CRÉDIT AGRICOLE S.A.

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SPAIN
SCENARIO 2019-2020

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"The challenge of progressive parties in the face of the slowdown"

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SPAIN

SCENARIO 2019-2020

1 SUMMARY
ECONOMIC RESILIENCE OR POLITICAL REVIVAL?

Spain began the new year with a new government, putting an end to a cycle of political instability that saw two back-to-back legislative elections. Despite the resurgence of tensions with Catalonia, it was the abstention of elected officials from the Republican Left of Catalonia that allowed the progressive coalition to secure the victory of P. Sanchez. The new government, consisting in part of radical left ministers, laid out a social agenda as its roadmap, and the initial measures of this agenda should be seen in the 2020 budget.

2020 is shaping up to be complicated for the progressive parties which, with no majority, will have to stay the course in an end-of-cycle environment. Growth turned out weaker in 2019 and is expected to hit its lowest level since the 2014 recovery. However, due to an inertia effect, it came out significantly higher than euro zone growth, as the consequences of the US-China trade war and the manufacturing downturn sapped the performances of the German and Italian economies. Initially protected by a diversified export sector, where services play a strong role, growth was helped by the momentum of domestic demand continuing to drive economic activity. With all traffic lights turning amber, 2020 should turn out to be a year of resilience.

Household consumption should continue to buoy economic activity. After a sluggish H1 2019, despite a sharp increase in disposable income, consumer spending is expected to pick up towards the end of the year, thanks in large part to the rebound in Q3 consumption. With households being the big winners of the government's future policy, consumer spending may accelerate slightly in H1 2020 before the reality of the labour market catches up, with its growing signs of a slowdown. Economic activity should nevertheless continue creating jobs, helping lower the unemployment rate.

Compared to 2018, **investment** was halved in 2019 due to the slowdown in business investment. FBCF (gross fixed capital formation) should be hurt by weaker construction activity in Q3, expected to decline further in Q4 2019. In the wake of a multi-year recovery, housing production diminished in after the mortgage law took effect in May 2019. The FBCF may slow even further in 2020. Tax hikes and increased labour costs are expected to alter business sentiment, with companies liable to postpone their investment decisions amid weaker demand.

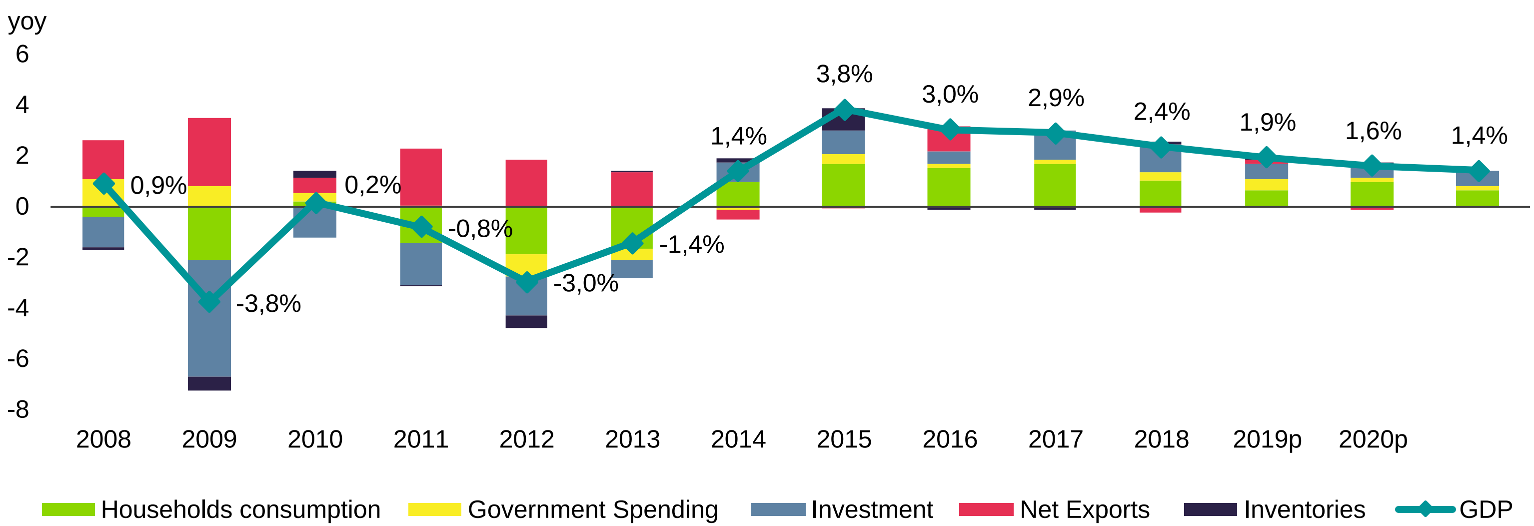
In 2020, **exports** should get a boost from a minor improvement in global economic conditions, thus limiting the negative contribution of trade to economic activity.

Lastly, the new government may resume **public-sector investment** in infrastructures with a focus on the energy transition which, along with the appointment of a Vice President in charge of the ecological transition, looks to be one of the top priorities of the new administration. Of course, it is questionable just how much room there is in the budget given the coalition's commitment to following European budget rules. While there are no figures as of yet for the measures announced by the government, the growing social security expenditures may not be offset by the increase in mandatory withholdings, especially considering that the economic downturn is liable to weigh on fiscal proceeds, digging the deficit even deeper. Although Spain succeeded in closing the excessive deficit procedure in 2019, it was criticised in the previous European half-year for its lack of fiscal consolidation and the size of its public debt.

