

July 17, 2019

SPAIN SCENARIO 2019-2020

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“

Economic momentum continues to surprise despite some clear signs of slack

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Without a government, despite a deteriorated economic climate and weak growth in the euro zone, the Spanish economy continues to surprise. First quarter growth figures were above expectations leading to an upward revision of growth forecasts. The collapse of the government and the calls for snap elections do not seem to have altered economic sentiment. Quite the contrary, Pedro Sanchez's social measures probably contributed to the slight optimism in the second quarter. Domestic demand remains robust on the back of buoyant investment performance and supportive fiscal policies.

And yet, evidence of a sharper slowdown has been gaining momentum. The boost of the SMI revaluation on wages, wealth effects linked to the financial markets recovery and the rise in house prices did not turn to consumption, as households opted for precautionary saving. Industry is suffering from the decline in exports, particularly in Europe. The decline in durable consumer goods production is spreading to intermediate goods. The shock on the automotive sector caused by delays in approvals has still not been absorbed and the slight improvement in industrial production in Q2 is attributable

to the recovery in the pharmaceutical sector. Unemployment rates continue to fall but job creation is running out of steam. Growth in 2019 is likely to remain above the Eurozone average, but Spain will have a tough time avoiding Europe's economic downturn, at a time when the country is likely to be plunged into a political crisis similar to the one in 2016. The elections did not allow Pedro Sanchez to build a majority and if he fails to secure support before the July confidence vote, new elections could be called in November.

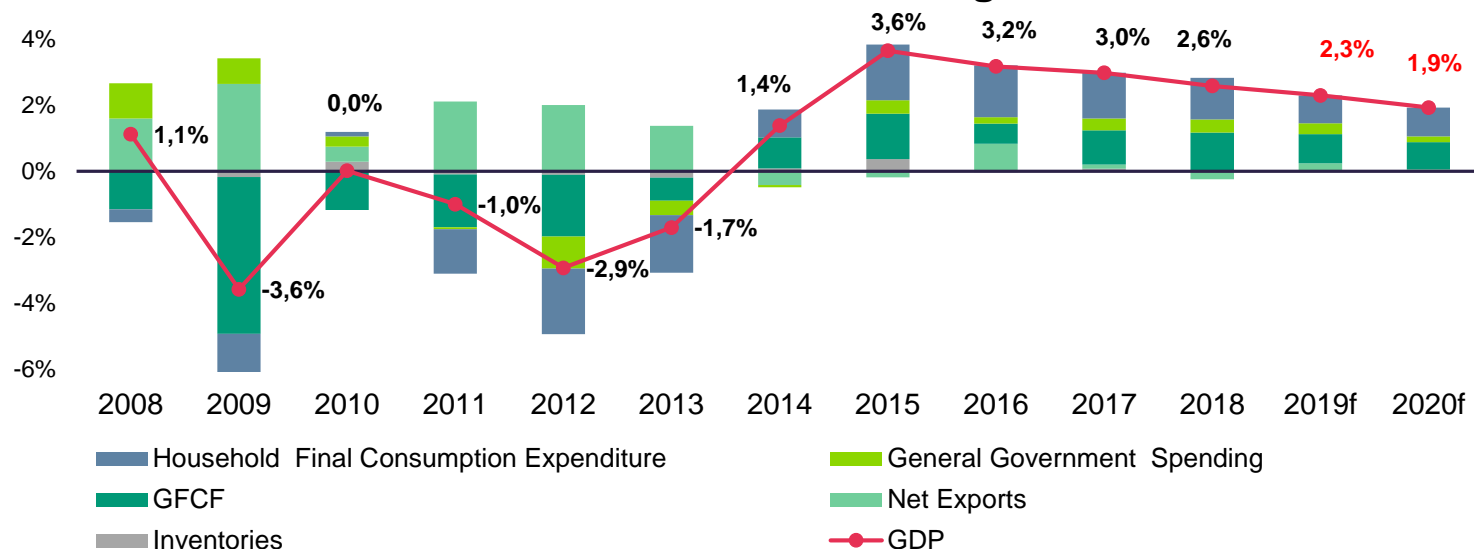
Household consumption growth remained subdued in Q1 but should gradually recover in Q2, driven by a still sustained rise in disposable income and low inflation. The rebound is likely to be short-lived and household expenditure growth should weaken as disposable income growth moderates and labour market conditions worsen.

The pace of investment is likely to ease somewhat. The weakening industrial cycle and political paralysis towards which Spain seems to be heading should weigh on business confidence in the coming months. Construction, which is still recovering, will contribute positively to GFCF in 2019 and then stabilize gradually as domestic demand slows and activity in the tourism sector weakens.

Public spending has largely offset the decline in external demand. During its nine months in office, Sanchez's government favoured a social policy targeting low-income households in line with the measures put in place by Mariano Rajoy. Although the bill was not passed, many of these measures were part of the 2019 budget. This increase in public spending is expected to be balanced by an increase in fiscal revenues, which are still benefiting from a favourable economic outlook. While Spain closed the excessive deficit procedure in June by exiting the corrective part of the public finance supervision process, the government deficit is expected to remain below the 3% threshold for the second year in a row. Nevertheless, the public deficit will still be significantly higher than the SGP target.

Net exports: Export growth is likely to decelerate further, but a drop in imports, amplified by a Q1 base-effect, should lead to a slight positive contribution of net exports.

