



SPAIN 2022-2023 SCENARIO

GROWTH EXPECTED TO MODERATE

October 2022

Ticiano Brunello

WORKING EVERY DAY
IN YOUR INTEREST



GROUP ECONOMIC RESEARCH

CONTENTS

1 | SUMMARY

2 RECENT ECONOMIC TRENDS

3 OUTLINE OF OUR SCENARIO

4 FOCUS: TREND IN INFLATION

5 FOCUS: 2023 BUDGET

SUMMARY

SLOWDOWN IN GROWTH IN Q3 AFTER STRONG GDP GROWTH IN Q2

After falling 0.2% in Q1 2022, Spanish GDP increased 1.5% in Q2 2022. This rebound in growth was driven by strong exports, private consumption and construction investment. On the supply side, momentum came from the merchant services segments, particularly those related to leisure and tourism. Despite this sharp expansion in activity, Spain's GDP is still 2.2pp lower than at the end of 2019, in contrast to the eurozone as a whole, where activity is already nearly 2pp higher.

The lifting of travel restrictions, which had already boosted activity in the second quarter, drove the continued recovery in international tourism during the summer months. However, on the employment front, social security registrations, which unexpectedly increased during the first half of the year, slowed in Q3. In addition, rising energy prices, which gradually spread to a growing share of goods and services in the household consumption basket, have reduced consumer purchasing power, resulting in weaker spending indicators. Similarly, expensive energy commodities and insecure supply are impacting production in the highest-electricity-consumption industries. Overall, this decline in manufacturing and household income is pushing down production demand from other sectors. In Q3, the first official estimate of GDP growth was 0.2%, with domestic demand still a

major contributor and foreign demand detracting from growth.

Various factors are expected to put downward pressure on the economic growth outlook in the coming quarters, including persistent inflation, a decline in economic confidence and severe ongoing uncertainty (some aspects are particularly influenced by the consequences of the current energy crisis and the armed conflict in Ukraine). In addition, tourism is likely to lose momentum once most of the pandemic-deferred demand has been met. Moreover, a weakening of external demand is expected amid simultaneous tightening of monetary policy at the global level. As a result, we expect GDP growth of 4.6% in 2022 after 5.5% in 2021, thanks to an overhang effect of 4.7%. Domestic demand is expected to add 1.6%, while external demand is projected to make a larger contribution of 3.3%, thanks to the recovery in tourism services.

Uncertainty will remain very high in 2023, but economic activity could regain momentum from next spring. Throughout the year, the contribution of energy and food prices is expected to gradually moderate. In addition, a very gradual reduction in bottlenecks and the economic consequences of the war in Ukraine will underpin activity.