1 OVERVIEW:

SPANISH GROWTH: SLOWDOWN CONFIRMED

Contribution to GDP



Sources : Eurostat, Crédit Agricole S.A / ECO

Spain	2019	2020	2021	2020				2021			
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP	1,9	1,6	1,4	0,4	0,4	0,3	0,3	0,3	0,4	0,4	0,4
Households consumption	1,2	1,7	1,2	0,5	0,4	0,3	0,3	0,2	0,3	0,4	0,4
Investment	2,9	2,7	2,8	0,4	0,5	0,6	0,6	0,7	0,8	0,8	0,8
Change in inventories*	0,1	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Net export*	0,2	-0,1	0,0	0,1	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Unemployment	14,1	13,6	13,5	13,6	13,6	13,9	13,4	13,3	13,4	13,9	13,4
Government net lending	-2,2	-1,9	-1,9								

* Contributions to GDP growth

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2 FOCUS: THE CHALLENGE OF PROGRESSIVE PARTIES

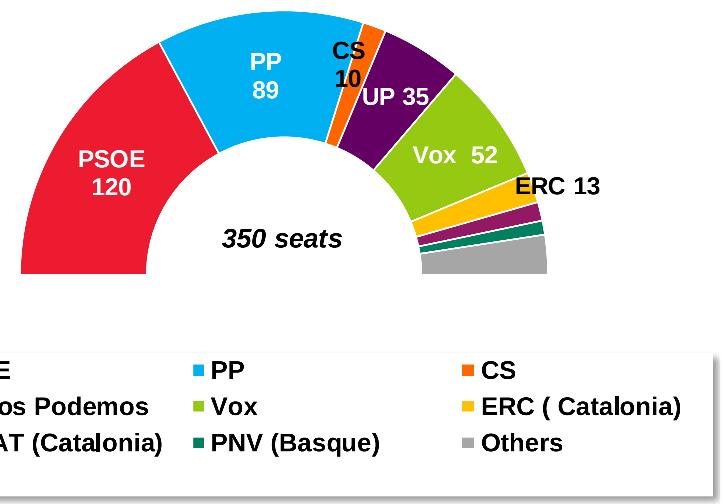
FIRST COALITION GOVERNMENT SINCE 1978

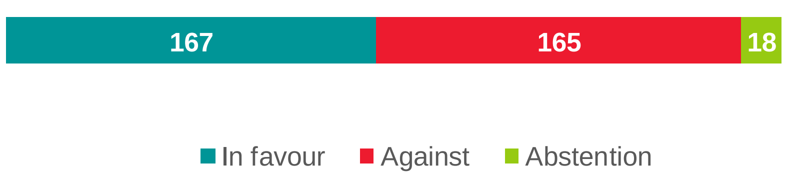
The coalition agreement, made public on 31 December, broadly outlined the platform of the new government comprised of four vice-presidents (three from the PSOE and one from Podemos).

Some of the top measures announced should be included in the 2020 budget: for example, the rise in the dependent children allowance for vulnerable families may ultimately be converted into universal income. Others include the indexing of pensions to inflation (+0.9% in January 2020) and the new minimum wage hike (set to hit 60% of the average wage). To fund these measures, mandatory withholdings are expected to increase, including a higher personal income tax rate: +2 pts on incomes exceeding €130,000 and +4 pts on incomes exceeding €300,000. The government should also change the corporate tax for large corporates to ensure a minimum tax rate of 15%, raised to 18% for financial institutions and oil companies. It is also considering a tax on digital large corporates.

The deal does not call for a repeal of the 2012 labour reform, but plans to modify certain mechanisms, with sector collective bargaining agreements to prevail over corporate agreements, and changing the rules governing layoffs during employee absences due to illness. These changes, though seemingly marginal, may end up causing labour laws to become more rigid, thus limiting job flexibility. In preparation, some companies defined multiple job regulation procedures (voluntary resignation plans) at the end of the year (54% more than in 2018, according to Labour Ministry data).

