?

The downturn of the manufacturing sector coincides with three major phenomena that appear to be responsible for its weakness: trade tensions, the maturity of the macroeconomic cycle and disruptions in the automotive sector.[1]

First of all, since the beginning of 2018, the US and China have been embroiled in a trade conflict that has escalated with the imposition of tariffs and the threat of greater restrictions on international investment flows. This has resulted in a surge in uncertainty (see fourth chart) and has damaged international trade,[2] two forces which, given the importance of exports for the industrial sector, would help to explain the weakness in manufacturing production.

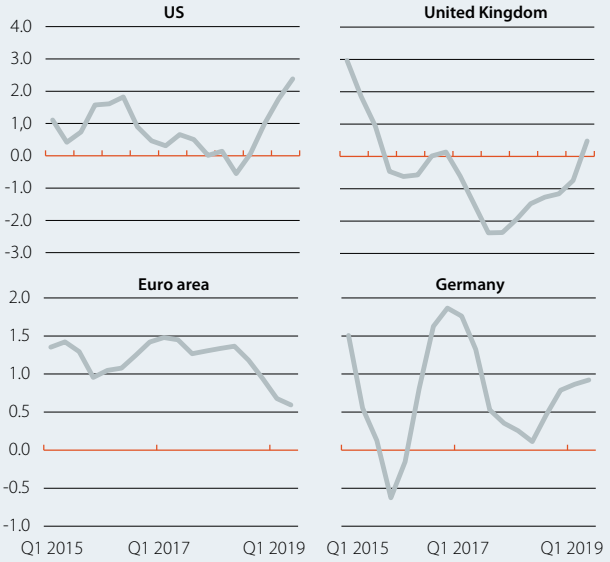
On the other hand, industry not only finds itself faced with a moderation in activity caused by trade tensions and uncertainty. In fact, trade disputes aside, following years of expansion, the major economies have reached a more mature point in the cycle, with fewer elements of cyclical momentum (for instance, the US is currently in the longest expansion in its history since 1850, while its unemployment rate, at around 3.5%, is at its lowest in the past 50 years). Therefore, more moderate growth in demand was to be expected.

Finally, a part of the weakness of industry is due to the idiosyncratic difficulties in the automotive sector, which has been hampered by regulatory changes and the great environmental challenge.[3] Indeed, while automotive production has contracted by 15% since the end of 2017, the rest of industrial activity has experienced a more gradual slowdown (although it is also contracting). In any case, the loss of momentum in manufacturing activity is widespread across the different sectors. In particular, since their cyclical peak in late 2017 or early 2018

1. Another possible explanation is the inventory cycle. In the past, in an industry that was more dominated by factories, this was an important driver of industrial cycles: an overestimation of demand led to an accumulation of stocks which, in turn, led to a reduction in production (until the accumulated excess stocks had been depleted).
2. According to data from the CPB World Trade Monitor, global trade in goods has gone from growing by around 5% per annum in 2017 to contracting by around 1% in Q3 2019 (data in volumes).
3. We analyse the difficulties and challenges of the sector in the article «The car, a key sector facing an uncertain future» in the MR06/2019.

Employment in the manufacturing sector

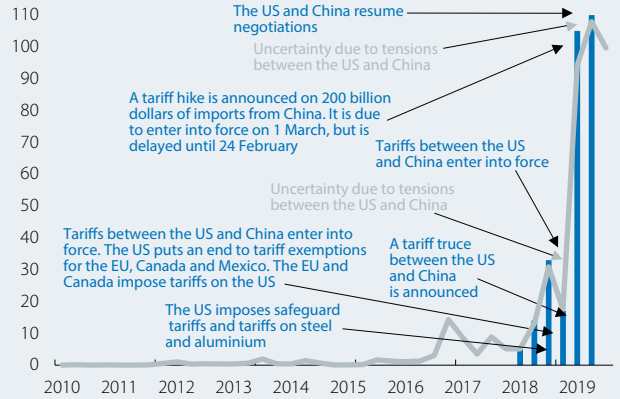
Year-on-year change (%, four-quarter moving average)



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

Global trade uncertainty

Index



Source: *CaixaBank Research, based on data from H. Ahir, N. Bloom and D. Furceri (2018). «World Uncertainty Index». Stanford mimeo.*

(depending on the sector), the four main macro-sectors of the sentiment indices developed by IHS Markit (automotive, machinery and equipment, technology and chemicals) have all registered a substantial slowdown, while the indicators of the first three are, in fact, at levels that indicate a contraction of activity.

In conclusion, the current manufacturing cycle is, for the time being, similar to previous episodes, but its future path will depend on whether the shocks experienced are exacerbated or prolonged. In this regard, the more constructive tone in the negotiations between the US and China should help to reduce uncertainty, although the maturity of the global economic expansion and the persistence of the difficulties in the automotive sector are likely to hinder a stronger rebound in industrial production.

Adrià Morron Salmeron and Àlex Ruiz

Good outlook for the US economy, with the permission of investment

- **The US economy continues to grow at a steady pace, although business investment has shown a marked slowdown in 2019.**
- **For the time being, this slowdown should not be cause for concern, since it is occurring after a period of strong growth spurred by the tax reform of 2017.**
- **In addition, the strength of the labour market, the negotiations currently underway with China and the Fed's accommodative shift will favour the continuity of the expansion in 2020.**

Since last July, the US has been in the longest expansionary phase in its history. Perhaps for this same reason, fears have arisen that the next recession is just around the corner. However, the latest data show that the country's GDP remained strong in Q3. In particular, US economic activity grew by 0.5% quarter-on-quarter (2.1% year-on-year), slightly above the forecast and the country's potential. But how much longer will this strength in the US economy's growth last?

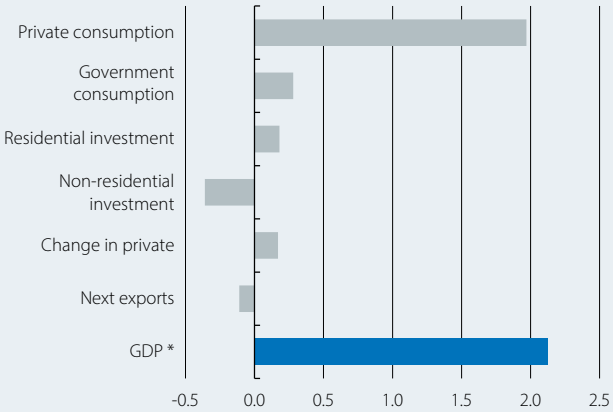
The breakdown of the GDP growth seen in recent quarters, by components of demand, shows a mixed picture that deserves some attention. Private consumption has remained the main pillar of US growth. At the other end of the spectrum, in Q3, business investment (non-residential) contracted again for the second consecutive quarter, driven by the fall in investment in structures and equipment (see first chart).

Focusing on investment, its recent weakness must be taken in context, as it follows the strong performance shown in 2018. In particular, late 2017 saw the implementation of a sharp cut in corporation tax, as well as changes in the accounting standards relating to tax deductions for investment costs.[1] These acted as a spur for investment, which grew above the historical average throughout 2018 (see second chart). In this regard, it is somewhat natural for 2019 to be a year marked by much more contained levels of investment. Nevertheless, it is worth mentioning that the rise in investment following the tax changes was lower than most analysts had predicted. Similarly, the slowdown during 2019 has been somewhat greater than expected. Without a doubt, the trade disputes between the US and China which began in 2018 have weighed down on companies' appetite for investment since then.[2] That said, we could see an improvement in this mood thanks to the negotiations currently underway between the two countries. Despite some of the future investment indices developed by the various Federal Reserves not showing such an improvement (see third chart), at least for the time being, we believe that it could nevertheless materialise in 2020.

On the other hand, in April, Democrats and Republicans came to an agreement on the need to allocate 2 billion dollars to improve the country's infrastructure (roads, bridges, broadband, etc.). Undoubtedly, an increase in public spending on infrastructure of this scale could also

Components of GDP in Q3 2019

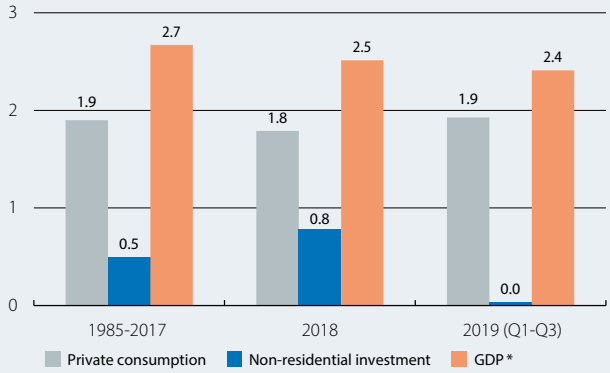
Contribution to annualised quarter-on-quarter growth (pps)



Note: ** Annualised quarter-on-quarter change (%).*
Source: *CaixaBank Research, based on data from the Bureau of Economic Analysis.*

US: GDP, consumption and investment

Contribution to annualised quarter-on-quarter GDP growth (pps)



Note: ** Annualised quarter-on-quarter change (%).*
Source: *CaixaBank Research, based on data from the Bureau of Economic Analysis.*

1. Tax Cuts and Jobs Act of 2017.
2. See E. Kopp, D. Leigh, S. Mursula and S. Tambunlertchai (2019). «US Investment Since the Tax Cuts and Jobs Act of 2017». Nº 19/120. International Monetary Fund.

give a significant boost to private investment. To date, however, these good intentions have not yet materialised in an infrastructure spending package, so a shift in the trend in investment in 2020 driven by this agreement appears less and less likely.

Finally, it should be noted that investment in intellectual property products has not only endured the uncertainty over trade and global geopolitics, but in the last two years it has even maintained a higher than usual growth rate (8% since 2018, versus the historical average of 6%). As such, investment in intellectual property products is less subject to the effects of uncertainty, especially in a country like the US, which has highly developed legislation on the matter.[3] Furthermore, the contrast between the strong performance of investment in intellectual property products and that of investment in structures suggests another possible explanation: the transition towards an economy that is increasingly focused on services and knowledge requires a lower level of investment, and one with a different composition (see fourth chart).

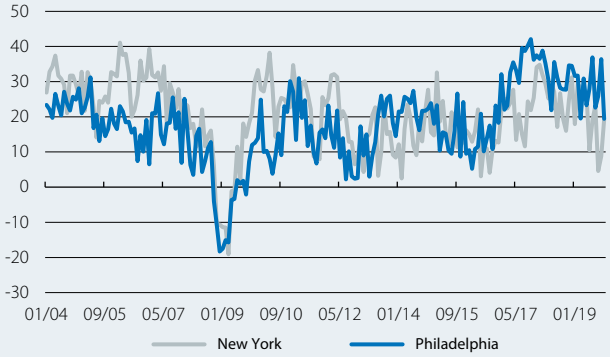
In short, the moderation in investment is something to be monitored, although it does not yet seem to be cause for concern. In addition, the strength of the labour market, with an unemployment rate at its lowest levels since the late 1960s and a higher than expected rate of job creation in an economy with full employment, will help to keep private consumption at high levels. Finally, the trade negotiations currently underway with China and the Fed's accommodative shift in recent months (see fifth chart) are two other factors that will favour the continuity of the expansion in 2020, with growth that we estimate at around 1.8%.

Clàudia Canals

3. See D. Czarnitzki and A.A. Toole (2011). «Patent protection, market uncertainty, and R&D investment» The Review of Economics and Statistics, 93(1), 147-159.