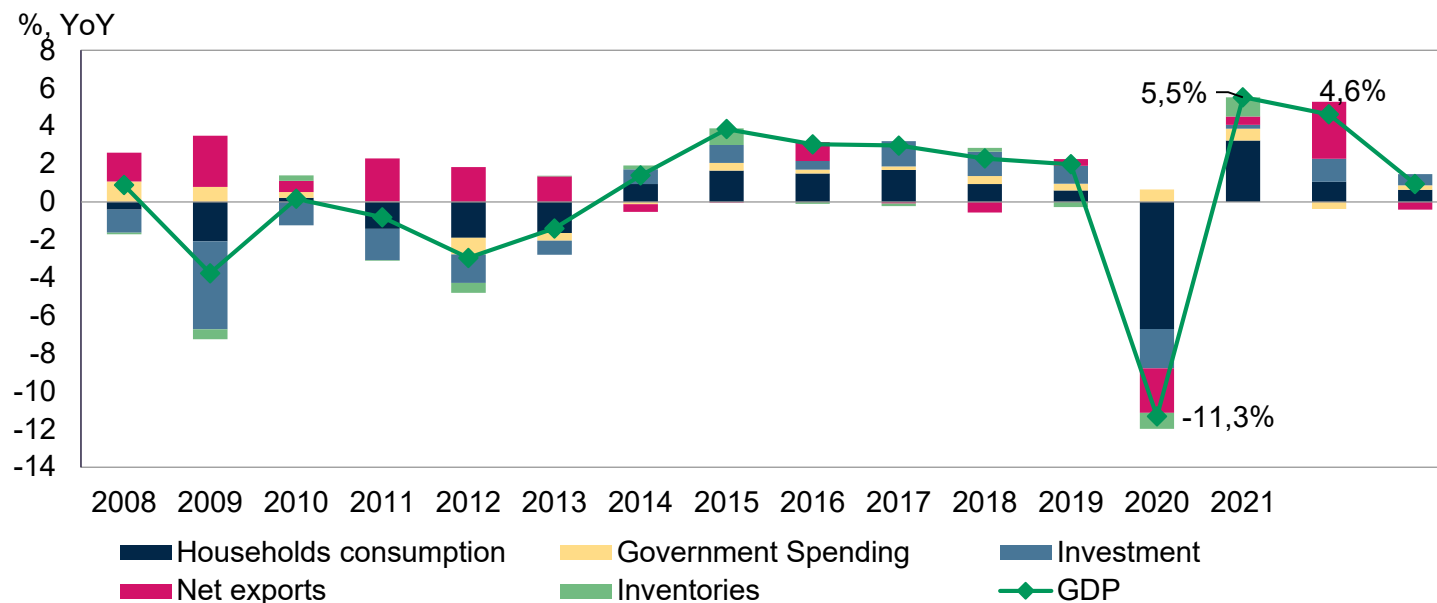
We anticipate a slowdown in private-sector consumption growth from 1.5% in 2022 to 0.7% in 2023. Investment by non-financial companies will suffer in the short term as a result of rising war-related uncertainties, the negative impact of higher production costs and continued disruption to supply chains. The impact of rising energy prices may be particularly pronounced in the sectors with the most intensive energy use, such as metals, steel, transportation and the chemical and extraction industries. According to our latest forecasts, investment is expected to slow down from Q3 2022, but should increase by 5.5% in 2022 and 2.6% in 2023, supported by Spain's recovery plan. The slowdown in GDP growth is expected to be substantial, with growth of 0.9% in 2023.

The government budget for 2023 (see Detailed Look) forecasts a deficit of 3.9% in 2023, thanks to an optimistic growth estimate of 2.1% (vs. 0.9% according to our forecasts). Spending, which is very focused on preserving the purchasing power of lower-income sectors and the deployment of NGEU funds, will help support growth, but our forecast includes a smaller reduction in the deficit than announced by the government. We only expect it to improve from 4.8% in 2022 to 4.4% in 2023.

SUMMARY

OUR GROWTH FORECASTS

Contributions to annual GDP growth



Sources: Eurostat, Crédit Agricole SA / ECO

Spain	2021	2022	2023	2022				2023			
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP	5.5	4.6	0.9	-0.2	1.5	0.2	-0.1	0.1	0.3	0.3	0.3
Private-sector consumption	6.0	2.0	1.2	-1.2	1.2	1.1	-0.3	0.1	0.3	0.3	0.4
Investment	0.9	5.7	2.8	3.3	2.5	1.4	0.2	0.5	0.6	0.5	0.5
Inventory changes*	1.0	-0.3	-0.1	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net exports*	0.4	3.0	-0.4	1.5	0.9	-0.7	-0.1	-0.2	-0.1	0.0	-0.1
Unemployment rate	14.8	13.3	13.1	13.3	12.7	13.3	13.8	13.4	12.7	13.2	13.2
Public deficit (% of GDP)	-7.0	-4.8	-4.4								