November 10, 2019 Election Results



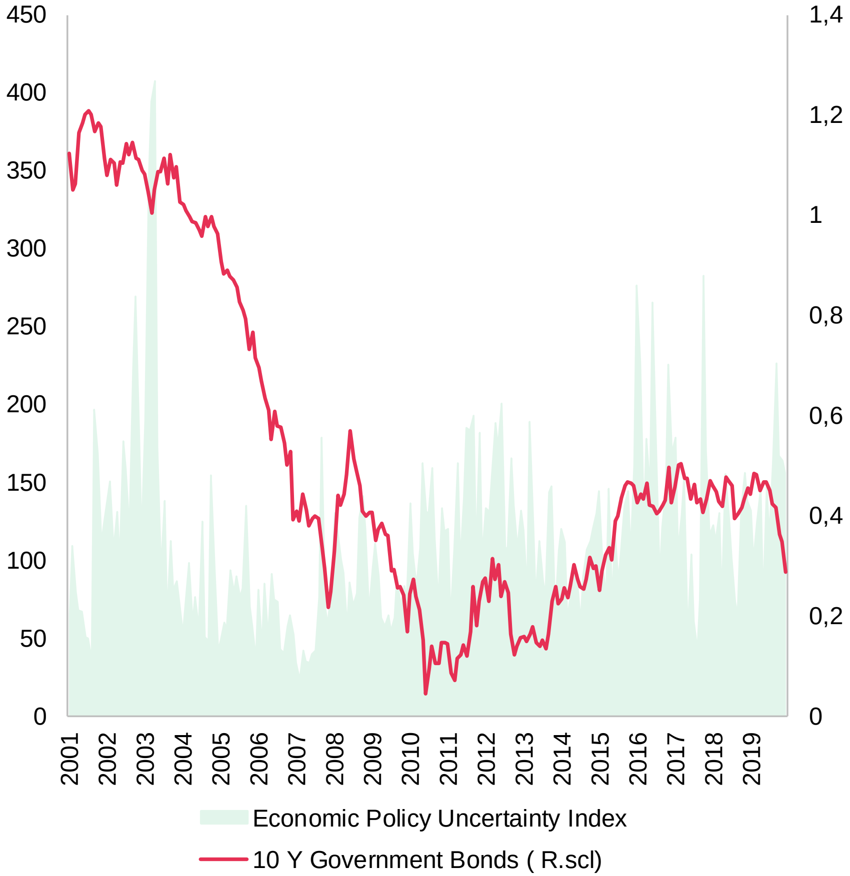


Source : El pais, Crédit agricole SA

FOCUS: THE CHALLENGE OF PROGRESSIVE PARTIES

FIRST COALITION GOVERNMENT SINCE 1978

Economic Policy Uncertainty Index VS 10Y Government Bonds



Sources: EPU, Reuters, Crédit Agricole S.A / ECO

The impacts of the coalition measures are difficult to determine. As was true in 2019, the minimum wage hike and pension increase should see households gain disposable income, but this gain may be limited by a greater downturn on the job market, hurt by higher labour costs and weaker activity. Furthermore, the 2019 scenario may repeat itself, with households favouring savings over consumption.

Despite the reassurances offered by Pedro Sanchez, the coalition platform may adversely impact business sentiment, already affected by the manufacturing slowdown. The upcoming corporate tax rise and higher labour costs stemming from the minimum wage hike could have a negative impact on Spanish competitiveness and investment.

Lastly, given the upturn in social security expenditures, there is a possibility public finances could deteriorate, triggering an increase in the public deficit (currently at 2%). Spain is bound by its European budget balancing obligations, but after five consecutive years of growth, little has been done to consolidate public finances, and the structural deficit still sits at around 3%.

With the new coalition government, the country appears to have put political instability behind it. The polarisation of Parliament guarantees that Pedro Sanchez will complete his term of office, as a new right-wing vote of censure would require an absolute majority. That said, lacking an absolute majority means that the future government could be limited in how much it can accomplish. The next decisive vote should be the 2020 budget, which will need the support of the pro-independence MPs to pass. However, the agreement between the PSOE and the ERC does not include the support of the Republican Left for the budget. If not passed, the 2018 budget is likely to be renewed.

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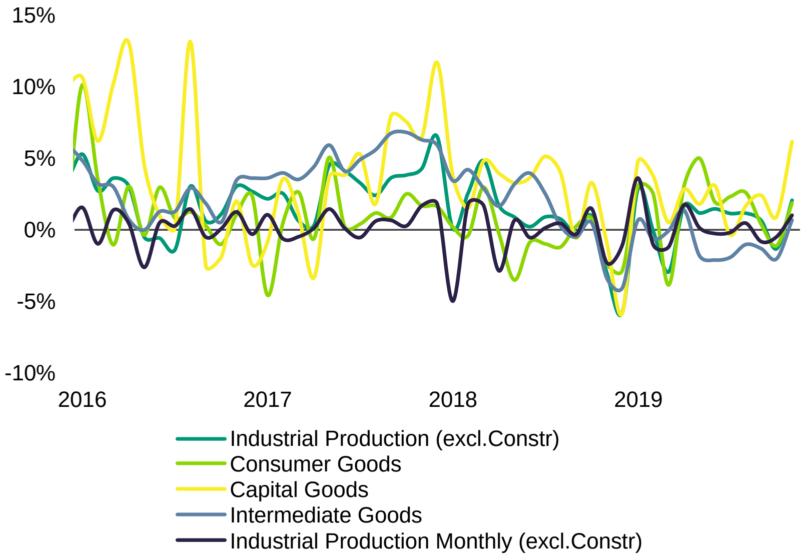
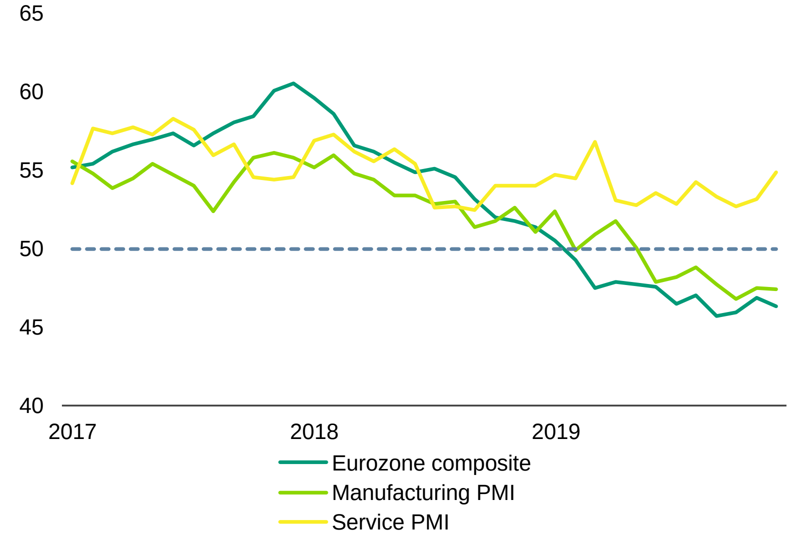
3 RECENT ECONOMIC TRENDS
INDUSTRIAL OUTPUT AND PMI