Contributions to annual GDP growth



Sources : Eurostat, Crédit Agricole S.A / ECO

Spain	2018	2019	2020	2019				2020			
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP	2,6	2,3	1,9	0,7	0,5	0,5	0,5	0,5	0,5	0,4	0,5
Households consumption	2,3	1,6	1,6	0,3	0,4	0,4	0,4	0,4	0,4	0,4	0,4
Investment	5,3	4,0	3,6	1,5	1,5	0,9	0,8	0,9	0,9	0,8	0,8
Change in inventories*	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Net export*	-0,2	0,2	0,1	0,1	-0,1	0,0	0,0	0,0	0,0	0,0	0,0
Unemployment	15,3	13,7	12,6	14,2	13,7	13,5	13,2	13,0	12,7	12,5	12,3
Government net lending	-2,5	-2,3	-2,0								

* Contributions to GDP growth

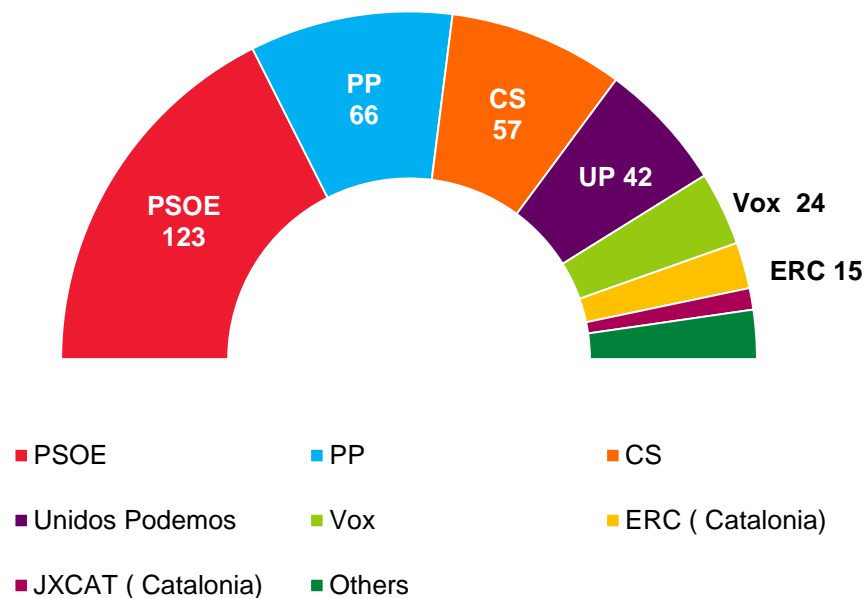
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FOCUS 1 : PEDRO SANCHEZ' TRICKY BET TOWARDS SNAP ELECTIONS IN NOVEMBER?

Outcome of the 28 April 2019 Spanish general elections

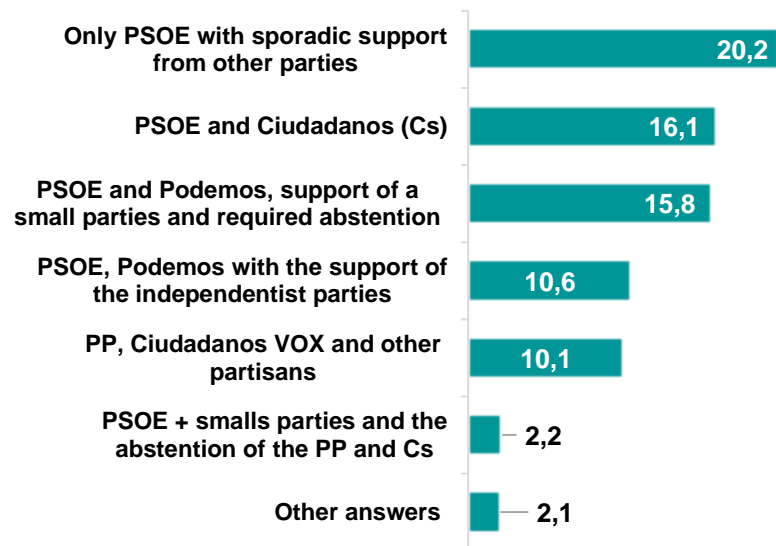


Sources : Ministry of the Interior, Crédit Agricole SA / ECO

Pedro Sanchez, who has emerged as a winner of the 28 April 2019 elections and who was reinforced by the European and regional elections outcome, will have a hard time forming a new government. The incumbent prime minister does not hold a parliamentary majority and must therefore ensure external support for the confidence vote, which is scheduled for 22 and 23 of July. Negotiations with his ally Podemos are stalling and he is struggling to reach an agreement. The socialist leader wants an all-Socialist government while Pablo Iglesias has confirmed his willingness to join the government. If the talks fail, fresh elections could be called for November.

The PSOE could probably get out of this new electoral round stronger, but the risk of not getting a majority remains high and would prolong for as long as the period of uncertainty.

CIS post-electoral survey: Preferential choice in the formation of the new government



**As you know, no political party or force obtained an absolute majority in the April 28 general election. Which of the following solutions to form a government do you prefer?*

Sources : CIS, Crédit Agricole SA / ECO

The CIS* post-election survey of May reveals that 84% of voters would not change their voting intentions from their April choice. They are also increasingly calling for a coalition government formed by the PSOE and Podemos (26.4%, 10 points more than in the last survey). Meanwhile, some socialist deputies that backed Mariano Rajoy in 2016 have made a request to the Popular Party asking it to abstain. Even if the PSOE is not endorsed during the first round of the confidence vote, a simple majority vote in the second round (which would imply abstention by part of the opposition) would allow Pedro Sanchez to form a government. Pablo Casado's negative response and Ciudadanos' refusal to engage in dialogue leaves little room for this scenario. It seems that without an agreement with Podemos, Spain is heading towards a new electoral round.