*Future capital expenditures index **

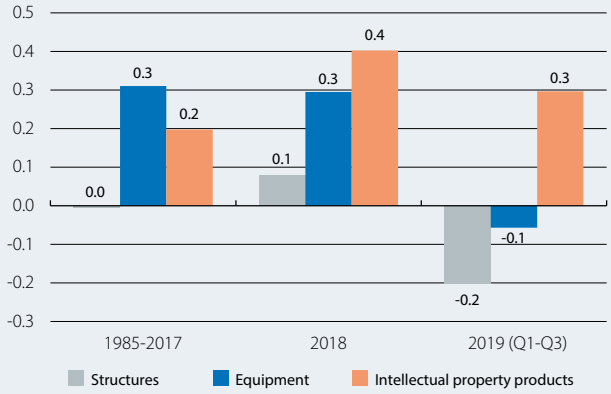
Level



Note: ** Diffusion index (expected capital expenditure over the next six months) by the Philadelphia Fed (includes the states of Pennsylvania, New Jersey and Delaware) and by the New York Fed (which comprises the state of New York). The index is calculated as the percentage of respondents who report an increase, minus the percentage who report a reduction. The index can take values of between +100 and -100. The mid-point (0) indicates that the same percentage of companies report an increase and a reduction in future investment.*
Source: *CaixaBank Research, based on data from the Federal Reserve Banks of Philadelphia and New York.*

US: non-residential investment

Contribution to annualised quarter-on-quarter GDP growth (pps)



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

*US: reference interest rate **

(%)

Note: ** Fed funds rate. Upper limit of the range marked.*
Source: *CaixaBank Research, based on data from the Federal Reserve.*

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

UNITED STATES

	2017	2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	08/19	09/19	10/19
Activity									
Real GDP	2.4	2.9	2.5	2.7	2.3	2.1	...	–	–
Retail sales (excluding cars and petrol)	4.5	4.6	3.5	3.4	3.6	4.3	4.4	4.5	3.7
Consumer confidence *(value)*	120.5	130.1	133.6	125.8	128.3	132.1	134.2	126.3	126.1
Industrial production	2.3	3.9	4.0	2.9	1.2	0.2	0.4	–0.1	–1.1
Manufacturing activity index (ISM) *(value)*	57.4	58.8	56.9	55.4	52.2	49.4	49.1	47.8	48.3
Housing starts *(thousands)*	1.209	1.250	1.185	1.213	1.256	1.282	1.375	1.266	1.314
Case-Shiller home price index *(value)*	200	211	214	215	216	217	216	217	...
Unemployment rate *(% lab. force)*	4.4	3.9	3.8	3.9	3.6	3.6	3.7	3.5	3.6
Employment-population ratio *(% pop. > 16 years)*	60.1	60.4	60.6	60.7	60.6	60.9	60.9	61.0	61.0
Trade balance[1] *(% GDP)*	–2.8	–2.4	–3.0	–3.0	–3.1	–3.1	–3.1	–3.1	...
Prices									
Headline inflation	2.1	2.4	2.2	1.6	1.8	1.8	1.7	1.7	1.8
Core inflation	1.8	2.1	2.2	2.1	2.1	2.3	2.4	2.4	2.3

JAPAN

	2017	2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	08/19	09/19	10/19
Activity									
Real GDP	1.9	0.8	0.3	0.9	0.8	1.4	...	–	–
Consumer confidence *(value)*	43.8	43.6	42.8	41.3	39.5	36.8	37.1	35.6	36.2
Industrial production	2.9	1.0	0.5	–1.1	–1.2	–1.1	–2.0	–0.3	–6.3
Business activity index (Tankan) *(value)*	19.0	20.8	19.0	12.0	7.0	5.0	5.0	–	–
Unemployment rate *(% lab. force)*	2.8	2.4	2.4	2.4	2.4	2.3	2.2	2.4	2.4
Trade balance[1] *(% GDP)*	0.5	–0.1	–0.2	–0.3	–0.5	–0.4	–0.5	–0.4	–0.5
Prices									
Headline inflation	0.5	1.0	0.9	0.3	0.8	0.3	0.2	0.2	0.2
Core inflation	0.1	0.3	0.3	0.4	0.6	0.6	0.5	0.6	0.6

CHINA

	2017	2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	08/19	09/19	10/19
Activity									
Real GDP	6.8	6.6	6.4	6.4	6.2	6.0	6.0	–	–
Retail sales	10.3	9.0	8.3	8.5	8.5	7.6	7.5	7.8	7.2
Industrial production	6.6	6.2	5.7	6.4	5.6	5.0	4.4	5.8	4.7
PMI manufacturing *(value)*	51.6	50.9	49.9	49.7	49.6	49.7	49.5	49.8	49.3
Foreign sector									
Trade balance[1,2]	420	352	352	381	395	430	421	430	439
Exports	7.9	9.9	4.0	1.2	–1.0	–0.4	–1.0	–3.2	–0.9
Imports	16.3	15.8	4.4	–4.4	–3.9	–6.4	–5.6	–8.2	–6.4
Prices									
Headline inflation	1.6	2.1	2.2	1.8	2.6	2.9	2.8	3.0	3.8
Official interest rate[3]	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4
Renminbi per dollar	6.8	6.6	6.9	6.8	6.8	7.0	7.1	7.1	7.1

Notes: *1. Cumulative figure over last 12 months. 2. Billion dollars. 3. End of period.*

Source: *CaixaBank Research, based on data from the Department of Economic Analysis, Bureau of Labor Statistics, Federal Reserve, Standard & Poor's, ISM, National Bureau of Statistics of Japan, Bank of Japan, National Bureau of Statistics of China and Thomson Reuters Datastream.*

EURO AREA

Activity and employment indicators

Values, unless otherwise specified

	2017	2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	09/19	10/19	11/19
Retail sales *(year-on-year change)*	2.5	1.6	1.7	2.5	2.1	2.7	3.1	...	...
Industrial production *(year-on-year change)*	3.0	0.9	–2.0	–0.5	–1.3	–2.2	–1.7	...	...
Consumer confidence	–5.4	–4.9	–6.4	–7.0	–7.0	–6.7	–6.5	–7.6	–7.2
Economic sentiment	110.1	111.2	108.8	106.0	104.1	102.5	101.7	100.8	101.3
Manufacturing PMI	57.4	55.0	51.7	49.1	47.7	46.4	45.7	45.9	46.6
Services PMI	55.6	54.5	52.8	52.4	53.1	52.8	51.6	52.2	51.5
Labour market									
Employment (people) *(year-on-year change)*	1.6	1.5	1.4	1.4	1.2	...	–	–	–
Unemployment rate *(% labour force)*	9.1	8.2	7.9	7.8	7.6	7.6	7.6	7.5	...
Germany *(% labour force)*	3.8	3.4	3.3	3.2	3.1	3.1	3.1	3.1	...
France *(% labour force)*	9.4	9.1	8.9	8.6	8.5	8.6	8.6	8.5	...
Italy *(% labour force)*	11.3	10.6	10.5	10.3	10.0	9.8	9.9	9.7	...
Real GDP*(year-on-year change)*	2.7	1.9	1.2	1.3	1.2	1.2	–	–	–
Germany *(year-on-year change)*	2.8	1.6	0.6	1.0	0.3	0.5	–	–	–
France *(year-on-year change)*	2.4	1.7	1.2	1.3	1.4	1.4	–	–	–
Italy *(year-on-year change)*	1.8	0.7	–0.1	0.0	0.1	0.3	–	–	–

Prices

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

	2017	2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	09/19	10/19	11/19
General	1.5	1.8	1.9	1.4	1.4	1.0	0.8	0.7	...
Core	1.1	1.2	1.2	1.1	1.2	1.1	1.2	1.2	...

Foreign sector

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

	2017	2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	09/19	10/19	11/19
Current balance	3.2	3.2	3.2	3.1	2.8	2.8	2.8	...	...
Germany	8.1	7.3	7.3	7.2	7.1	7.5	7.5	...	...
France	–0.7	–0.6	–0.6	–0.5	–0.7	–0.9	–0.9	...	...
Italy	2.7	2.6	2.6	2.6	2.8	2.9	2.9	...	...
Nominal effective exchange rate[1] *(value)*	96.5	98.9	98.5	97.3	97.3	97.7	97.4	97.3	...

Credit and deposits of non-financial sectors

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

	2017	2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	09/19	10/19	11/19
Private sector financing									
Credit to non-financial firms[2]	2.5	3.8	4.0	3.7	3.9	...	...	...	...
Credit to households[2,3]	2.6	3.0	3.2	3.3	3.3	...	...	...	...
Interest rate on loans to non-financial firms[4] *(%)*	1.3	1.2	1.2	1.2	1.1	...	...	...	...
Interest rate on loans to households for house purchases[5] *(%)*	1.7	1.6	1.6	1.6	1.6	...	...	...	...
Deposits									
On demand deposits	10.1	7.9	7.1	7.0	7.7	...	...	...	...
Other short-term deposits	–2.7	–1.5	–0.9	–0.4	0.4	...	...	...	...
Marketable instruments	1.4	–4.4	–3.4	–3.7	–4.6	...	...	...	...
Interest rate on deposits up to 1 year from households *(%)*	0.4	0.3	0.3	0.3	0.3	...	...	...	...

Notes: *1. Weighted by flow of foreign trade. Higher figures indicate the currency has appreciated. 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 Eurostat, European Central Bank, European Commission, national statistics institutes and Markit.*

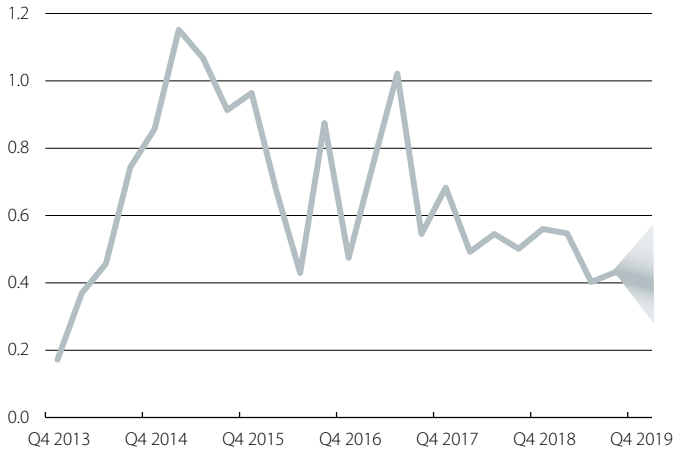
The Spanish economy continues its gradual slowdown

Spain continues to grow above the rate of its neighbours. The Spanish economy is experiencing a slowdown which reflects the moderation inherent to a more mature phase of the cycle (2019 will mark the sixth year of expansion) and the impact of a less favourable external environment. With just a month left before the year of the year, all the indicators suggest that GDP will grow by 1.9% in 2019, well above the 1.1% expected for the euro area as a whole. This is below the 2.7% average growth for 2014-2018. However, as argued in the article «The Spanish economy in 2020: things are not looking so bad» in the Dossier of this same *Monthly Report*, the risk of recession is estimated to be a contained 15%. Thus, in 2020 the economy is expected to maintain a growth rate of around 1.5%, driven by domestic demand and the growth in household disposable income. In addition, the Spanish economy is facing this slowdown with fewer macroeconomic imbalances than in the past. As such, according to our forecasts, the current account will end 2019 with a surplus of 1.6% of GDP, compared to the –9.4% deficit registered in 2007, the year prior to the Great Recession; household debt will stand at around 65% of GDP, whilst in 2007 it was almost 90%, and non-financial corporate debt will reach around 90%, whereas at the end of 2007 it exceeded 120%. The relative competitiveness of the Spanish economy has also improved dramatically since 2007 and the recent rise in labour costs is far from reversing this trend. Following on from this, the inflation gap with the euro area in 2019 is negative, standing at –0.4 pps, whilst in 2007 prices in Spain rose by 0.6 pps more than in the euro area. Nevertheless, there is still work to be done. For instance, the less favourable external environment removes a support factor for the improvement of the net international investment position (which has gone from –97.8% of GDP in Q2 2014 to –80.0% in Q2 2019). Similarly, the correction of public debt, which has made very slow progress in a period of strong growth (standing at 97.8% of GDP in Q3 2019, close to the peak of 100.9% registered in Q1 2015), will have fewer cyclical tail winds to push it along.