Industrial Production



Sources : Eurostat, Crédit Agricole SA / ECO

Purchasing manager index



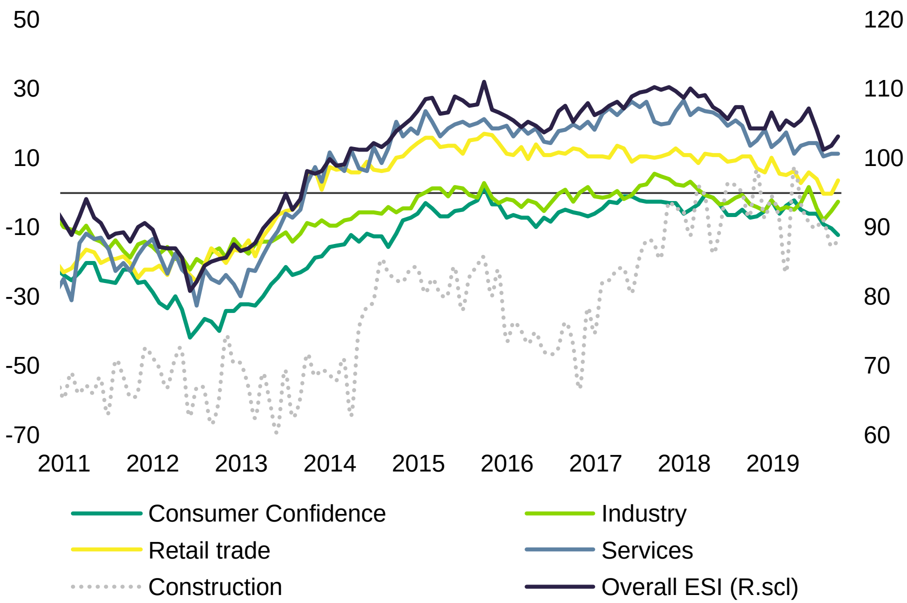
Sources : Markit Crédit Agricole SA / ECO

YTD trends remain valid at end-2019. The manufacturing sector is still in the red. Despite improving slightly in December, business sentiment in the manufacturing sector is on the decline (-5.1). The PMI, under 50 in December, points to a contradiction in manufacturing activity, reflected in decreased production and a weaker order pipeline amid surplus capacities. Manufacturing jobs have also been impacted since the month of May, with a decline in demand for labour and staff cuts. The main reason underlying the sector's problems is weaker domestic and foreign demand.

The PMI survey nevertheless indicated a slight improvement in the outlook for the manufacturing industry in 2020. Recent industrial output data have confirmed the results of the survey. Industrial output clearly improved in November (after falling month-on-month for two months in a row), driven by the expansion of capital and consumer goods, but the intermediate goods segment continued to struggle and order pipelines indicated the continuation of the trend. In the wake of the automotive industry downturn and the decline in housing construction, metals and the production of metal products (together representing 12% of the manufacturing sector) continued to lose steam.

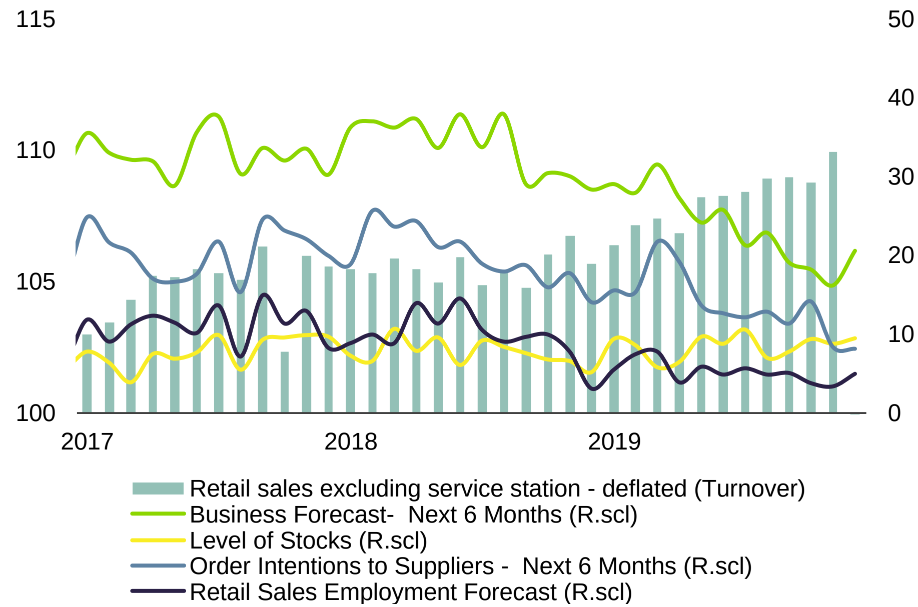
2 RECENT ECONOMIC TRENDS
ESI AND RETAIL SALES

ESI and its component



Sources: Eurostat, Crédit Agricole SA / ECO

Retail Sales



Sources: INE, Ministry of the Economy and Finance, Crédit Agricole SA / ECO

For now, the service sector has proved immune to the manufacturing sector decline. Fears of seeing the slowdown spread have been alleviated by the sector's robust figures. The purchasing managers index for services is holding steady above 50 and even picked up momentum in December (54.9 versus 53.2 in November). Service sector sentiment may have taken a hit from its 2017 peak, but is still significantly higher compared to other sectors, buoyed in particular by the vitality of the secondary automotive market and transport services.

However, these changes mask a slowdown in tourist business, which ended the summer on a lacklustre note due to the decreased number of tourists from the UK and Germany. After a -2% YoY drop in October, the number of overnight stays picked up just 0.5% in November.

Retail sales continued to climb, on the back of YTD purchasing power gains. Paradoxically, sector forecasts have declined, as has consumer sentiment, hitting a low point in November in line with 2014 levels.