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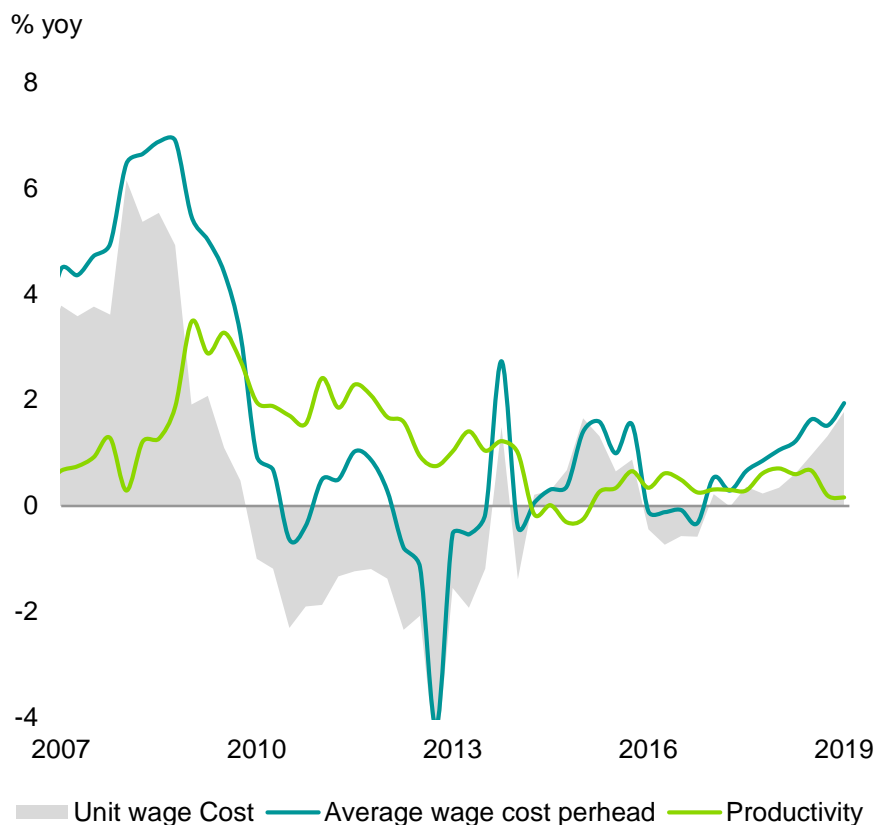
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FOCUS 2 : SMI INCREASE

A MIXED EFFECT MEASURE

Unit labour costs (market sector)



Last point: March 2019

Sources: Eurostat, European Commission, Crédit Agricole S.A / ECO

The 22% increase in the minimum wage, a key measure born out of the Sanchez-Podemos agreement in October 2019, as well as the change in social security contribution brackets, have not been without consequences on labour costs.

The Q1 quarterly labour cost survey shows a 2.1% year-on-year increase in labour costs, the largest rise in five years. This follows seven straight quarters of rises, bringing the average monthly cost per head to €2,550.

The SMI revaluation does not explain by itself the rise in labour costs. The renegotiation of several company and industry collective agreements also led to an average wage increase of 3.4% and 2.2% respectively, as well as a shift in contribution limits that directly penalizes companies (24.8% of social security contributions are the responsibility of the employer) leading to a non-wage costs increased of 3.5%.

Sectors such as services (2.3%), and industry (1.8%) and regions (Extremadura, Galicia) where low wages are most represented, have seen the highest cost increases.

It is currently difficult to assess the impact of the SMI revaluation. While wage increases have spilled over into disposable income, there has been no tangible effect on consumption. Second quarter survey data show, however, a slight improvement in household confidence compared to the first three months of the year.

Meanwhile, rising production costs do not seem to have passed on to prices. Inflation remained contained in the first quarter (0.6%), thereby curtailing a loss of competitiveness. The pace of job creation has slowed even though the unemployment rate has been declining steadily.