Healthy economic activity, albeit with the dichotomy between services and manufacturing. As we approach the year end, the latest available indicators point towards a similar level of economic activity growth in Q4 as in the previous quarter (when it stood at 0.4% quarter-on-quarter). However, this encouraging performance hides a differing trend between sectors. In October, the PMI index for the services sector stood at 52.7 points. Although in expansive territory (above 50), this is 6 decimal points lower than in September and 2.1 points below the average for 2018. In contrast, the manufacturing PMI remains at levels indicative of a contraction in the sector's activity (46.8 points in October, 9 decimal points lower than in September and 6.1 points below the average for 2018), while the industrial production index has stagnated (+0.8% year-on-year in September) following the sudden drop in late 2018 and early 2019. Furthermore, the demand-side indicators are

Spain: GDP

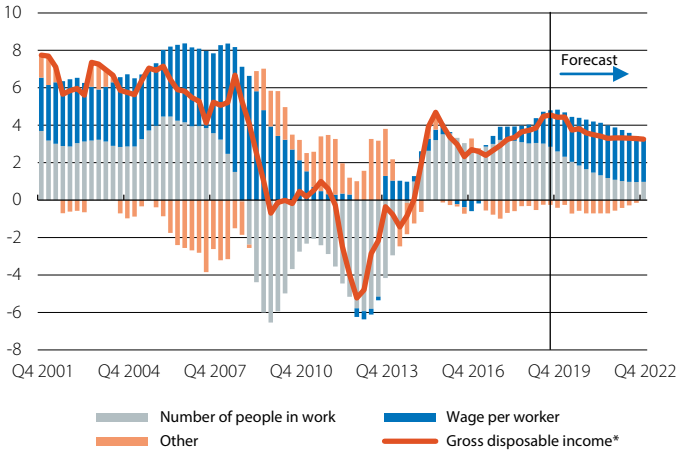
Quarter-on-quarter change (%)



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

Spain: gross disposable income of households

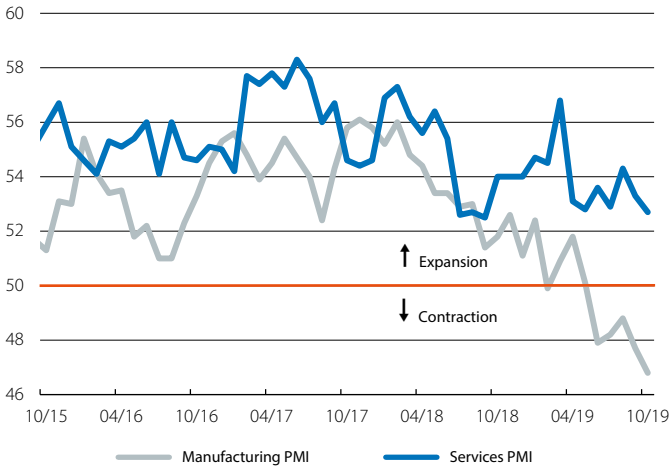
Contribution to year-on-year change (pps)



Note: *Cumulative sum for Q4. * Year-on-year change.*
Source: *CaixaBank Research, based on data from the National Statistics Institute.*

Spain: economic activity indicators

Level



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

also exhibiting dichotomies. The strong performance of retail sales (3.9% year-on-year in September, excluding service stations) reflects the resistance of private consumption. However, car sales replicate the weakness of manufacturing and have failed to emerge from their rut (in the 12-month cumulative period up to October, they stood 6.6% below the figures for the same period last year).

Gradual slowdown in the labour market, in line with the lower growth of the economy. The number of people registered with Social Security rose by 2.3% in October (2.4% in September), representing an increase of 436,920 in the number of people who have registered in the past 12 months. Over the same period, the number of people in unemployment fell by 77,044. By sector, Social Security affiliation in the industrial sector registered a moderate pace of growth of 1.2% year-on-year, 1 decimal point lower than the figure for September, while growth in affiliation in the construction sector slowed to 3.7% year-on-year, 4 decimal points lower than in September. Affiliation in the tourism and services sectors, meanwhile, maintained its growth rate at 2.7% and 2.8% year-on-year, respectively.

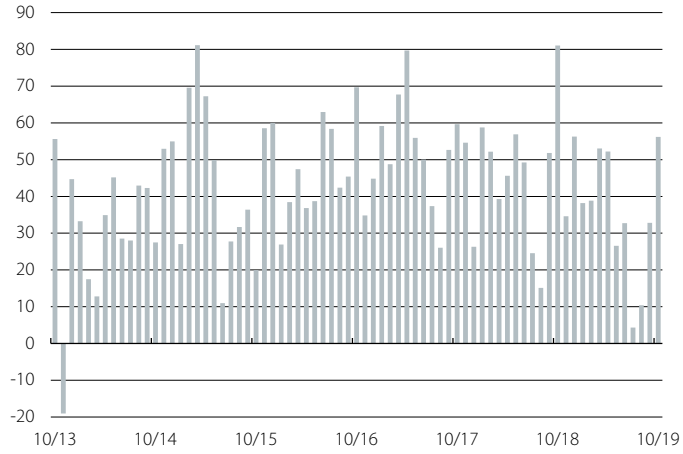
Inflation at moderate levels. In November, headline inflation stood at 0.4% year-on-year, marking the beginning of a recovery compared to the figures of previous months (0.1% in September and October). This improvement particularly reflects the fading of the base effects of the oil price, as the indicator now compares the price in November 2019 (around 56 euros per barrel) with that of November 2018 (58.03 euros), well below the 70 euros registered in October 2018. Thus, as this effect fades over the coming months, headline inflation will draw closer to core inflation, which remains at a moderate 1.0%.

The deterioration of the foreign surplus continues. In September, the balance of trade in goods deteriorated, driven by the balance of non-energy goods. As a result, the trade deficit stood at 2.8% of GDP (12-month cumulative figure). This represents a 0.29-pp deterioration compared to a year earlier, which is entirely attributable to the worsening of the balance of non-energy goods. In particular, non-energy exports grew well below non-energy imports (1.5% year-on-year on a 12-month cumulative basis, versus 3.1%).

The price of housing stabilises. The price of housing according to valuation appraisals grew by 0.1% quarter-on-quarter in Q3 and by 3.1% in year-on-year terms, repeating the figures of the previous quarter. This is a somewhat lower growth rate than expected, implying that the slowdown in the sector could end up being more pronounced than anticipated. The slowdown in housing prices is taking place within a context in which demand is also showing some regression, although it remains high. The supply-side indicators are also registering a certain slowdown. That said, once again, it should be mentioned that they are still growing at a healthy pace and above that of the economy as a whole. Looking ahead to the coming quarters, the moderation in the sector's growth looks set to continue. Nevertheless, this should not be interpreted as a sign of weakness, but rather as a normalisation towards more sustainable growth rates following the strong upswing experienced during the recovery.

*Spain: registered workers affiliated with Social Security **

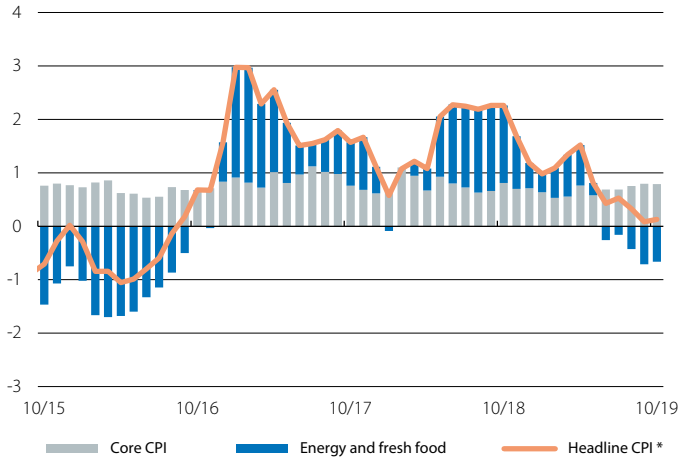
Monthly change (thousands of people)



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

Spain: CPI

Contribution to year-on-year growth (pps)



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

*Spain: foreign trade in goods **

Year-on-year change in the 12-month cumulative balance (%)

Note: ** Nominal data, non-seasonally adjusted. Excluding energy.*
Source: *: CaixaBank Research, based on data from the Department of Customs.*

The foreign sector or *Il Gattopardo*, a major change that changes little

- **The Bank of Spain has substantially revised the statistical series of the external accounts. With the new series, in Q1 2019, the current account balance has improved from 0.6% to 1.6% of GDP, but the net international investment position has deteriorated from –77.6% to –80.0% of GDP.**
- **Nevertheless, the trends of recent years (reduction in the current account surplus and improvement in the NIIP) have not changed, and the improvement in the NIIP is now slower.**

In September, the Bank of Spain (BoS) conducted an in-depth review of the historical statistics of the foreign sector in coordination with the EU, Eurostat and the ECB, incorporating new sources of information and an alignment with international standards. The resulting revision has had a substantial impact on the data of the balance of payments and the international investment position.

Specifically, in Q1 2019 (the most recent comparable period), the current account balance has gone from 0.6% to 1.6% of GDP, while the net international investment position (NIIP) has deteriorated from –77.6% to –80.0% of GDP. In the case of the current account, this difference of 1.0% of GDP is particularly due to a higher tourism balance (0.50% of GDP),[1] although a better balance of goods (0.16%), of non-tourism services (0.15%) and of income (0.20%) have also contributed to the improvement. As for the NIIP, the deterioration is mostly the result of changes in the direct investment position.

However, a closer analysis of the current account reveals that **these major changes scarcely alter the trends seen in the Spanish economy's foreign sector in recent years** (since 2016). In terms of the deterioration in the current account surplus, in Q1 2019 the current account balance lost 1.02 pps of GDP compared to Q4 2016, almost the same as the decline prior to the review. Similarly, the deterioration of the balance of goods does not change significantly, dropping to 1.06% of GDP from 1.12%, with exports continuing to grow less than imports (in Q1 2019, they grew by 2.5% and 5.6% year-on-year, respectively, compared to 2.4% and 6.2% prior to the review).

Tourism services deserve a special mention. Despite the tourism balance rising from 3.4% to 3.8% of GDP (Q1 2019), this change occurs uniformly throughout the series, so the deterioration since the end of 2016 barely changes with the revision (from 0.02% according to the old series to 0.05% of GDP). What is significant, however, is the greater strength that the revision attributes to the growth of tourism imports (Spaniards travelling abroad), which accelerates more following the review (in Q4 2017 they grew by 4.6% year-on-year, and in Q1 2019, by 9.0%). As a result, the deterioration in the tourism balance between the end of 2017 and Q1 2019 is slightly higher (0.23%, versus 0.20% prior to the review).

As for the NIIP, the revised series continues to show a recovery since the low point of Q2 2014, albeit slower than previously believed. Specifically, while the low point

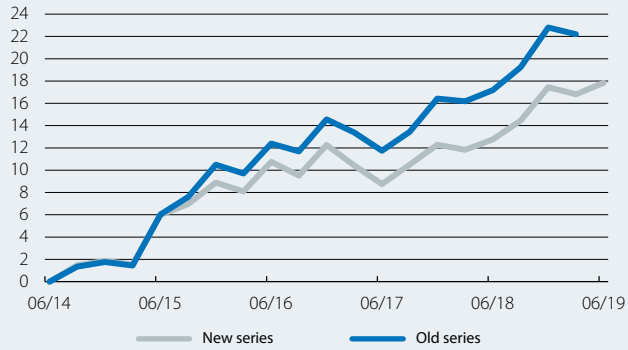
Spain: revision of the components of the current account balance *

(pps of GDP)

Note: ** Difference between the value after and prior to the revision, for each of the balances that comprise the current account balance (the total represents the change in the current account balance due to the revision).*
Source: *CaixaBank Research, based on data from the Bank of Spain.*

Spain: net international investment position

*Cumulative change in pps of GDP (0 = Q2 2014) **



Note: ** Cumulative change since the low point of Q2 2014 (–97.8% of GDP after the revision, –100,3% prior to it).*
Source: *CaixaBank Research, based on data from the Bank of Spain.*

1. The revision of the tourism balance is primarily attributable to changes on the income side due to the incorporation of data from the EGATUR survey (in the most recent years, payments are also modified). Previously, only the rates of change were taken into consideration.

of 2014 has gone from –100.3% to –97.8% of GDP, the cumulative improvement relative to this low point was 17.8 pps of GDP in Q2 2019 (16.8 pps in Q1 2019), whereas before the revision the cumulative improvement in Q1 2019 amounted to 22.2 pps of GDP. The positive side of this is that practically all of the revision is due to changes in the valuation of liabilities (in particular, real estate properties owned by non-residents).

The conclusion is that, although this review by the BoS improves the macroeconomic picture by raising the current account surplus, the trends remain the same: a deterioration in the balance of goods, with weak export growth, and deceleration in the pace of tourism growth, with strong growth in tourism imports. Furthermore, the recovery in the NIIP is slower than expected due to a downward revision of the valuation effects.