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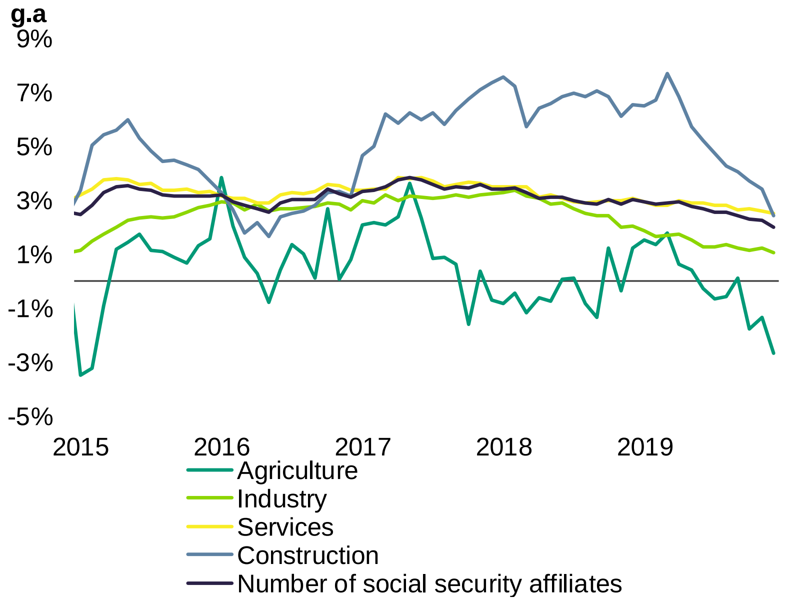
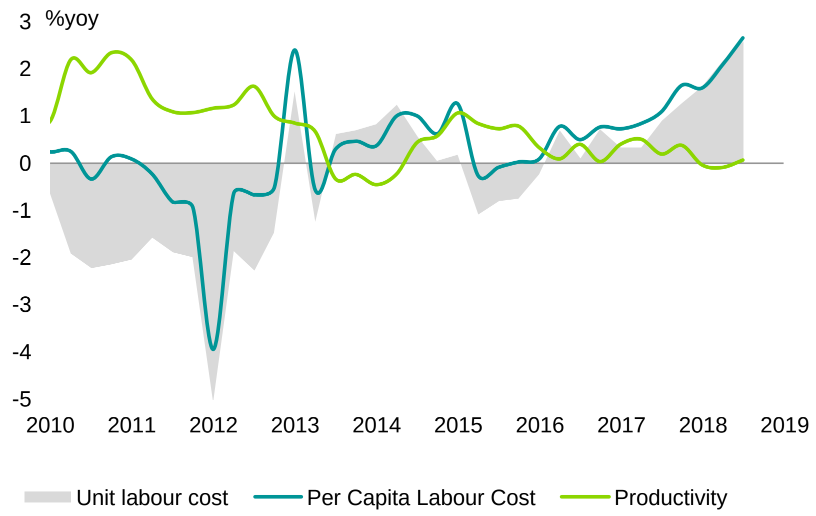
OUR SCENARIO FRAMEWORK
LABOUR MARKET

Employment: Social Security Affiliations



Sources : Ministry of Labour, Crédit Agricole SA / ECO

Unit labour costs



Sources : Eurostat, Crédit Agricole SA / ECO

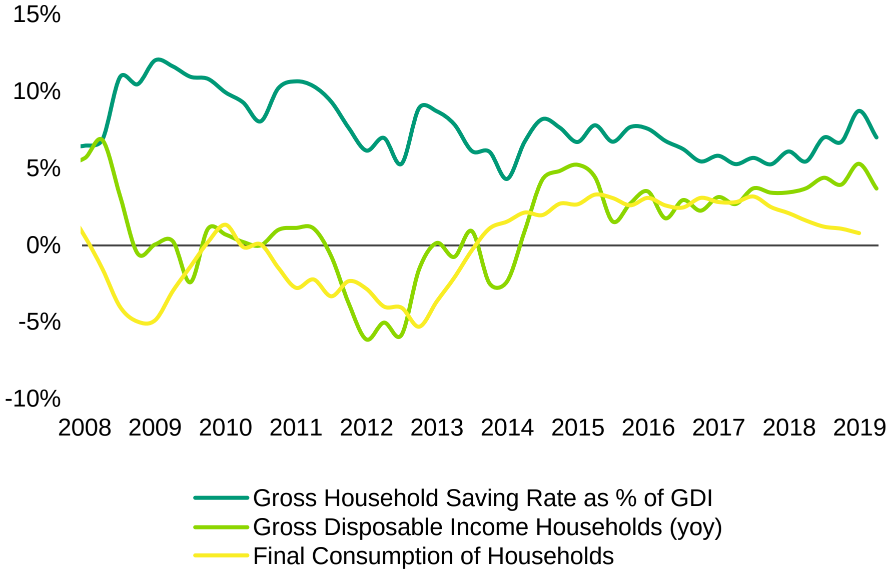
The job market has slowed even further. Data for the month of December pointed to a sharp downturn in social security registrations, from a monthly average of 2.4% in Q3 to 2% in December, i.e. the weakest improvement since October 2014. All business sectors were affected, but the decline in job creations was not surprisingly steeper in sectors showing signs of losing steam such as construction (2.4% in December 2019 versus 6.5% in December 2018) and industry (1.1% in December 2019 versus 2% in December 2018). Job market imbalances are only expected to gradually diminish, however. The number of unemployed workers slid 1.2% year-on-year, bringing the unemployment rate back to 14.1% in Q3, its lowest level since 2013, expected to drop further in 2020.

Despite the easing trend observed on the job market, wages should keep climbing, albeit at a slower pace than H1, when they were helped by the January minimum wage hike. The coalition government should implement another minimum wage hike in 2020, though to a lesser extent than last year. The government is planning to gradually raise the minimum wage to 60% of the average wage by the end of the administration.