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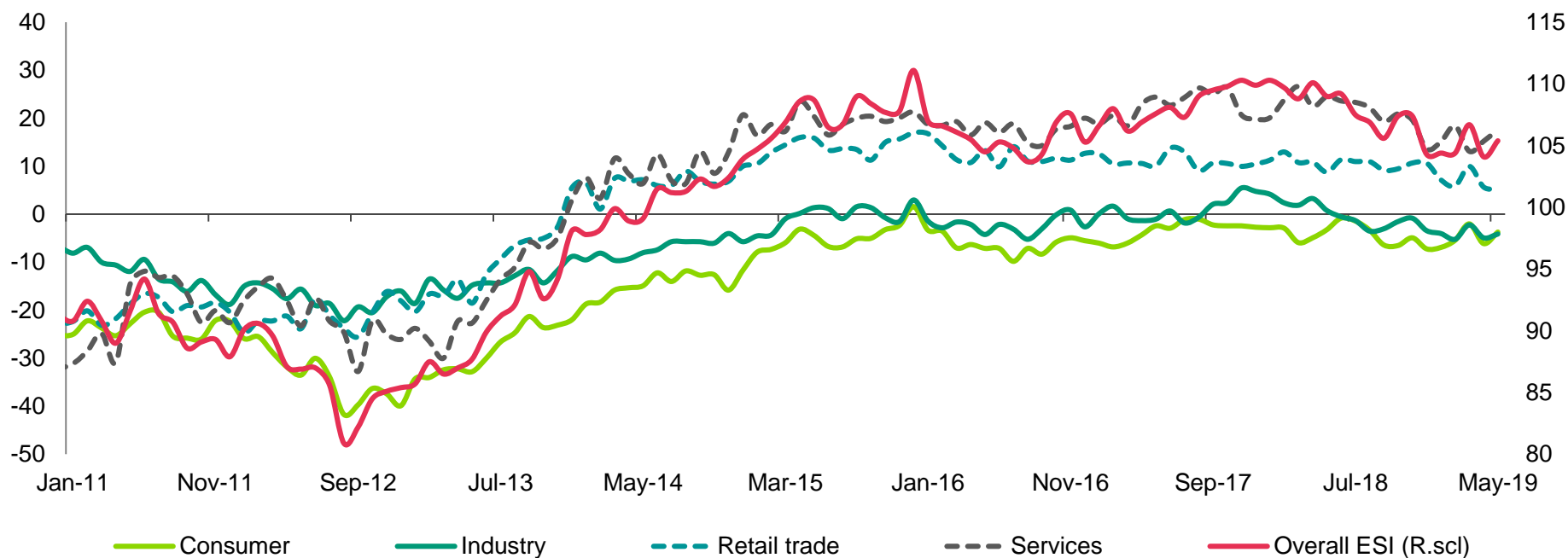
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LATEST CYCLICAL TRENDS

SURVEYS OUTCOMES REMAINING GLOOMY

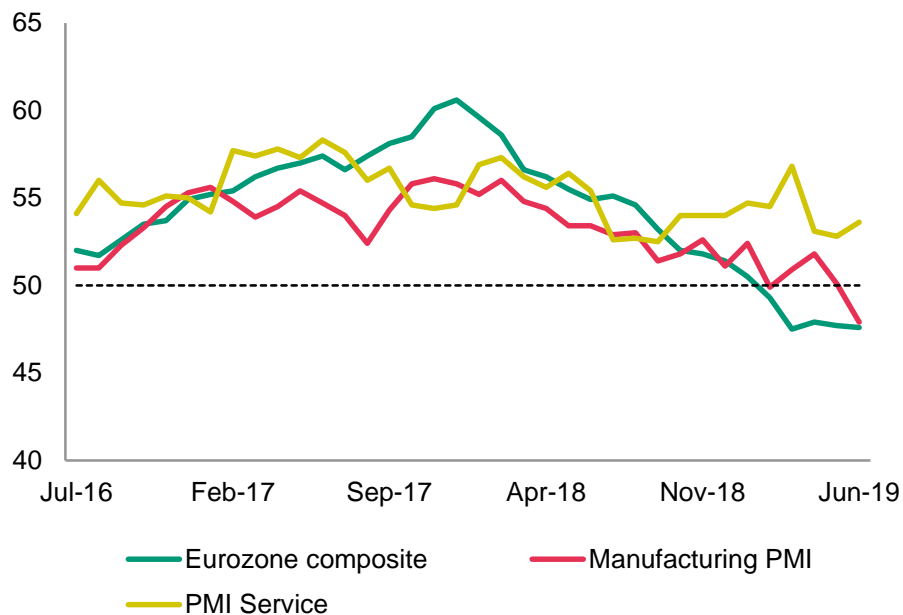
Confidence indicators



Sources: Eurostat, European Commission, Cr dit Agricole S.A / ECO

Business confidence is still suffering from an adverse external environment. Poor prospects in the industrial sector and rising protectionist risks have worsened corporate expectations in industry, which have been eroding since December 2017. The weak consumer confidence has not tarnished the prospects for retail trade and services, which reflect the resilience on the domestic market, but they are not immune to the slackening of the economy. Consumer confidence improved in Q2, slightly offsetting the stagnation in activity in the industrial sector.