*Contributions to GDP growth

CONTENTS

1 SUMMARY

2 | RECENT ECONOMIC TRENDS

3 OUTLINE OF OUR SCENARIO

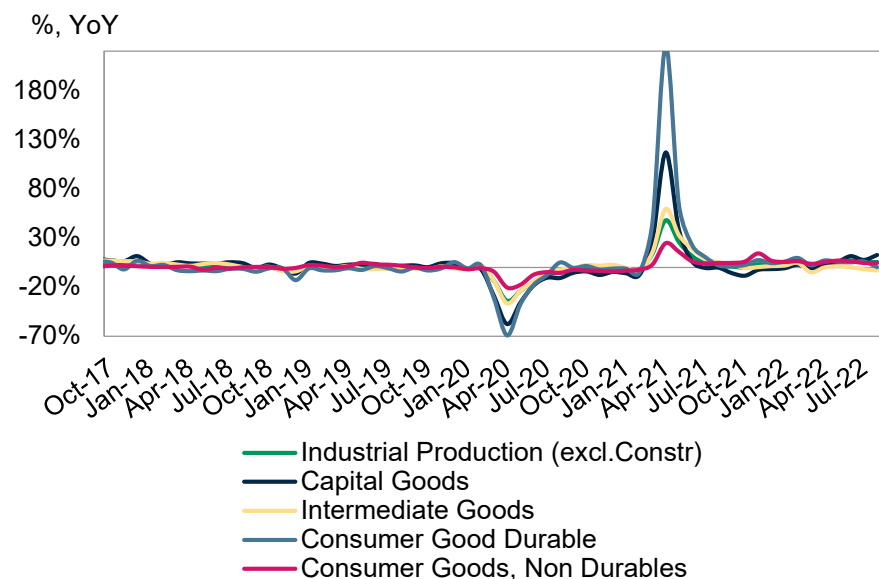
4 FOCUS: TREND IN INFLATION

5 FOCUS: 2023 BUDGET

RECENT ECONOMIC TRENDS

BARELY POSITIVE GROWTH IN Q3

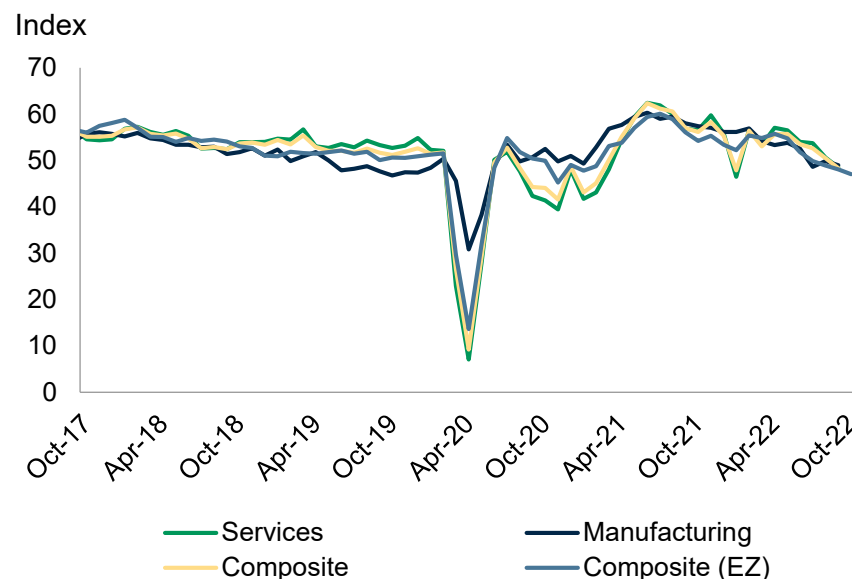
Industrial output



Sources: Eurostat, Crédit Agricole SA / ECO

GDP grew more than expected in Q2, but the growth rate of the Spanish economy slowed significantly in Q3. The lifting of most pandemic-related restrictions, which had already boosted activity in Q2, drove the continued recovery in international tourism during the summer months. However, social security registrations, which unexpectedly increased during the first half of the year, slowed in Q3. In addition, rising energy prices, which gradually spread to a growing share of goods and services in the household consumption basket,

Purchasing Managers Index (PMI)