OUR SCENARIO FRAMEWORK

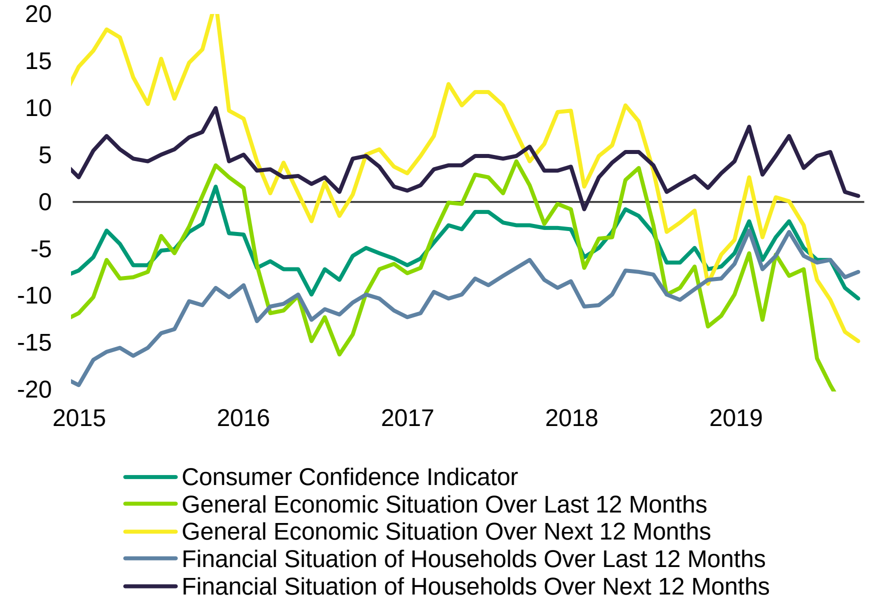
HOUSEHOLD CONSUMPTION AND WAGES

Gross disposable income, saving and consumption



Sources : Eurostat, Crédit Agricole SA / ECO

Household survey



Sources : European Commission, Crédit Agricole SA / ECO

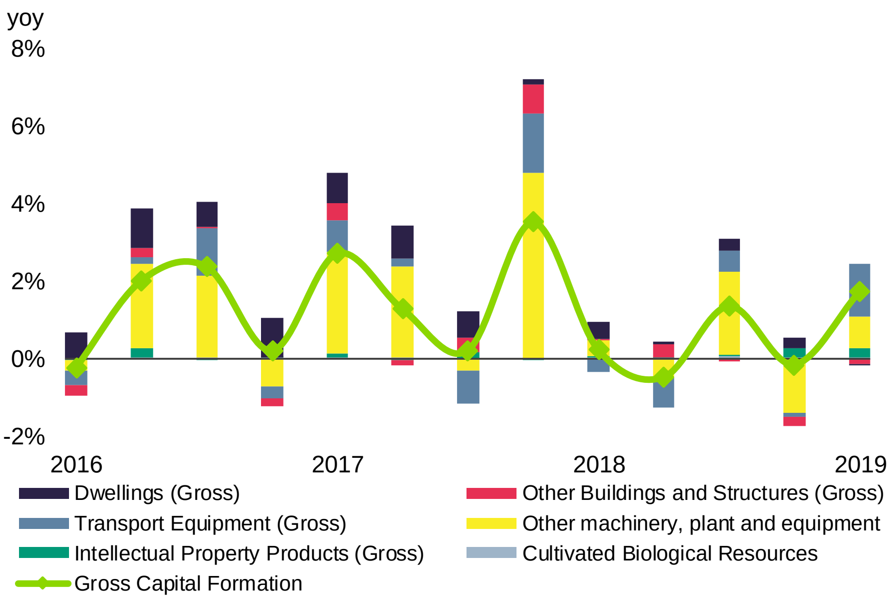
The review of national economic accounts confirmed the sharp Q3 rebound in household consumption after a sluggish first half. Household consumption stood at +0.8% (versus an initial estimate of 1.1%) and all signs indicate that it should improve over the next two quarters driven by higher social security spending.

Consumer durable purchases held steady, particularly car sales which rose 5% on average in the fourth quarter. Retail sales also picked up in November. These changes contrasted with the persistently negative perception of households and the distribution sector, seemingly decorrelated with consumer behaviour. The consumer sentiment index, on the decline since April 2019, bottomed out in November. Household surveys are no longer optimistic, as they have seen their financial position deteriorate since July and their outlook for the next 12 months is barely any better.

After making considerable gains in the first half, disposable income slowed sharply in the third quarter, but nevertheless continued to climb faster than during the recovery phase. Plus, the measures announced by the new government should encourage household purchasing power in the current low inflation environment. In addition to the minimum wage hike, the government is expected to raise pensions by 0.9% in January 2020.