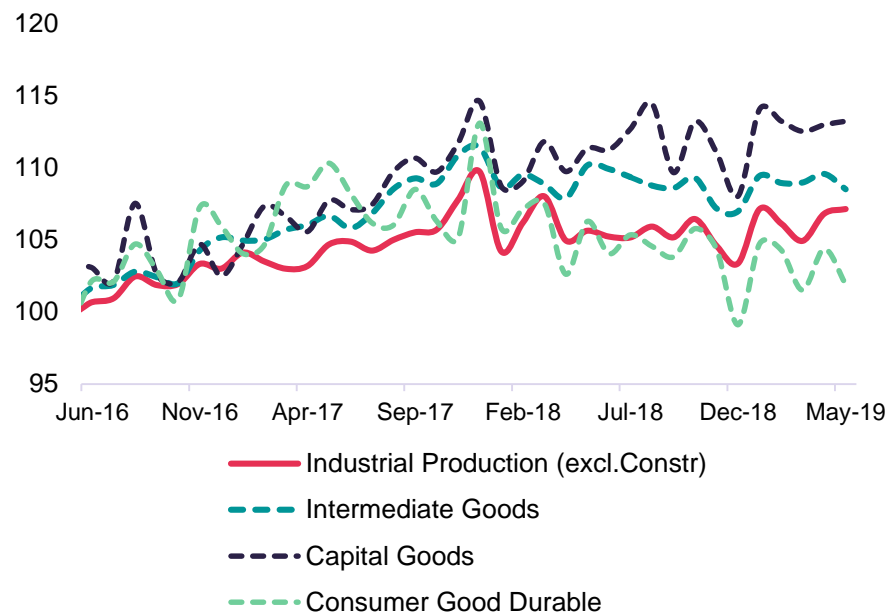
Purchasing Managers Index



Sources: Markit, Crédit Agricole SA / ECO

Spain has been finally caught up by the weakening of the manufacturing cycle. The purchasing managers' index fell for the first time below the 50th threshold in June to 47.9, its lowest point in 6 years. Facing a lack of domestic and foreign opportunities, companies reduced their production and hiring even though input prices were lower. The June moderation in manufacturing output is also reflected in the CIS survey data.

Industrial production



Sources : INE, Crédit Agricole SA / ECO

Still, industrial production recovered slightly in the second quarter with an increase of 0.3% in May following a 1.8% increase in April. This slight rebound is still driven by the production of capital goods, which offset the ongoing decline in the durable consumer goods segment since the start of the year that is spreading to intermediate goods.

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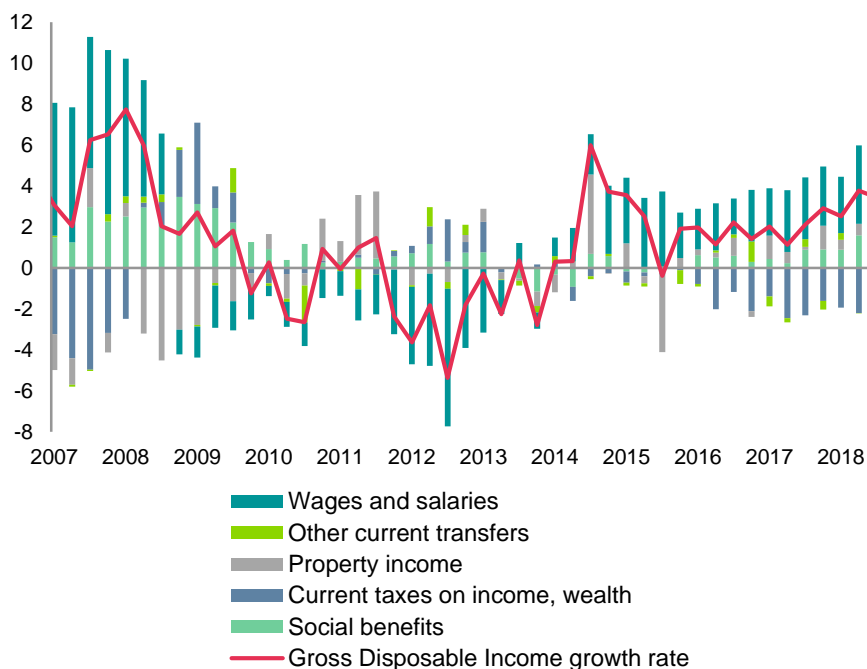
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OUR SCENARIO FRAMEWORK

HOUSEHOLD CONSUMPTION AND WAGES

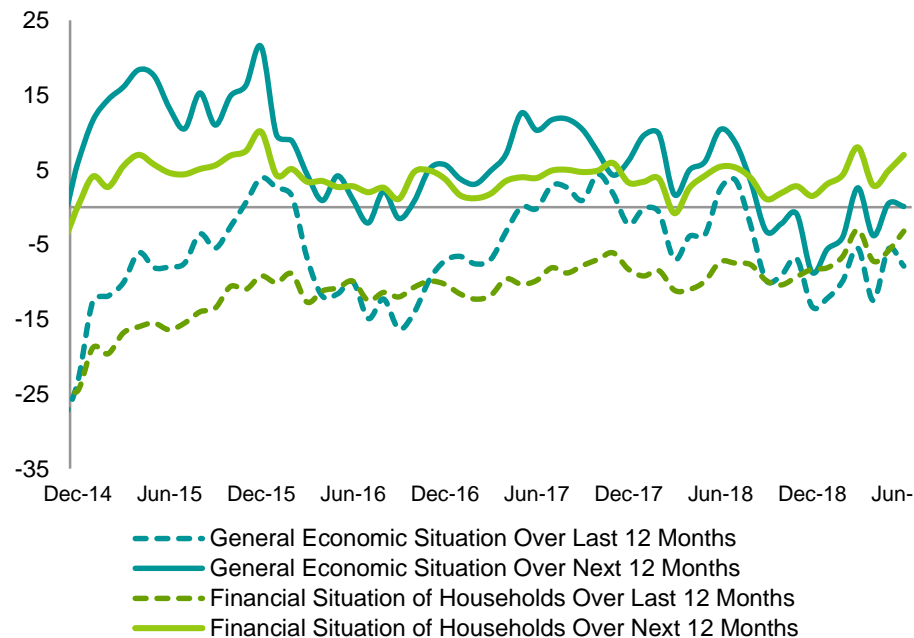
Changes in gross disposable income and its breakdown



Sources: Eurostat, Crédit Agricole SA / ECO

Consumption growth remained subdued in Q1 2019 (+0.3% quarter-on-quarter). This lackluster figure contrasts with the increase in disposable income (+3.4%), which is still supported by rising wages (0.7p of contribution to the RDB), a recovery in wealth income since Q4 2018 and the revaluation of pensions. Conversely, the savings rate recovered over the period from 4.6% in Q4 2018 to 5.3%.