Jordi Singla

Spain: direct investment liabilities

Stock (pps of GDP)

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

Activity and employment indicators

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

	2017	2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	09/19	10/19	11/19
Industry									
Industrial production index	3.2	0.3	–2.7	0.0	1.5	1.1	0.8	...	...
Indicator of confidence in industry *(value)*	1.0	–0.1	–1.9	–3.8	–4.6	–2.0	–4.6	–7.9	–5.1
Manufacturing PMI *(value)*	54.8	53.3	51.8	51.1	49.9	48.2	47.7	46.8	...
Construction									
Building permits *(cumulative over 12 months)*	22.9	25.7	23.9	25.8	21.9	13.0	12.6	...	...
House sales *(cumulative over 12 months)*	14.1	14.2	11.5	8.3	5.5	1.3	–0.8	...	...
House prices	6.2	6.7	6.6	6.8	5.3	...	–	–	...
Services									
Foreign tourists *(cumulative over 12 months)*	10.0	4.0	0.9	1.0	1.5	2.1	2.1	1.6	...
Services PMI *(value)*	56.4	54.8	54.0	55.3	53.2	53.5	53.3	52.7	...
Consumption									
Retail sales	1.0	0.7	1.5	1.3	2.2	3.3	3.4	2.6	...
Car registrations	7.9	7.8	–7.6	–7.0	–4.4	–7.9	18.3	6.3	...
Consumer confidence index *(value)*	–3.4	–4.2	–6.2	–4.8	–4.0	–5.8	–6.2	–9.1	–10.3
Labour market									
Employment [1]	2.6	2.7	3.0	3.2	2.4	1.8	–	–	...
Unemployment rate (% labour force)	17.2	15.3	14.4	14.7	14.0	13.9	–	–	...
Registered as employed with Social Security [2]	3.6	3.1	3.0	2.9	2.8	2.5	2.4	2.3	...
GDP	**2.9**	**2.4**	**2.1**	**2.2**	**2.0**	**2.0**	**–**	**–**	**...**

Prices

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

	2017	2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	09/19	10/19	11/19
General	2.0	1.7	1.7	1.1	0.9	0.3	0.1	0.1	0.4
Core	1.1	0.9	0.9	0.7	0.8	0.9	1.0	1.0	...

Foreign sector

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

	2017	2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	09/19	10/19	11/19
Trade of goods									
Exports *(year-on-year change, cumulative over 12 months)*	8.9	2.9	2.9	2.4	2.3	1.7	1.7	...	...
Imports *(year-on-year change, cumulative over 12 months)*	10.5	5.6	5.6	6.1	3.9	3.0	3.0	...	...
Current balance	**31.1**	**23.3**	**23.3**	**19.6**	**21.4**	**21.3**	**21.3**	**...**	**...**
Goods and services	41.6	32.6	32.6	30.2	31.6	31.2	31.2	...	...
Primary and secondary income	–10.5	–9.3	–9.3	–10.6	–10.2	–9.8	–9.8	...	...
Net lending (+) / borrowing (–) capacity	**33.9**	**29.1**	**29.1**	**25.5**	**27.4**	**27.0**	**27.0**	**...**	**...**

Credit and deposits in non-financial sectors [3]

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

	2017	2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	09/19	10/19	11/19
Deposits									
Household and company deposits	2.8	3.2	3.7	5.3	5.8	5.4	4.9	5.1	...
Sight and savings	17.6	10.9	10.0	11.3	10.9	10.3	9.6	9.8	...
Term and notice	–24.2	–19.9	–16.8	–13.7	–12.8	–13.2	–13.4	–13.3	...
General government deposits	–8.7	15.4	16.9	17.8	15.7	3.7	4.4	1.3	...
TOTAL	**1.9**	**3.8**	**4.5**	**6.0**	**6.4**	**5.3**	**4.9**	**4.9**	**...**
Outstanding balance of credit									
Private sector	–2.2	–2.4	–2.2	–2.1	–1.1	–1.1	–1.4	–1.9	...
Non-financial firms	–3.6	–5.5	–5.7	–5.5	–3.0	–2.3	–2.7	–3.5	...
Households - housing	–2.8	–1.9	–1.4	–1.1	–1.2	–1.6	–1.6	–1.6	...
Households - other purposes	3.7	5.1	4.7	4.2	3.8	3.1	2.1	1.5	...
General government	–9.7	–10.6	–11.8	–10.4	–7.2	–5.4	–5.7	0.8	...
TOTAL	**–2.8**	**–2.9**	**–2.8**	**–2.6**	**–1.5**	**–1.4**	**–1.7**	**–1.7**	**...**
NPL ratio (%)[4]	**7.8**	**5.8**	**5.8**	**5.7**	**5.4**	**5.1**	**5.1**	**...**	**...**

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: the economy displays strength

GDP showed strong growth in Q3 and remained resilient in the face of the external environment. In particular, the economy grew by 1.9% year-on-year (the same figure as in Q2) and by 0.3% quarter-on-quarter (0.6% in Q2), driven by domestic demand which contributed 3.2 pps to year-on-year growth. Thus, private consumption accelerated to 2.3% year-on-year, thanks to the improvements in the labour market, while investment continued to grow at a steady pace in Q3, albeit slower than in previous quarters: 5.8% in Q3, after growing by 8.2% in Q2 and by 11.3% in Q1. The contribution of foreign demand, meanwhile, remained negative (–1.3 pps), as a result of imports growing well above exports. All in all, it should be noted that exports accelerated up to 2.6% (1.6% in Q2), favoured by the strong performance in exports of non-tourist services. With regard to Q4, the available indicators suggest that the economy remains resilient. In particular, in October, the economic climate indicator grew by 2.1% (2.2% in September), while the coincident indicators remained stable and at favourable levels: 2.0% in the case of aggregate activity and 2.5% in the case of private consumption. All this leads us to expect a GDP growth of 1.9% for 2019 as a whole, and of 1.7% in 2020.

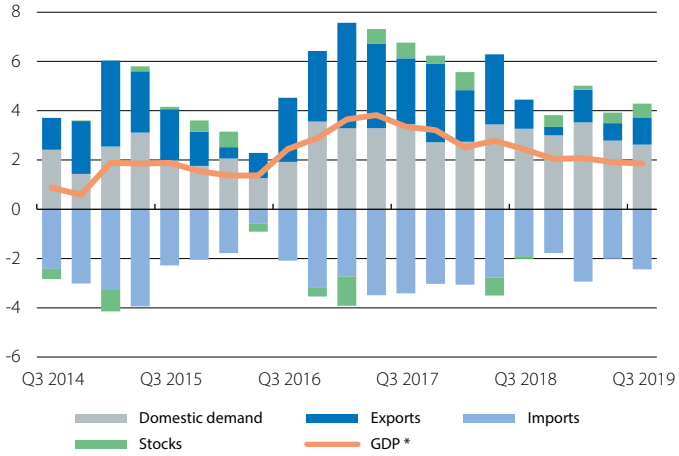
The current account balance deteriorated again in September. In particular, in September, the current account deficit stood at 1.6 billion euros (0.7% of GDP, 12-month cumulative figure). However, this deterioration is occurring in a context of strong growth in investment, which has a high import content and therefore drives up imports, eroding the external balance. In fact, the worsening of the deficit in the balance of non-energy goods up to 8.4% of GDP (–7.1% in September 2018) was what contributed the most to the deterioration of the current account balance. In the meantime, the capital balance has a surplus that remains sufficient to offset the deterioration in the current account and allows Portugal to maintain a surplus in its external accounts.

Tourism displays a healthy growth. In September, tourist lodgings registered year-on-year growth rate of 6.1% in the number of non-resident visitors (cumulative figure for the year), representing an acceleration compared to the figures for August (5.7%) and for 2018 as a whole (4.8%). By country, tourists from Spain, the US, Brazil, the United Kingdom and China were the main contributors to this acceleration, accounting for over 75% of the total growth. The average yield per available room, meanwhile, continues to rise (47.8 euros in September, +1.2% year-on-year), albeit at a slower pace than in previous years (+4.8% in 2018).

Inflation returns to positive territory, but remains very low. After the declines in the consumer price index (CPI) between

Portugal: GDP

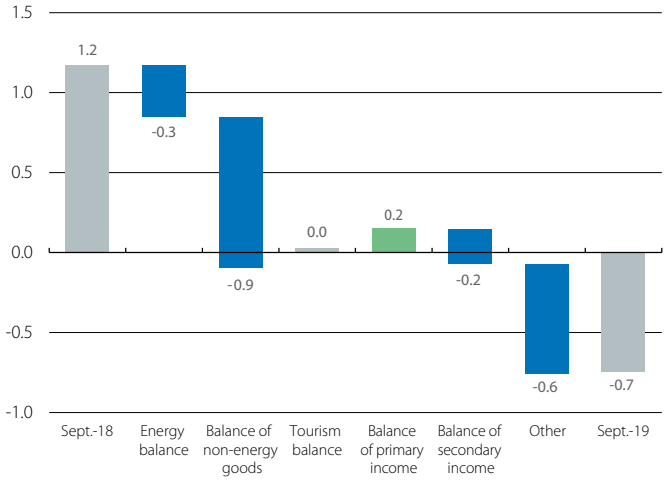
Contribution to year-on-year growth (pps)



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

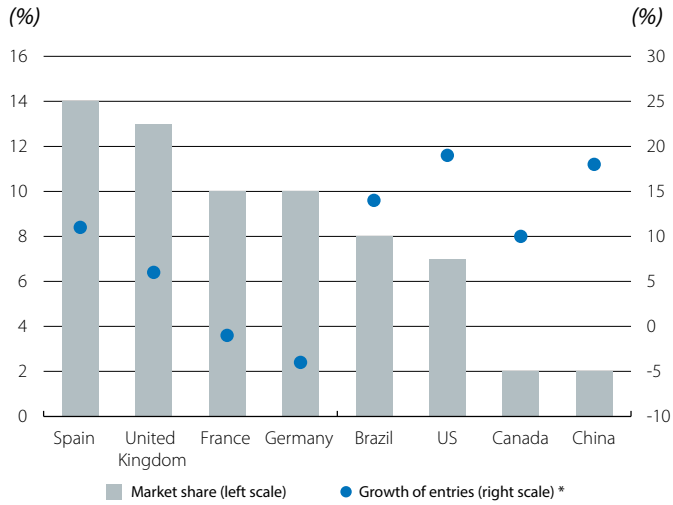
Portugal: current account balance

Contribution to the deterioration (pps of GDP)



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

Portugal: non-resident tourism



Note: ** Cumulative year to date up to September 2019, year-on-year change.*
Source: *CaixaBank Research, based on data from the National Statistics Institute of Portugal.*

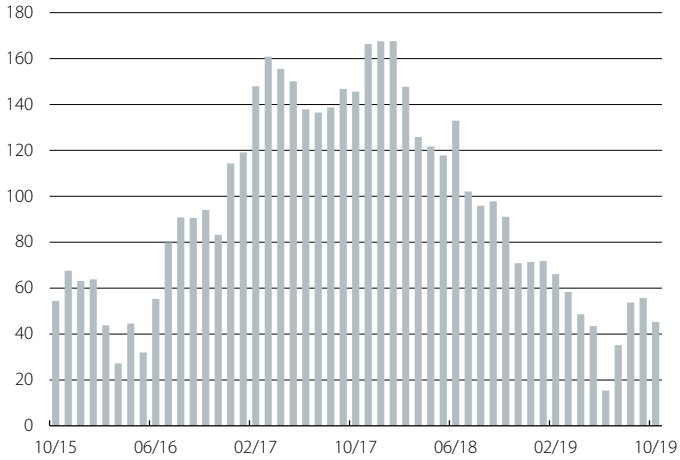
July and September, and its stagnation in October (0.0% year-on-year), headline inflation return to positive values in November (0.3% year-on-year). This recovery reflected, above all, the rise in core inflation, which stood at 0.6% year-on-year in November (0.2% between July and October). Thus, in the absence of data for December, all the indicators suggest that inflation will stand at a contained 0.4% for 2019 as a whole, well below the 1.0% registered in 2018. This weakness compared to 2018 can be explained by the fall in energy prices and various government measures, such as those aimed at reducing the prices of electricity, public transport and telecommunications.

Job creation slows down, but wages support the growth in income. In October, job growth slowed to 0.9% year-on-year (1.2% in September), according to the seasonally-adjusted data published by the National Statistics Institute. The unemployment rate, meanwhile, remained stable at 6.5% for the second consecutive month, 0.1 pp below that registered in October 2018. Thus, the data indicate that a deceleration is occurring in the labour market, in line with the gradual slowdown in economic activity. At the same time, however, the average monthly gross wage per worker continues to rise significantly (+3.0% in Q3).