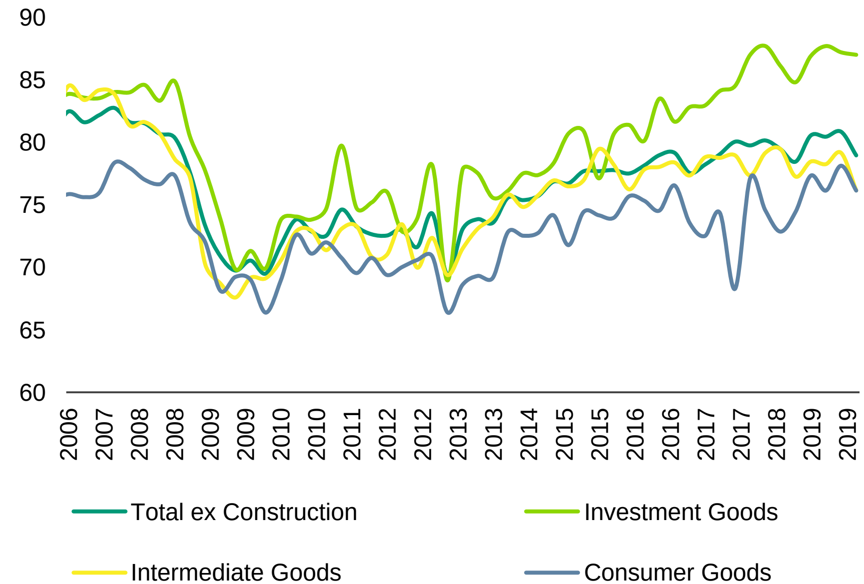
4 OUR SCENARIO FRAMEWORK
INVESTMENT

Investment Contributions



Sources : Eurostat , Crédit Agricole SA / ECO

Capacity utilisation rate



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

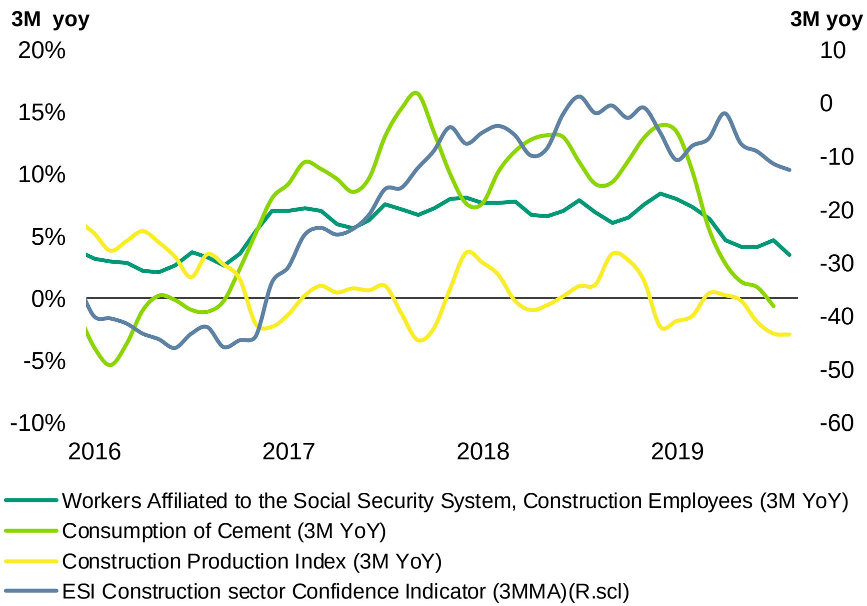
After climbing 1.7% investment made a big contribution to Q3 growth. Transport equipment purchases more than offset lacklustre turnouts in other FBCF segments. Consumer goods purchases also recovered in Q3.

Q4 data point to positive momentum in business investment. Industrial output and capital goods orders are positive. This renewed momentum may diminish in Q1 2020, however, despite an improved international environment. Compared to 2018, waning demand has limited constraints on production capacities.

Production capacity usage rates, which hit a peak in H1 2019, slid back to 79% in Q4. Corporate margins have eroded, partly due to higher labour costs. With the newly announced tax cuts and wage hikes, businesses may put off investment decisions despite persistently accommodative financial conditions.

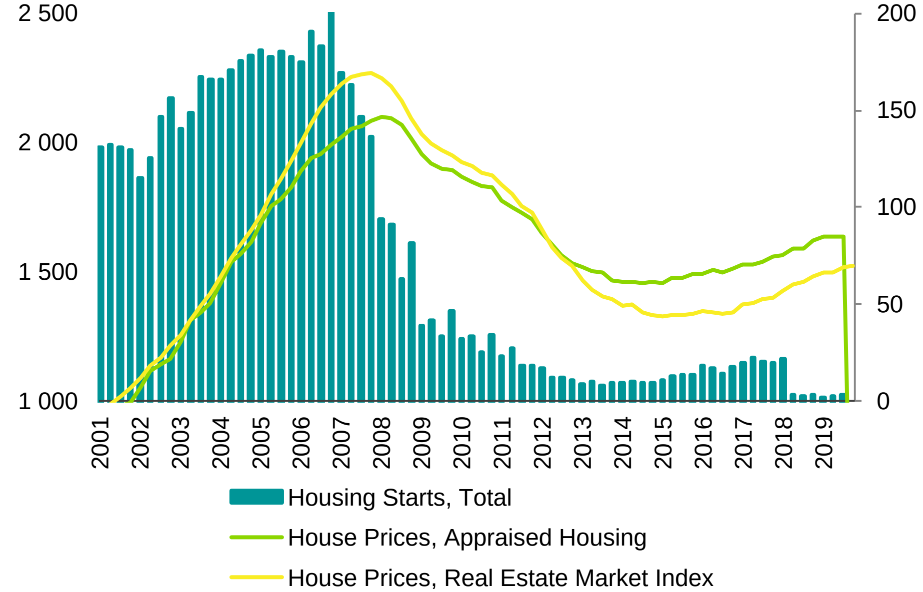
4 OUR SCENARIO FRAMEWORK
CONSTRUCTION

Leading indicators for construction output



Sources : Eurostat, Crédit Agricole SA / ECO

Housing licence and prices



Sources: Housing Ministry, Crédit Agricole SA / ECO.