Consumer survey



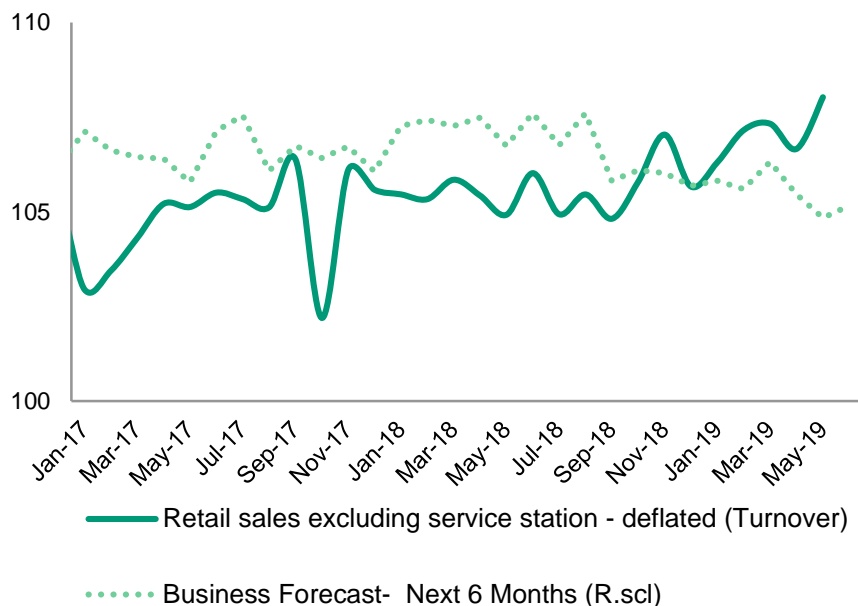
Sources: European Commission, Crédit Agricole SA / ECO

Signals of a recovery in consumption over the coming three months are on the rise. Surveys on the household financial situation point to an improvement in financial conditions and expectations over the next 12 months and consumer credit remains dynamic. However, this rebound should be short-lived.

OUR SCENARIO FRAMEWORK

HOUSEHOLD CONSUMPTION AND WAGES

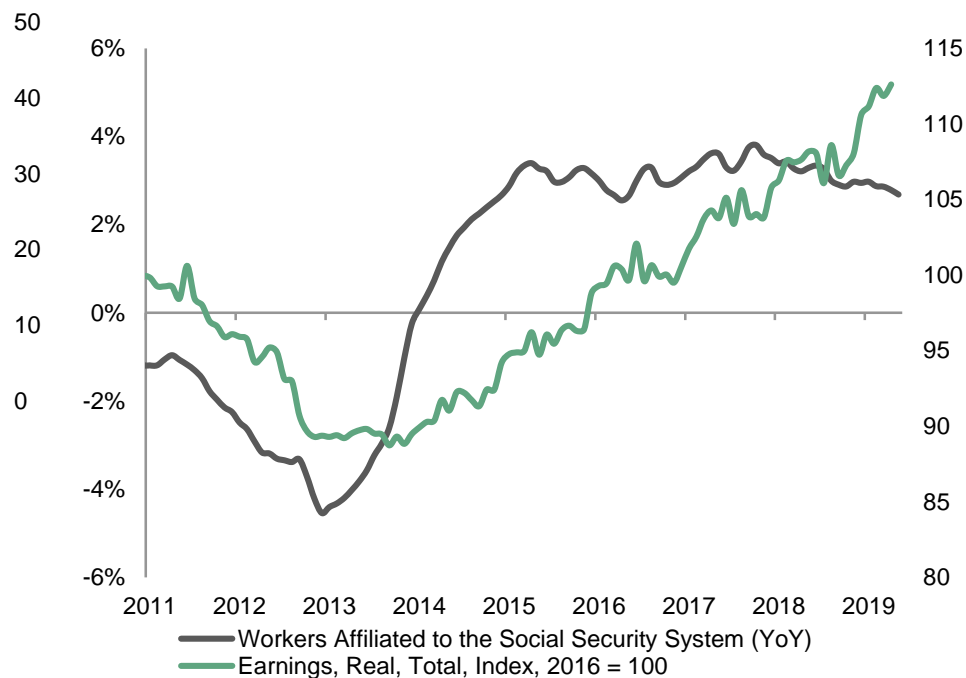
Retail Sales Index



Sources: Eurostat, Crédit Agricole SA / ECO

The retail sales index also rose in May and sector projections highlight a continuum of this trend. As the growth of disposable income moderates and labour market conditions worsen, consumption is likely to weaken from the fourth quarter of 2019. Households should nevertheless benefit from a favourable price environment, with inflation set to remain moderate during 2019 and 2020 at around 1.0% and 1.1%.