The general government balance is improving at a slower rate. In October, the balance reached 0.6% of GDP (998 million euros, cumulative data for the year to date), which represents a +0.2% improvement compared to the same period in the previous year. By component, the growth in income exceeds that of expenditure (4.2% and 3.2%, respectively). However, in October, tax revenues slowed compared to September due to the payment of income tax and corporation tax reimbursements, and due to the slowdown in the growth rate of VAT collections. On the other hand, staff costs grew substantially (4.7%, versus the 2.2% forecast by the government), but were offset by the fall in interest payments and a reduced execution of investment.

Portugal: employment

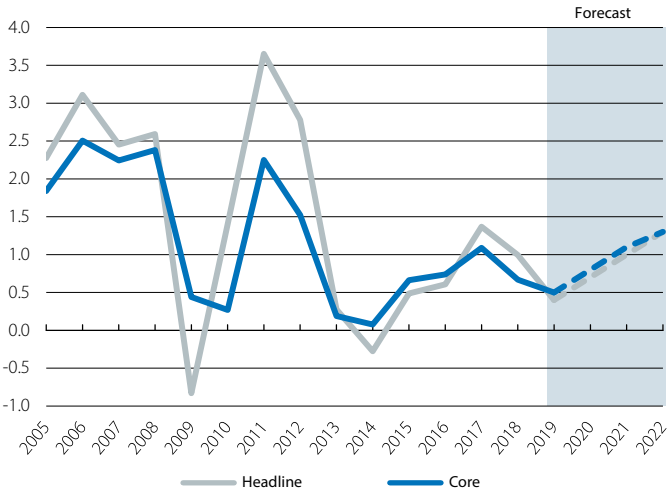
Year-on-year change (thousands of people)



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

Portugal: inflation (CPI)

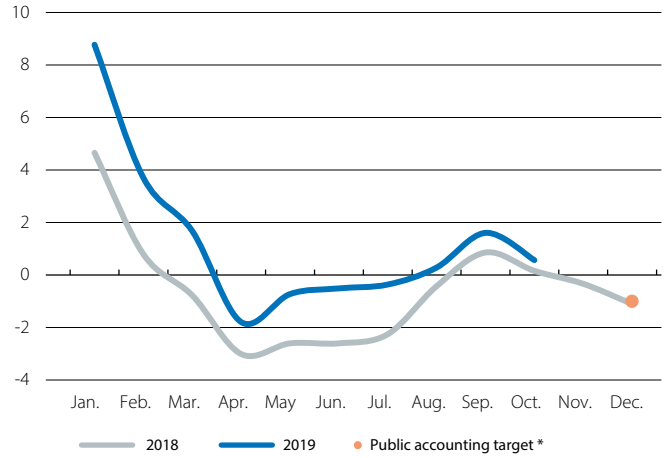
Annual average (%)



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

Portugal: central government balance

(% of GDP)



Note: ** The official target (in terms of national accounting) is –0.1% of GDP in 2019.*
Source: *CaixaBank Research, based on data from DGO and the General State Budget for 2020.*

Activity and employment indicators

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

	2017	2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	09/19	10/19	11/19
Coincident economic activity index	3.4	2.5	2.0	2.1	2.2	2.1	2.0	2.0	...
Industry									
Industrial production index	4.0	0.1	–1.3	–3.7	–2.2	–4.2	–5.5	–2.4	...
Confidence indicator in industry *(value)*	2.1	0.8	–0.8	–1.4	–3.3	–3.7	–4.1	–4.2	–4.4
Construction									
Building permits *(cumulative over 12 months)*	16.6	19.1	19.1	20.8	15.7	11.8	11.8	...	...
House sales	20.5	16.8	9.4	7.6	–6.6	...	...	...	...
House prices *(euro / m² - valuation)*	5.1	5.8	6.2	6.7	7.5	7.8	7.8	7.6	...
Services									
Foreign tourists *(cumulative over 12 months)*	16.0	4.8	5.2	4.5	4.9	5.8	6.1	...	...
Confidence indicator in services *(value)*	13.3	14.1	13.0	15.3	14.2	11.5	9.9	10.4	11.4
Consumption									
Retail sales	4.1	4.2	5.2	4.3	5.9	4.5	3.9	3.5	...
Coincident indicator for private consumption	2.7	2.6	2.4	2.3	2.3	2.5	2.5	2.5	...
Consumer confidence index *(value)*	–5.4	–4.6	–5.4	–8.3	–8.9	–7.6	–7.1	–7.2	–6.9
Labour market									
Employment	3.3	2.3	1.6	1.5	0.9	0.9	1.1	0.9	...
Unemployment rate (*% labour force*)	8.9	7.0	6.7	6.8	6.3	6.1	6.5	6.5	...
GDP	**3.5**	**2.4**	**2.0**	**2.1**	**1.9**	**1.9**	**1.9**	...	...

Prices

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

	2017	2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	09/19	10/19	11/19
General	1.4	1.0	0.8	0.8	0.5	–0.2	–0.1	0.0	0.3
Core	1.1	0.7	0.5	0.8	0.6	0.1	0.2	0.3	0.6

Foreign sector

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

	2017	2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	09/19	10/19	11/19
Trade of goods									
Exports *(year-on-year change, cumulative over 12 months)*	10.0	5.1	5.1	5.8	3.3	2.2	2.2	...	...
Imports *(year-on-year change, cumulative over 12 months)*	13.7	8.2	8.2	9.2	8.3	8.0	8.0	...	...
Current balance	**2.4**	**0.8**	**0.8**	**–1.1**	**–1.2**	–1.6	–1.6	**...**	**...**
Goods and services	2.9	1.6	1.6	0.1	–0.5	–1.1	–1.1	...	...
Primary and secondary income	–0.5	–0.8	–0.8	–1.2	–0.7	–0.5	–0.5	...	...
Net lending (+) / borrowing (–) capacity	**4.1**	**2.8**	**2.8**	**1.0**	**0.8**	**0.4**	**0.4**	**...**	**...**

Credit and deposits in non-financial sectors

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

	2017	2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	09/19	10/19	11/19
Deposits [1]									
Household and company deposits	1.7	3.8	4.2	4.9	4.5	5.3	5.3	...	...
Sight and savings	15.7	14.3	14.6	14.2	13.3	15.1	15.0	...	...
Term and notice	–5.8	–3.0	–3.1	–1.9	–2.3	–2.5	–2.6	...	...
General government deposits	1.3	–1.9	–9.9	–11.6	–11.9	–17.1	–21.0	...	...
TOTAL	**1.6**	**3.5**	**3.4**	**4.1**	**3.6**	**4.1**	**3.7**	...	...
Outstanding balance of credit [1]									
Private sector	–4.0	–1.7	–1.8	–2.6	–1.9	–1.4	–1.5	...	...
Non-financial firms	–6.5	–3.8	–4.5	–5.7	–3.8	–3.0	–3.2	...	...
Households - housing	–3.1	–1.5	–1.3	–1.5	–1.4	...	...	...	...
Households - other purposes	0.9	4.5	5.2	3.1	2.6	...	...	...	...
General government	9.3	2.4	–11.6	–12.5	–8.1	–6.4	–7.1	...	...
TOTAL	**–3.5**	**–1.6**	**–2.3**	**–3.0**	**–2.1**	**–1.6**	**–1.7**	...	...
NPL ratio *(%)* [2]	**13.3**	**9.4**	**9.4**	**8.9**	**8.3**	**...**	...	...	...

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

2020 global outlook: inevitable slowdown, unlikely recession

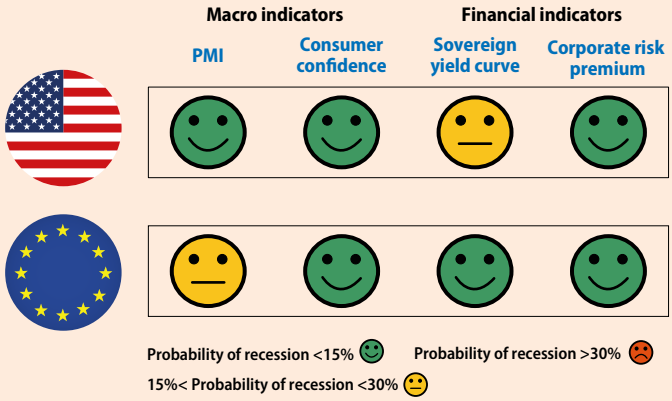
In this era of immediacy and compulsive tweets, pessimism (when it is not alarm) reigns supreme. Many analysts and citizens already take it as a given that a financial crisis is coming in 2020. What truth lies in this bold assertion? Is a recession inevitable? In this article, we begin the now classic Outlook Dossier of each December by presenting various exercises and reflections to shed a little light.

Slowdown or recession?

We must not deceive ourselves: the world's major economies are in the midst of a slowdown that is proving to be more pronounced than expected and which is set to continue in 2020. In particular, we see a significant slowdown in the US (around 0.5 pps less growth), a stabilisation in the euro area at modest levels, going from a rate of 1.9% in 2018 to 1.1% in 2019, and a gradual slowdown in China, bringing the country's growth to well below 6.0%. All in all, we expect the global economy to grow in 2020 slightly more than it did in 2019, hoisted up by the improvement in economic activity in several emerging economies such as India, Brazil, Turkey and Russia.

The idea of a recession, however, is something quite different,[1] as it would imply a substantial deterioration of the downturn in the major economies compared to our forecast. To seek some clarity on the matter, we analysed the probability of a recession occurring in 2020 in the euro area and in the US, on the basis of the evolution seen of four indicators that are considered key in the literature. These include two macroeconomic indicators (manufacturing PMI and consumer confidence) and two financial indicators (yield curve and corporate risk premium).[2] The results are relatively reassuring, since the probability of recession they suggest is less than 15%, except in two cases where there would be an orange flag (no cases of red flags): **only the US yield curve and the euro area manufacturing PMI show a probability of recession between 15% and 30%** (see first chart).

Risk of recession



Source: *CaixaBank Research, based on a probit model.*

Therefore, we can conclude that, **today, the risk of recession is relatively contained**. This does not change the fact that the slowdown in the global economy is a palpable reality and, indeed, more pronounced than expected a year ago, when there were no orange flags. Can we draw a line under the issue and, while we are at it, the article too? Certainly not. Global factors such as heightened uncertainty in the spheres of politics and trade are behind the slowdown, so any new adverse shocks could lead us into a more sombre situation. That is why it is key to assess the sensitivity of growth to these risks, which is what we analyse in the next section.

Analysis of the main risks in 2020

In part, the economic slowdown in which we are currently immersed is the result of the greater maturity of the business cycle in the world's major economies. Intuitively, when the unemployment rate is at minimum levels, as is the case in Germany and the US, it is harder to expand production since hiring new staff is more difficult. This more mature phase of the cycle led us to believe that the slowdown would be gradual, especially since the major economies do not generally have any significant macroeconomic or financial imbalances (the most obvious exception is the high corporate debt in China). The problem is that there have been two adverse shocks affecting economies that are already in a slowdown due to the cycle: on the one hand, an **uncertainty shock** caused by the **trade war** between the US and China and by heightened political tensions and, on the other, **the contraction of the manufacturing sector**, which has been particularly painful for the automotive industry.

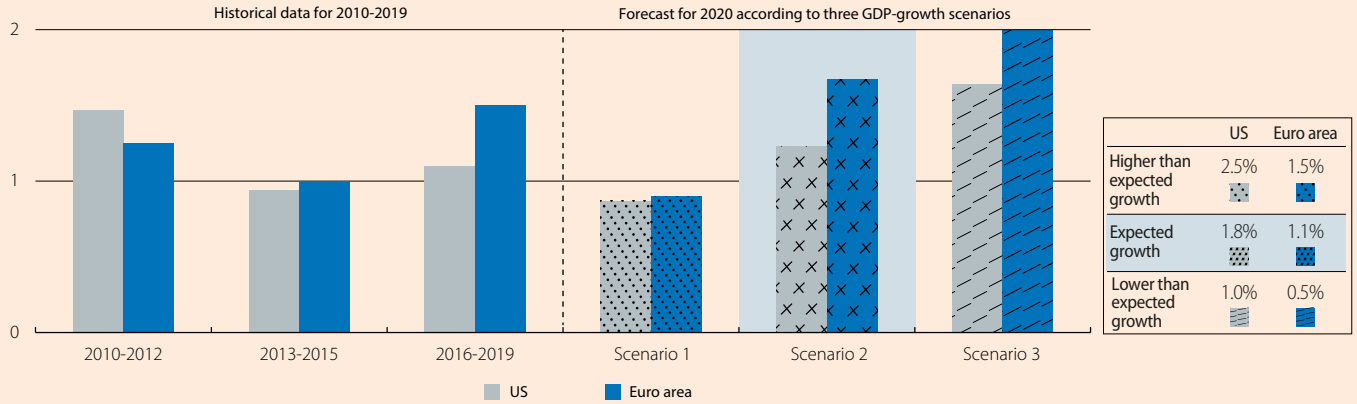
How will the political and trade risks evolve in 2020? To answer this question, we have used the historical relationship to estimate the sensitivity of economic growth to changes in the political uncertainty index developed by the economists Baker, Bloom and Davis, controllers for the main macroeconomic variables in both the US and the euro area. The results, presented in the second chart, show that **our growth outlook is consistent with a stabilisation of political uncertainty at relatively high levels**.