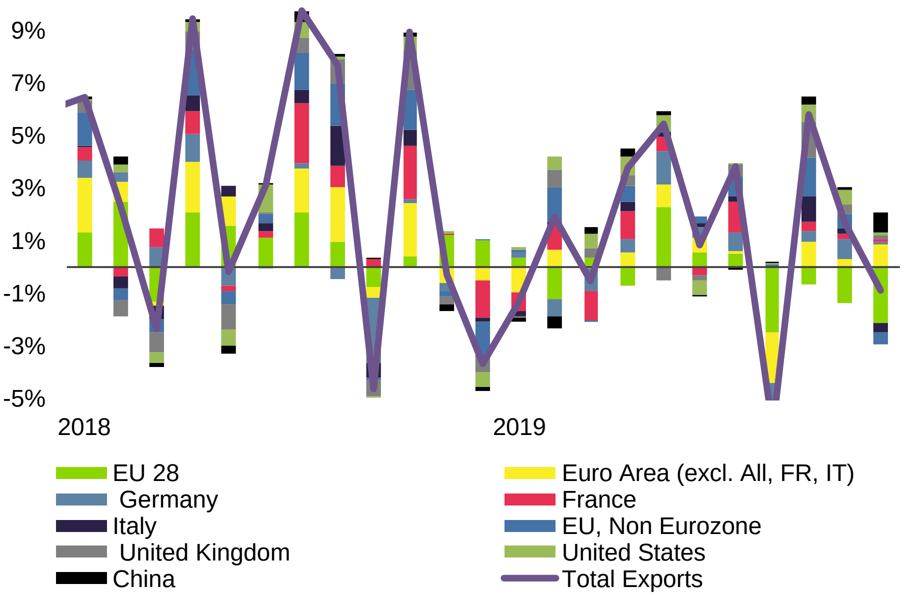
As in the third quarter, the construction sector is expected to continue weighing on the FBCF's contribution to economic activity. After years on the recovery track, sector indicators are in the red. Though production costs have risen significantly since January 2019 (+2.5% on average from January to October), construction has recorded a drop in demand brought on by flagging new home sales. The production volume index has contracted since September, adversely affected by the decline in residential construction. Leading indicators show no signs of improvement in the short term. Cement sales dropped off in November and sector employment is falling. This correction, partly due to the entry into force of a new mortgage law, looks set to continue for some time. The sector downturn can also be attributed to the drop in housing demand from non-residents and weaker demand for rental investment, hurt by lower returns with the rise in real estate prices (from 4% in 2018 to 3.9% in Q3 2019). The rent control measures announced by the government for major cities should further limit growth in this segment.

Sales of new homes were not the only ones penalised by the implementation of the new mortgage law, with existing home sales also contracting in September and October. Real estate prices have been affected as a result, slowing from 6.8% and 5.3%, respectively, in Q1 and Q2, to 4.7% in Q3 2019.

4 OUR SCENARIO FRAMEWORK

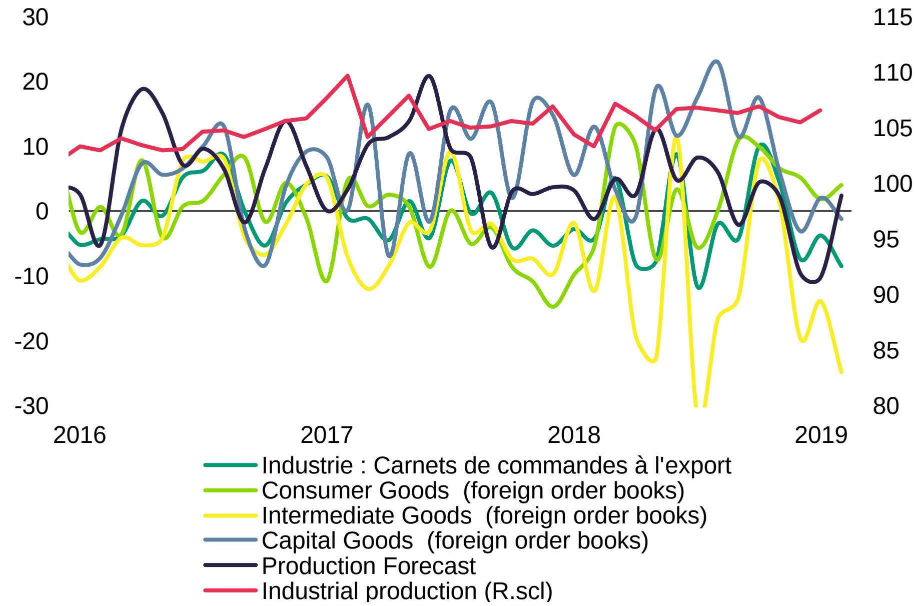
FOREIGN TRADE

Exports by trade partners



Sources : Bank of Spain, Crédit Agricole SA / ECO

Exports orders books



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

The risk weighing on global trade seems to have caught up with Spanish exporters. The contribution of foreign trade was negative in Q3. Despite the recovery of service exports, export growth was nil in Q3, hurt by a 1% contraction in product exports. Thanks to the increase in the FBCF, product imports have picked up, after posting a moderate rise in H1. This trend is expected to carry over into Q4.

Despite the slight improvement in product exports, the contribution of foreign trade is liable to remain limited. Stabilisation of the manufacturing sector and a slight pick-up in automotive sales should stem the erosion of exports in H1 2020. December production forecasts point to a minor improvement in the sector outlook compared to last quarter. The decline in domestic demand should also help curb the sector’s negative contribution to economic activity.

Risks matrix

Spain: Risk matrix

		Probability	Impact
↓	Government without a majority in the House with little room for manoeuvre	High	High
	Sharper slowdown in the industrial cycle and weaker production in the automotive sector	Moderate	High
	Global trade slowdown	Moderate	High
↑	Improved growth prospects for the Eurozone	Moderate	High
	Lower public financing costs	High	Low

Source: Crédit Agricole SA / ECO

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