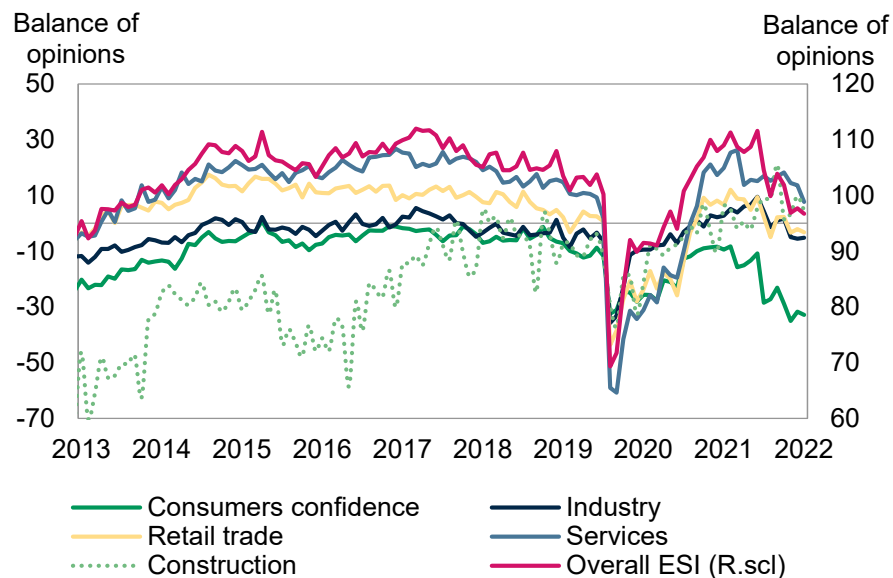
Sources: Markit, Crédit Agricole SA / ECO

have reduced consumer purchasing power, resulting in weaker spending indicators. Similarly, expensive energy commodities and insecure supply are impacting production in the highest-electricity-consumption industries. Overall, this decline in manufacturing and household income is also pushing down production demand from other sectors. Purchasing manager surveys perfectly reflect these effects, with the services, manufacturing and composite sectors all pointing to a contraction in activity in September.

RECENT ECONOMIC TRENDS

CONFIDENCE IS DETERIORATING

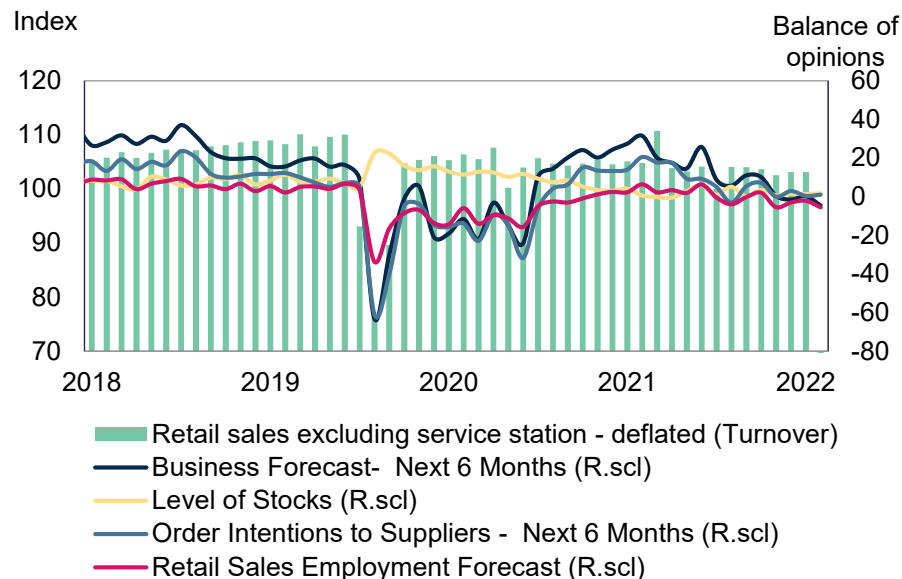
ESI and its components



Sources: Eurostat, Crédit Agricole SA / ECO

The components of the European Commission's economic sentiment surveys also confirm a recovery in confidence across all sectors, particularly related to consumption. The results of the Bank of Spain's latest survey on business activity also pointed to a decline in the revenue of Spanish companies in Q3, after the slight improvement observed in Q2. In any case, there is significant sectoral variation, as

Retail sales



Sources: ICI, Crédit Agricole SA / ECO

the service segments most related to tourism and leisure activities reportedly posted relatively high revenue growth in Q3, while in other sectors, such as industry and agriculture, companies are expected to have recorded declines in their quarterly billings. We therefore expect very moderate growth in Q3 2022, at around 0.3% quarter-on-quarter.