Even so, **in the US we cannot rule out a significant increase in political uncertainty due to the new electoral cycle**, which could shave more than 5 decimal points off growth according to our sensitivity analysis. The key will lie in how the impeachment process against President Donald Trump unfolds and the degree of polarisation in the November 2020 presidential elections. A

1. Technically defined as two consecutive quarters with negative quarter-on-quarter growth.
2. We use a probit model with a binary dependent variable equal to 1 if quarter-on-quarter growth is negative, and of 0 if it is not. We estimate the impact of each indicator on this variable over different time horizons (one quarter in the future, in two quarters, etc.). Subsequently, we predict the probabilities of a recession occurring in 2020 using the latest data from the indicators.

Political uncertainty index for the US and euro area

Level



Note: *The political uncertainty index is divided by its average in order to normalise it. The data for 2019 correspond to the average of the first three quarters. We plot growth in the US and the euro area against the uncertainty index and the main macro variables, and we predict the value of the index that corresponds to the growth we expect in 2020. We then use the econometric relationship between growth and uncertainty to estimate how much uncertainty diverts from the expected scenario if growth proves to be higher or lower than expected.*
Source: *CaixaBank Research, based on data from Eurostat, BEA and Baker, and Bloom and Davis (2016).*

moderate Democrat candidate could lower the fierceness of the electoral campaign, while a candidate with a more heterodox position could lead to a more intense electoral confrontation that might bring with it greater uncertainty.

In the euro area, **our estimates suggest that we will not see a dramatic increase in political uncertainty in 2020**. On the one hand, the likelihood of a hard Brexit has fallen significantly (but not disappeared), although the discussions to forge the new trade agreement between the United Kingdom and the EU will play a prominent role in 2020. On the other hand, the new coalition government in Italy is taking a more constructive approach, while the new year is mostly clear in electoral terms, since there are no major election dates on the calendar at the European level (at least in theory).

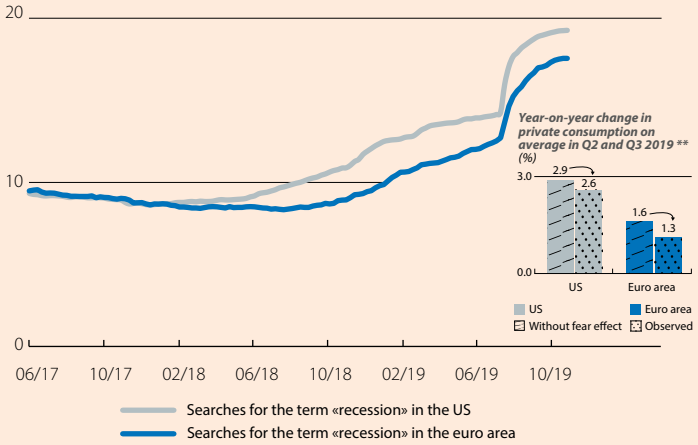
The fear effect

As we have seen, our scenario does not envisage a global recession. However, there is one factor that could amplify the downturn and which we must not lose sight of. This is the so-called fear effect: if the risks described and the way they are perceived end up affecting consumer confidence and business sentiment, then the scope of the uncertainty shock could be greater. To avoid creating a fear effect, **it is critical that the main economic institutions, and economists as a collective, make a balanced assessment of the macroeconomic scenario** and avoid falling into unfounded alarmism. Otherwise, this could contribute to creating a climate of rampant pessimism that leads to growth falling by more than expected.

In the case of the private sector, we have already seen how the latest business sentiment indicators in the services sector are registering levels that, while reasonable, are somewhat less comfortable. As for households, we have assessed whether a fear effect is occurring that is eroding private consumption in the US and the euro area. To do this, we analysed the portion of the change in consumption that is not explained by either the macroeconomic fundamentals or uncertainty, and which could be related to emotions such as fear, pessimism or, on the contrary, excessive confidence. The results, presented in the third and last chart, show that the fear effect exists and is playing a relatively important role both in the US and in the euro area.

Searches for the term «recession» on Google and impact of the fear effect on private consumption

*Level (12-week moving average) **



Notes: **A value of 100 indicates a term's peak popularity. Average of the popularity indices weighted by the GDP of Germany, France, Spain and Portugal. ** We estimate the consumption predicted by the macroeconomic fundamentals and uncertainty, and then compare it with the growth predicted by these variables plus the fear effect (i.e. we include in the new regression the first lag of the residual of the regression of consumption growth against the fundamentals and political uncertainty).*
Source: *CaixaBank Research, based on data from Google Trends.*

In short, everything suggests that 2020 will be a year marked by a continuation of the economic slowdown in the major economies. Nevertheless, it seems unlikely that we will fall into a global recession (in fact, our forecasts point to global growth of slightly over 3.0%). However, containing the surge in trade-related and political uncertainty, which have already claimed a heavy toll, will be key, as will be an adequate response from economic policy. As such, 2020 will be a demanding year, but things may turn out better than some doomsayers would suggest.

Javier Garcia-Arenas

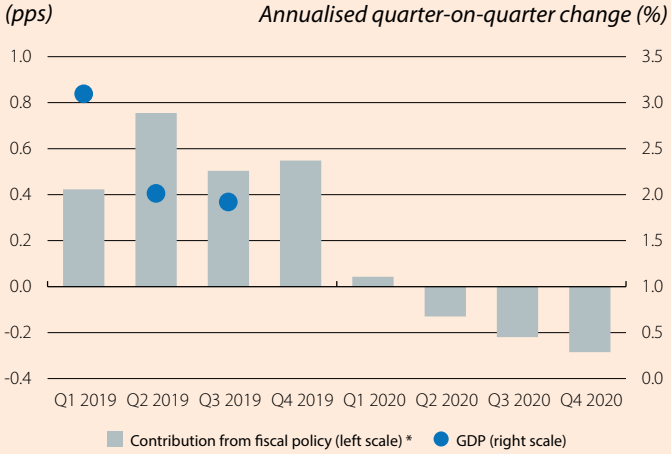
What margin for manoeuvre does economic policy have?

After several years of expansion, the global economy has slowed down in recent quarters and the risks of recession have begun to generate concern. All eyes have now focused on how monetary and fiscal policies could help to spur the economy. Monetary policy has already made a move: the Fed has cut interest rates three times and the ECB has issued a new stimulus package.

Monetary policy: still the only game in town?

In the last decade, the bulk of the responsibility for stabilising the economy has fallen on the central banks, to the point that monetary policy has become known as «the only game in town». However, **both the intensity of the turbulence experienced since 2008 and the strong latent structural dynamics**[1] **have reduced the central banks' scope for future action**. As an example, in 2007 the Fed started from an interest rate of 5.25% (which allowed for 20 cuts of 25 bps before hitting 0%). In contrast, in the last hiking cycle (between 2015 and 2018) the Fed only managed to raise rates up to 2.50%.

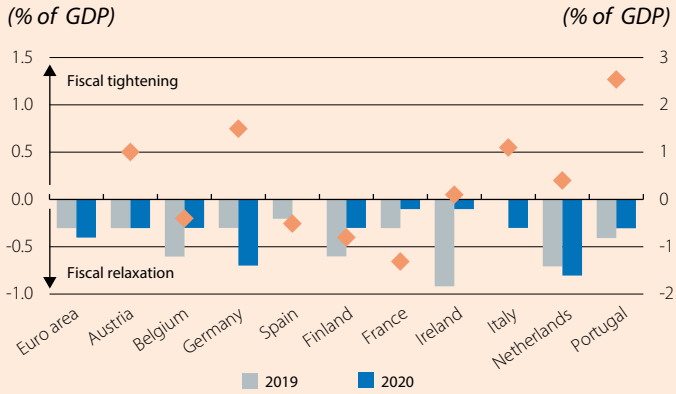
US: contribution of fiscal policy to GDP



Note: ** According to the methodology of the Hutchins Center, a positive contribution indicates that fiscal policy pushes GDP growth above its potential (and vice-versa).*
Source: *CaixaBank Research, based on the estimates from the Hutchins Center Fiscal Impact Measure.*

Despite their lower margin for action, in 2019 the **central banks have already exhausted much of the available space**. In the US, the three 25-bp cuts implemented by the Fed have consumed one third of the 225-bp margin it had available for reducing reference rates. In Europe, meanwhile, the ECB could run out of space to purchase more public debt securities towards the end of 2020, if it maintains the current limits under which it cannot buy more than 33% of each issue. On the other hand, with the latest rate cut, the ECB could be approaching the so-called «reversal rate»: the level at which a further reduction in the reference rates would have contractionary effects on the economy (estimates place this rate at around –1.0%, relatively close to the –0.50% at which the depo rate currently stands).[2] This proximity shows that the margin for monetary policy stimulus is more limited than in the past.

*Euro area: position of fiscal policy * and primary structural balance ***



Notes: ** The position of fiscal policy (left scale, columns) provides an approximation of the change in the primary structural fiscal balance. ** The primary structural balance forecast for 2020 (right scale) is represented with diamond-shaped markers.*
Source: *CaixaBank Research, based on the European Commission's assessment of the 2020 Draft budgetary plans.*

Furthermore, a growing number of voices are warning of the costs of a long period of negative rates. In fact, in Sweden, despite a reduction in the outlook for growth and inflation, the Riksbank has decided to wind back its policy of negative rates.[3]

In the US, unlike in the euro area, **the Fed still has a margin of 150 bps in its reference rates**, and in the event of a significant deterioration in the economy, it would still have the option of reactivating asset purchases. **However, fears that monetary policy is approaching its limits have resonated strongly in the euro area** and calls have intensified for fiscal policy to step forward in 2020.

The struggle of fiscal policy

In the US, although **the estimates presented in the first chart suggest that fiscal policy will deduct some growth** (after having contributed substantially in 2018-2019), the indicators point towards a reasonably favourable performance from economic activity. In addition, the Fed still has room for manoeuvre. Moreover, with the presidential elections looming (to be held in November 2020), the Trump administration could renew the fiscal stimulus in the event of a more marked slowdown in the economy.

In the euro area, on the other hand, some form of fiscal stimulus is expected. As shown in the second chart, according to the budgetary plans presented before the European Commission, in 2020 a fiscal stimulus of 0.4 pps of GDP is expected across the euro area as a whole.[4] The main drivers are, essentially, Germany (0.7 pps) and the Netherlands (0.8 pps), while a more modest

1. That is, the fall in the natural rate of interest. See the various articles of the Dossier «The future of financial conditions: a paradigm shift?» in the MR02/2019.
2. See the article «The farewell of (Super) Mario Draghi» in the MR11/2019.
3. The Riksbank raised rates from –0.50% to –0.25% in December 2018 and, last October, sent a clear message of its intention to raise them to 0% in December 2019. This is despite the analysts' consensus revising the forecast for GDP growth in 2020 from 1.8% to 1.2% over the last few quarters (as well as revising the inflation forecast from 2.0% to 1.7%).
4. Projected change in the structural primary balance between 2019 and 2020, according to the European Commission's analysis of the 2020 Budget Plans.