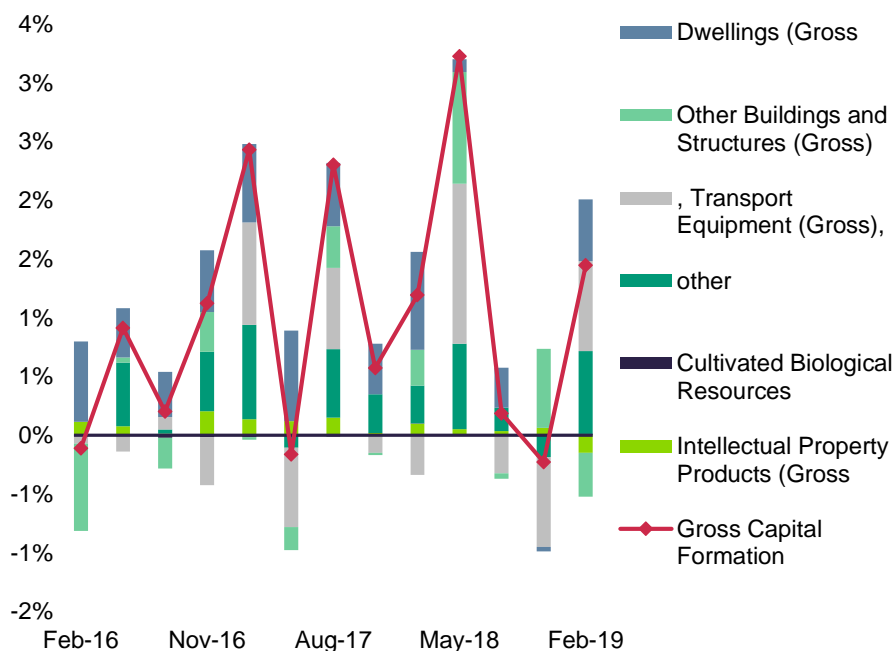
Employment and wages:



Sources: INE, INEM, Crédit Agricole SA / ECO

Slower industrial growth and rising costs are putting pressure on job creation. The slowdown in the number of social security affiliations continues, from an annual growth rate of 3.2% in 2018 to an average of 2.8% in the second quarter. The slackening is more pronounced in the primary sector as well as in industry, while it remains stable in the services sector. At the same time, unemployment rate is still falling, but at a slower pace. Loss of dynamism in the labour market will gradually constrain wage growth.

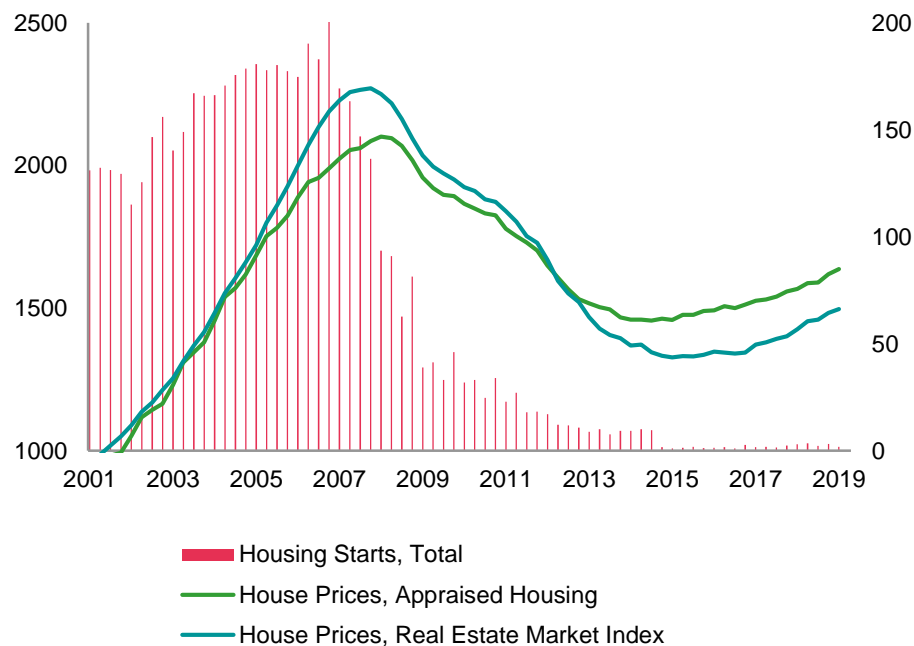
Contributions to Investment



Sources: Eurostat , Crédit Agricole SA / ECO

Against a background of ongoing accommodative financial conditions and high production capacity utilization (CUR), investment remained dynamic in Q1, with a strong contribution from both productive investment and transport to GFCF and GDP growth. A worsening international environment, a slowdown in the industrial cycle and the political paralysis towards which Spain seems to be heading should nevertheless weigh on corporate confidence in the coming months, indicating a deceleration in investment in the second half of 2019. Production capacity utilization peak is outdated and CUR has stagnated for industry since the beginning of the year and is falling for consumer goods.