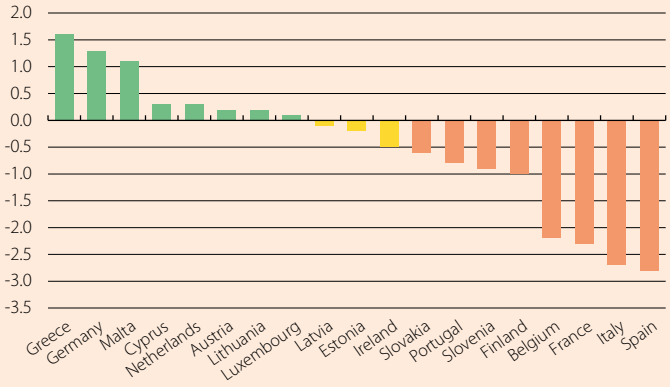
stimulus is anticipated in Italy (0.3 pps) and France (0.1 pps). In Spain, a relatively neutral fiscal policy is expected.

To estimate the impact of this fiscal stimulus, we must take into account how it affects the other components of the economy. We can obtain this information from the so-called «fiscal multipliers», which estimate the net effect that an increase in public expenditure has on GDP. **According to the consensus in the economic literature, the multipliers for public expenditure stand between 0.6 and 0.8,[5] meaning that the budgetary plans would boost growth by around 0.3 pps in 2020.**

The third chart shows that **the space for an additional fiscal push in the euro area is somewhat limited and unevely distributed**. In this context, the following items take on an important role. Firstly, the **fiscal multipliers are higher in a low interest rate environment**, so it is possible that the multipliers of the euro area are actually higher than those mentioned. For instance, using data for the US, Ramey and Zubairy (2018)[6] found that the multiplier for public spending rises to 1.7 when the reference rates stand at 0%.

*Euro area: fiscal space **

(% of potential GDP)



Note: ** Difference between the structural fiscal balance projected by the 2020 Budget Plans and the target structural balance per the medium-term budgetary framework (MTBF).*
Source: *CaixaBank Research, based on the European Commission's assessment of the 2020 Draft budgetary plans.*

On the other hand, fiscal stimuli generate externalities which, in a union like the euro area (i.e. with a fixed exchange rate and a common monetary policy), **are essentially channelled through trade**. In particular, according to the multipliers estimated by Dabla-Norris *et al.* (2017),[7] which we reproduce in the fourth chart, the spillover from the aforementioned fiscal stimulus in Germany or the Netherlands could add 0.1 pp to the growth of the euro area periphery.

The importance of smart fiscal policy

The causes of the slowdown (especially uncertainty and the maturity of the business cycle) generate doubts over the effectiveness of classical fiscal policies. It should be borne in mind that fiscal multipliers are higher when the use of an economy's productive capacity is low, and they are lower in economies with higher levels of debt (due to a potential tightening of the financial conditions if the sustainability of the debt is called into question). However, in the euro area, greater fiscal space is to be found in economies with a high degree of resource utilisation, while those economies that have higher unemployment also have limited fiscal space and higher debt.

Euro area: fiscal multipliers and externalities

Ratio between the cumulative change in GDP and the cumulative change in public expenditure

Recipient country of the stimulus	Country of origin of the stimulus: Germany	France	Netherlands	Italy	Spain	Portugal
Germany	**0.71** (0.63-0.82)	0.22 (0.14-0.31)	0.21 (0.15-0.26)	0.11 (0.07-0.15)	0.08 (0.05-0.11)	0.06 (0.03-0.08)
France	0.09 (0.06-0.12)	**0.53** (0.45-0.61)	0.07 (0.05-0.10)	0.06 (0.04-0.10)	0.04 (0.02-0.06)	0.03 (0.02-0.04)
Netherlands	0.17 (0.13-0.20)	0.14 (0.09-0.20)	**0.52** (0.46-0.58)	0.07 (0.04-0.10)	0.05 (0.03-0.07)	0.03 (0.01-0.05)
Italy	0.13 (0.09-0.17)	0.16 (0.11-0.23)	0.11 (0.07-0.14)	**0.50** (0.46-0.54)	0.06 (0.04-0.09)	0.04 (0.02-0.06)
Spain	0.12 (0.08-0.16)	0.14 (0.10-0.20)	0.09 (0.06-0.13)	0.08 (0.05-0.11)	**0.31** (0.27-0.35)	0.06 (0.04-0.08)
Portugal	0.12 (0.08-0.16)	0.15 (0.09-0.20)	0.08 (0.04-0.12)	0.07 (0.03-0.10)	0.07 (0.05-0.10)	**0.29** (0.25-0.33)

Note: *The ratios shown in the diagonal path (in blue) are the fiscal multipliers, while all other values show the externalities, or spillovers, in the other countries. The figures in brackets indicate the confidence intervals at 68%.*
Source: *M.E. Dabla-Norris* et al. *(2017). «Fiscal Spillovers in the Euro Area: Letting the Data Speak». IMF Working Paper.*

The complexity of the current environment requires the design of fiscal policy to be refined. In this regard, **a boost to investment focused on infrastructure, new technologies and the energy transition would have the virtue of providing a fiscal stimulus** to combat the cyclical slowdown, while at the same time **reducing the uncertainty** surrounding the structural transformations affecting the major economies **and boosting potential growth**.

With all this, what can we expect to see? On the one hand, although Germany and the Netherlands have a considerable fiscal space, both countries have traditionally ended up implementing a policy that is less expansionary than expected. On the other hand, **the presence of positive externalities between euro area countries and the differing margin for fiscal policy highlight the importance of developing a supranational fiscal authority**, with the ability to implement a coordinated fiscal policy.[8] Will the euro area be capable of giving itself capacity to implement fiscal policy before the next recession?

Adrià Morron Salmeron

5. V.A. Ramey (2019). «Ten years after the financial crisis: What have we learned from the renaissance in fiscal research?» Journal of Economic Perspectives, 33(2), 89-114.
6. V.A. Ramey and S. Zubairy (2018). «Government spending multipliers in good times and in bad: evidence from U.S. Historical data». Journal of Political Economy, 126(2), 850-901.
7. M.E. Dabla-Norris *et al.* (2017). «Fiscal spillovers in the Euro Area: letting the data speak». International Monetary Fund.
8. The EU budget being discussed for the period 2021-2027 is of a modest size: around 2% of total public spending and 1% of the EU's gross domestic income.

The Spanish economy in 2020: things are not looking so bad

The end of the year is drawing near, and with it comes our usual exercise of reviewing the outlook for the economy over the next year. As we shall see, we anticipate that growth will moderate in 2020, but this moderation will be nothing else than a transition towards a phase of more gentle growth following a long cycle of economic recovery.

In the past six years, the Spanish economy has gone through a spell of strong economic growth which has enabled it to recover – and, in the case of some indicators, exceed – the levels of economic activity seen prior to the financial crisis.[1] However, as early as in 2018 the economic recovery began to lose some steam and this trend has continued throughout 2019. GDP growth went from 2.9% in 2017 to 2.4% in 2018 and a variety of indicators suggest that the economy will end 2019 with growth of around 1.9%-2.0%. This moderation has materialised through two channels: the smaller boost from the foreign sector and the moderation in household spending. Let us look briefly at each of these channels, since they will prove useful for helping us to understand the outlook for 2020.

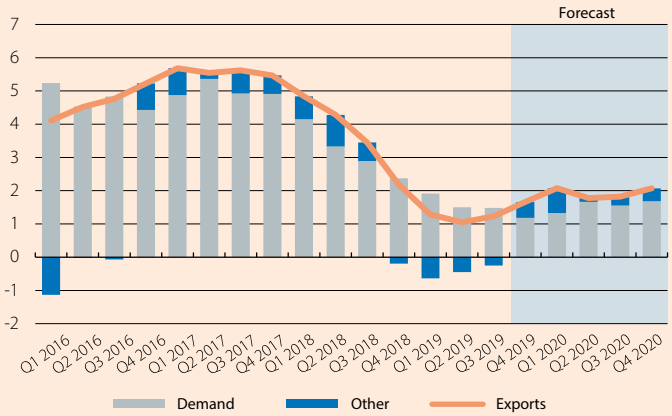
The key factors for 2020: the foreign sector and consumption

With regard to the foreign sector, in the first chart we show the year-on-year growth of Spanish exports and its breakdown between foreign demand[2] and a residual term.[3]

At first glance, we see how the slowdown in foreign demand explains much of the slowdown in export growth. What factors lie behind this decline in foreign demand? There are at least two such factors: firstly, in March 2018, the trade tensions between the US and China began to escalate, and secondly, 2018 also marked the beginning of a gradual slowdown of growth in the euro area.[4]

Spain: breakdown of exports

Contribution to growth (pps)



Note: *This breakdown is calculated using a first-difference regression estimated using an ordinary least squares method, including a variable that captures foreign demand as a regressor.*
Source: *CaixaBank Research, based on data from the National Statistics Institute.*

The second factor that has contributed to the slowdown in the growth rate has been the moderation in private consumption: whereas in 2017 consumption was growing at a rate of 3.0% per annum, the latest forecasts (which incorporate data for the first three quarters of the year) place growth for 2019 at 1.2% per annum. While the slowdown was initially caused by a lower contribution from non-durable goods in its first phase (between Q4 2017 and Q3 2018),[5] in recent quarters the moderation of growth in consumption has been driven by durable goods, which are currently generating a negative contribution. This is likely to be due to a slowdown in household spending on vehicles:[6] faced with an increase in regulatory uncertainty and the challenge of technological change (the replacement of combustion by electric engines), consumers may have chosen to postpone their spending plans until these unknowns have cleared.[7] If this is the case, spending on vehicles could experience a rebound effect as these unknowns dissipate, due to the pent-up demand that is currently accumulating.

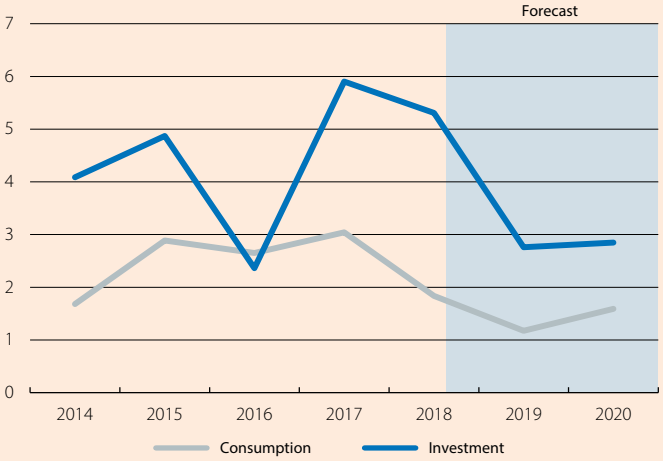
So, what can we expect for 2020? All the indicators suggest that next year will be defined by the same key elements. As we can see in the first chart, to the extent that global growth, and that of the euro area in particular, remains contained, **we do not expect to see a significant surge in exports**. Therefore, the foreign sector will continue to provide very modest contributions to growth. Moreover, the global environment will remain a source of risk. Brexit, the trade negotiations between the US and China, and the difficulties experienced by the automotive sector at the European level are factors that are still far from being resolved.

1. For example, GDP in Q3 2019 stood 7% above the peak reached in 2007.
2. Built as a weighted average of the imports from Spain's main trading partners.
3. This component includes everything not captured by the foreign demand component. This may include changes in the relative competitiveness of Spanish exports compared to its main competitors.
4. The year-on-year growth of the euro area in Q4 2018 stood at 1.2%, which is 1.8 pps lower than in Q4 2017.
5. We analysed the causes of this behaviour in the article «Quo Vadis, consumption?» from the MR11/2019.
6. One indicator that suggests this possibility is that of vehicle registrations, which in year-on-year terms have fallen by an average of 7.0% between October 2018 and July 2019.
7. The regulatory uncertainty is due to both doubts surrounding the mix of taxes that governments will impose on vehicles and possible restrictions on the movement of combustion-engine vehicles.

Furthermore, we anticipate a moderation in the growth rate of **domestic demand,** though it will remain the **main driver of the economy. Household incomes will continue to grow at notable rates,**[8] thanks to the rise in wage growth, which will offset the slowdown in job growth. This growth in incomes will allow consumption to rise slightly above the figures for 2019. All in all, as can be seen in the second chart, this upswing will be limited and we anticipate that households will continue to rebuild their savings buffers in response to a somewhat more modest macroeconomic outlook. While this increase in savings will weigh down on the economy's growth rate in the short term, it will give it greater resilience for the future. Finally, we anticipate that investment will continue to grow thanks to the reasonably good prospects for domestic demand and the accommodative financial environment, albeit at more moderate rates due to the difficulties of the manufacturing sector.[9]

Spain: consumption and investment

Annual change (%)



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

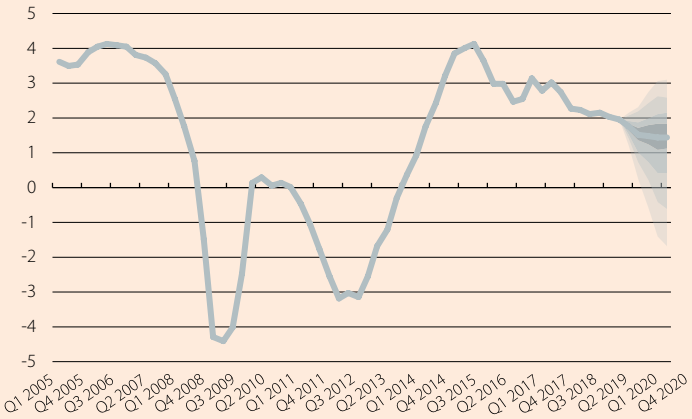
Taking all the factors set out above into account, **we anticipate that the economy will grow by 1.5% in 2020**, a modest rate compared to the average growth rate of 2.7% between 2014 and 2018, but higher than the growth forecast for the euro area (around 1.0%).

Will there be a recession?

Over these past few months, a climate of concern has formed among public opinion over the possibility that a new recession could grip the Spanish economy in the coming quarters.[10] In view of this, it is worth reflecting on whether this concern is justified.

Spain: GDP

Year-on-year change (%)



Note: *The degree of transparency of the shaded area provides an indication of the probability of deviation relative to our forecasts. Lighter colours mean a lower probability of occurrence. For reference, the lightest band of the lower part of the chart corresponds to a probability of occurrence of between 10% and 20%.*
Source: *CaixaBank Research, based on data from the National Statistics Institute.*

In order to shed some light on this dilemma, we use a macroeconomic model that we have developed here at CaixaBank Research.[11] The third chart shows the evolution of GDP growth that we expect to see up until Q4 2020, as well as the deviations from our forecasts that we could see if shocks that alter the expected growth trajectory occur. We estimate that **the probability of a negative shock materialising in 2020 that is significant enough to plunge the Spanish economy into a new recession is 15%.**[12,13] This probability, together with the trend of GDP we expect for 2020 with a growth of 1.5%, tells us that Spain is in a period of deceleration consistent with a more mature phase of the expansionary cycle and with a low risk of recession, which should reassure us a little. As is sometimes said: *things are not looking so bad, after all!*

Oriol Carreras and Eduard Llorens i Jimeno

8. In nominal terms, we expect growth of around 4%. The growth in Q2 2019, the latest available data, was 4.5% on a four-quarter cumulative basis.
9. The sector is feeling the impact of greater protectionism at the international level, the decline in foreign demand and the idiosyncratic difficulties being experienced by the automotive sector itself.
10. Proof of this is the fact that the word «recession» is currently as popular in Google searches as it was during the euro crisis.
11. This is a general equilibrium semi-structural model of the Spanish economy, where the short term is determined by aggregate demand while, in the long term, aggregate supply and demand are equal.
12. Probability of there being at least two consecutive quarters with negative quarter-on-quarter growth between Q4 2019 and Q4 2020.
13. A probability of 15% implies an event that occurs, on average, once in every 7 years. In this regard, it is more similar to an episode like the dotcom crisis (between 2000 and 2002), which caused a marked slowdown in the US economy but had a moderate global impact, than it is to an episode like the financial crisis, which has a much lower probability of occurence (less than 5%).

The Portuguese economy in 2020: a positive economic outlook, but greater uncertainty

After growing by an average of 3.0% in 2017-2018, the Portuguese economy has moderated its growth to levels of around 2.0% in 2019. The entry into a more mature phase of the cycle and the fading of temporary support factors that drove growth in recent years are the main causes behind the more moderate expansion. Even so, this rate is sufficient to support Portugal's convergence with the rest of the euro area without generating macro-financial imbalances.

To address 2020, we must first conduct a brief review of 2019. Domestic demand has continued to make a notable contribution to growth, similar to that of 2018. It has also continued to benefit from the strong performance of private consumption, which in turn relies on the strength of the labour market. However, it is investment that has stood out in 2019, and its acceleration has been visible in all its components: machinery, transport and construction. Nevertheless, the acceleration of investment has contributed to a greater growth in imports than in exports, meaning that the foreign sector's contribution to economic growth has been negative (–1.2 pps). As a result, the current account and capital balance fell to 0.2% of GDP.

Portugal: macroeconomic table

Year-on-year change (%)

	2018	2019	2020	2021
Real GDP	2.4	1.9	1.7	1.6
Private consumption	3.1	2.2	1.9	1.7
Public consumption	0.9	0.5	0.2	0.2
Gross fixed capital formation	5.8	7.4	4.4	4.4
Exports	3.9	2.5	2.3	2.6
Imports	5.9	5.2	3.7	3.3
Domestic demand (contrib.)	3.1	2.8	2.1	2.0
Foreign demand (contrib.)	–0.8	–1.2	–0.6	–0.3
Variation of stocks (contrib.)	0.1	0.3	0.3	0.0

Source: *CaixaBank Research.*

What can be expected for 2020?

First of all, **2020 will be marked by the prolongation of the global uncertainty factors** (trade tensions, Brexit, geopolitical conflicts, etc.) that are already present in 2019. These factors will particularly affect the export sector, which will maintain a moderate rate of growth, and investment, insofar as both the increase in uncertainty and the disruptions occurring in the automotive sector could lead to the postponement of investment decisions. However, we anticipate that the deceleration of growth will be relatively moderate, thanks in part to the fact that the **ECB's accommodative policies** will facilitate the deleveraging process in both the public and the private sectors, and they will support lower financing costs. In addition, if the deceleration is more abrupt than expected, there would be some scope for implementing slightly expansionary fiscal policies to dampen its effects.[1]

Thus, **we expect the economy to grow by 1.7% in 2020**, 2 decimal points less than in 2019. **Domestic demand and exports will be the main drivers of growth**, although their contribution will be somewhat lower than in recent years.

Domestic demand will be affected by the lower growth in private consumption and investment. In the case of consumption, in 2020 it will become even more apparent that households have already practically caught up with the spending decisions that were postponed during the years marked by the financial crisis and the slowdown of job growth. On top of this we have a savings rate at all-time lows, making high-value purchases more unlikely. Investment, meanwhile, is expected to moderate significantly, given that many companies will postpone investment decisions in a global environment marked by heightened uncertainty and lower foreign demand. However, the receipt of EU funds, the strength of residential investment and the low financing costs will continue to support growth of investment above 4.0%.

How will exports evolve?

In the current context, exports are the component that is the most difficult to predict. As such, it is worthwhile performing a more detailed analysis of its outlook, especially if we take into account its leading role in the Portuguese economy's recovery in recent years.

In particular, we analysed the relationship between exports of Portuguese goods and services and the growth of its main trading partners. In the second chart we can see how **the growth of exports began to decline, coinciding with the slowdown in the growth of key partners, which followed a similar trend**. When we analyse the statistical relationship between the two variables, we see that a 1-pp decline in the economic growth of the major trading partners has a 2-pp negative impact on export growth.

1. In addition, the increase in the salaries of public sector workers that has already been approved could have a positive impact on household consumption in 2020.

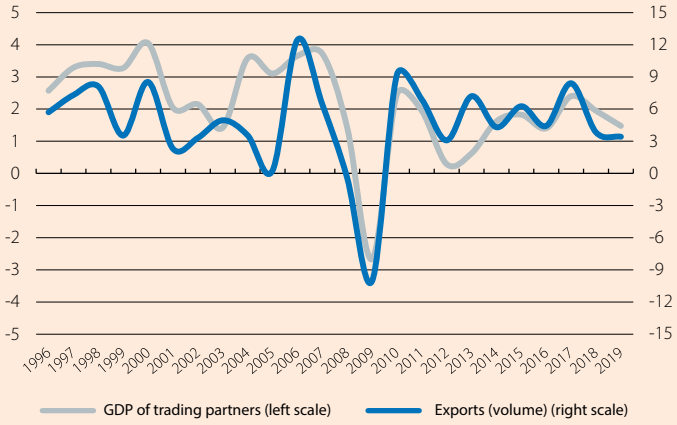
In this way, if we take into account that our forecasts anticipate that Portugal's main trading partners[2] will grow in 2020 by 0.1 pp less than in 2019, export growth could fall by a relatively modest 0.2 pps.

Beyond these estimates, there are risks that could erode the foreign sector more than expected. Firstly, we will have to wait and see what impact Brexit has. This is an important factor insofar as exports to the United Kingdom (Portugal's fourth largest trading partner) represent 4.3% of Portugal's GDP. Secondly, we will have to see to what extent vehicle production and exports could be adversely affected by the postponement of car purchasing decisions, in an environment marked by the deep structural changes of the sector and regulatory uncertainty.

In spite of the risks underlined, one element to keep in mind is that the importer content of Portuguese exports is high (1 euro exported translates into a 44-cent increase in imports). Therefore, the slowdown in exports would result in imports also registering a more moderate growth, mitigating the negative impact of foreign demand on growth.

Portugal: exports and GDP of its trading partners

Year-on-year change (%)



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

Will it be a good year?

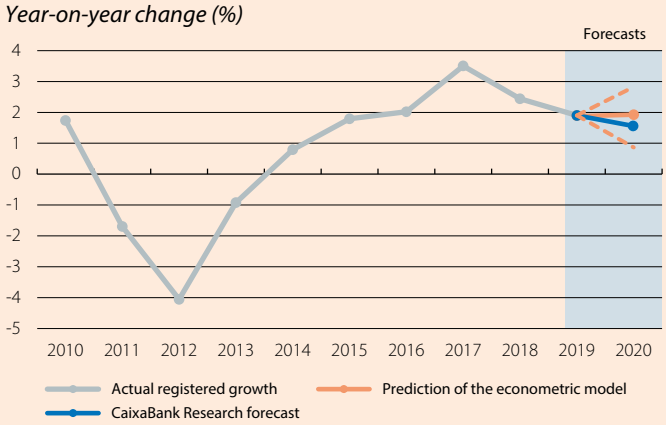
To do this, we make a small model to predict GDP growth in 2020 based on the expected trend of consumer, industry and services confidence indicators.[3] In this regard, the prediction exercise indicates a GDP growth of 1.8% in 2020, very much in line with our forecast (1.7%). Furthermore, **we estimate that the probability of growth exceeding 1.5% stands at 72%**, while the probability of growth being below 0.6% is estimated to be less than 5% (0.6% would mean nil quarter-on-quarter growth in the four quarters of the year).

In short, **the Portuguese economy is currently more resilient than it was in previous episodes of global slowdown**. This time, it has much more solid foundations thanks to the strengthening of competitiveness, the reduction of significant imbalances (the reduction in private debt deserves special mention) and the structural reforms implemented in recent years.

Daniel Belo and Teresa Gil Pinheiro

Portugal: GDP

Year-on-year change (%)



Note: *The prediction of the econometric model is obtained from a regression of growth against the consumer confidence index and the manufacturing and services confidence indices of the National Statistics Institute of Portugal (R^2 of 91%). We estimate the values of the independent variables in 2020 using an AR(1) model, and then we predict the growth in 2020. The dotted lines show 90% confidence intervals.*
Source: *CaixaBank Research.*

2. 86% of all exports of goods and services go to 20 different countries. In order of importance, these include Spain (~20%), France (~13%), Germany (~11%), the United Kingdom (~10%), and the US (~5%). Angola and Brazil are in 8th and 9th place, respectively, with market shares of less than 3%, while China is in 15th with only a 1% share.

3. We predict the values of these indicators in 2020 using an AR(1) model, and then use these predictions to forecast growth in 2020. We then plot GDP growth against the consumer and business confidence indicators. The main specification is $GDP\ growth_t = \beta_0 + \beta_1 * Consumer\ confidence_t + \gamma * Manufacturing\ business\ confidence_t + \alpha * Services\ business\ confidence + \varepsilon_t$, using annual data beginning in the year 2002. Data from the National Statistics Institute.

Through our studies, we help 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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Design and production: www.cegeglobal.com
Legal Deposit: B. 21063-1988 ISSN: 1134-1920

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