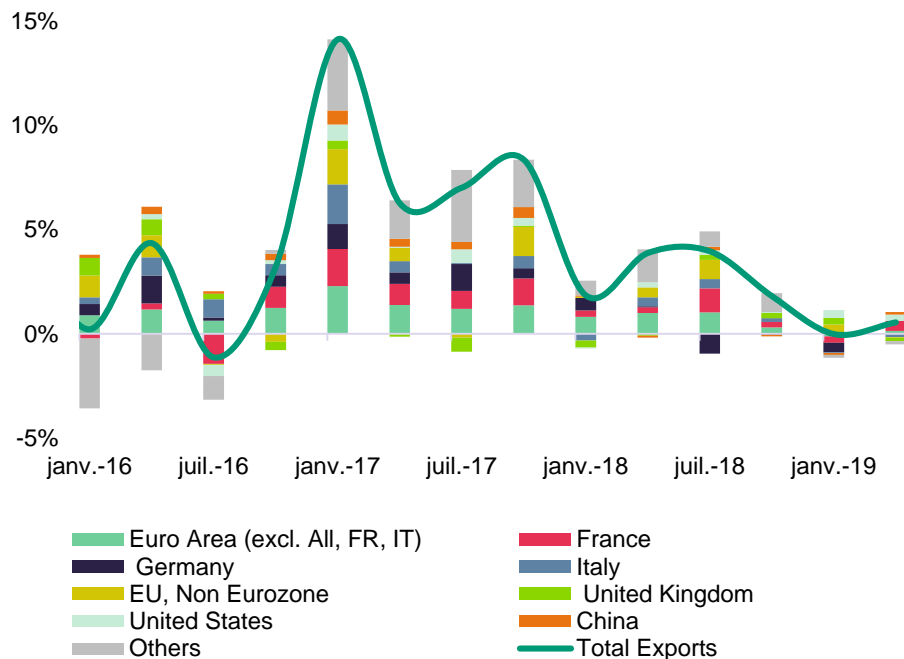
Construction sector



Sources: Ministry of Housing, Crédit Agricole SA / ECO

Although construction's contribution remained positive in Q1, the sector's recovery is weakening. The number of real estate transactions stalled in April (-1.6% year-on-year according to data from the Spanish Notarial Statistical Information Centre). Mortgage lending is also easing and the overall stock of housing loans to households is still shrinking. Real estate prices remain dynamic (+6.7%) but this upward trend hides major heterogeneous trends from one region to another (+9.7% in Madrid against 2.4% in Extremadura).

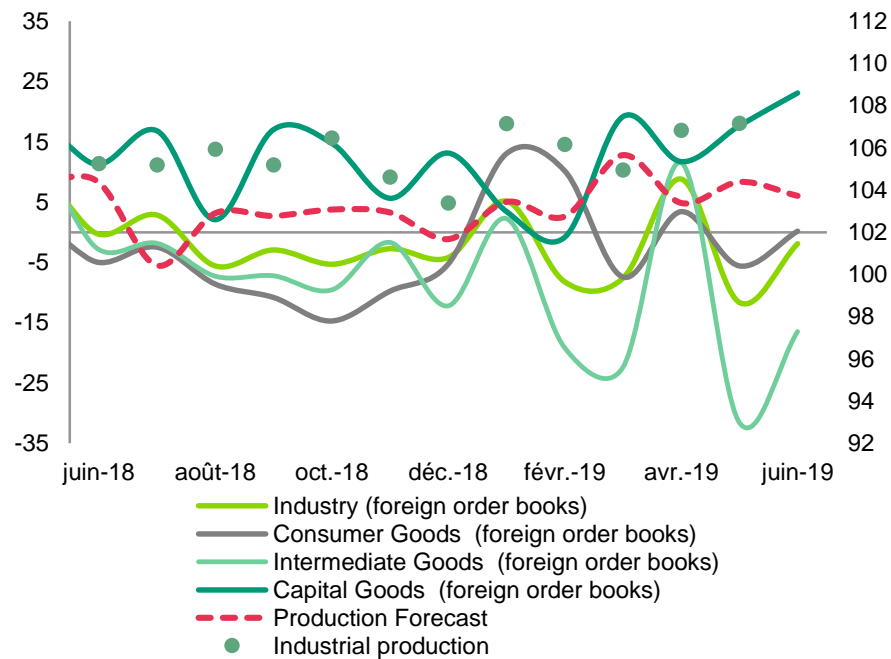
Total export contribution by country



Sources: Bank of Spain, Crédit Agricole SA / ECO

Falling imports in Q1 translated into a positive contribution from external demand over the period notwithstanding a slight contraction in goods and services exports. Exports of goods fell by 1.7% year-on-year (-0.3% compared to the previous quarter), as a result of a -0.7% decrease in the addressed demand from the Euro Zone (recipient of 66% of Spanish exports) with a decline of 3.9% in Germany and -2% in France. As a result, the positive contribution of the agri-food and capital goods sectors, which account for 17% and 19.8% of goods exports, failed to offset the contraction in foreign sales of passenger cars and consumer goods.

Export order books



Sources: ICI survey Ministry of Industry and Trade , Crédit Agricole SA / ECO

Export order books point to a slight recovery in exports in Q2 but this improvement should be temporary. After three quarters of deterioration, competitiveness with the EU and other OECD countries improved slightly in the first quarter. Given the sluggish growth profile within the euro zone and among the main emerging partners (Turkey, China, etc.), neither market share gains nor the maintenance of a weak euro-dollar will be sufficient to counter the adverse effect of depressed demand expected at the end of 2019.

OUR SCENARIO FRAMEWORK

RISKS UNDERLYING OUR SCENARIO

Matrix of risks related to the scenario

Spain: Risk matrix

		Probability	Impact
↓	Snap elections and generalized political instability. Higher risk of ungovernability.	High	High
	Sharper slowdown in the industrial cycle and drop in the automotive sector's production	High	High
	Trade war between China and the United States and higher protectionist risk	Moderate	High
	A more accommodating ECB policy faces a supply and credibility constraint	Moderate	High
	Implications of Brexit on exports	High	High
↑	Recovery within the Euro Zone	Moderate	High
	Lower public financing costs	High	Low

Source: Crédit Agricole SA / ECO



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17/06/2019	<u>France – Public finance 2018-2022</u>	France
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