CONTENTS

1 SUMMARY

2 RECENT ECONOMIC TRENDS

3 | OUTLINE OF OUR SCENARIO

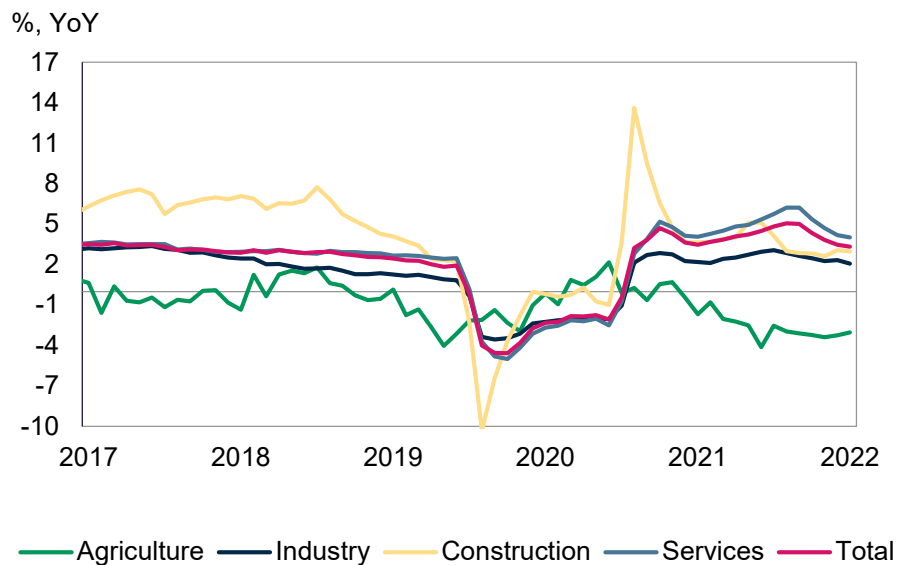
4 FOCUS: TREND IN INFLATION

5 FOCUS: 2023 BUDGET

OUTLINE OF OUR SCENARIO

EMPLOYMENT: MODERATION ALREADY UNDERWAY IN Q3

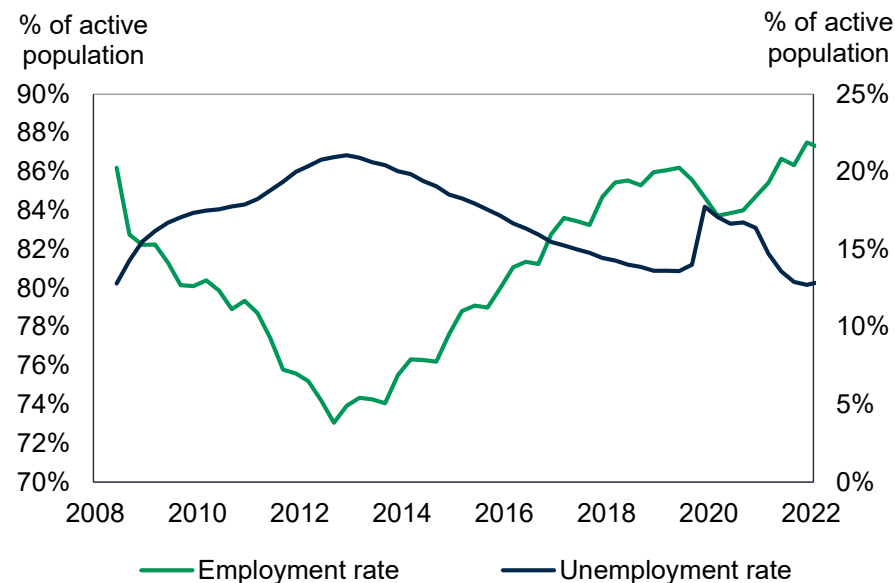
Employment: Social Security enrolment



Sources: Ministry of Labour, Crédit Agricole SA / ECO

Employment slowed in the summer months, although the strong momentum of permanent contracts remains. However, growth in social security registrations, which unexpectedly increased during the first half of the year, slowed in Q3. This moderation was fairly widespread by business segment, although the strong annual growth in employment maintained by the service sectors most associated with tourism stood out. The increase in employment remains concentrated in permanent contracts, which posted year-on-year growth of more than 20% on average in Q3, while employment of temporary workers declined

Unemployment rate



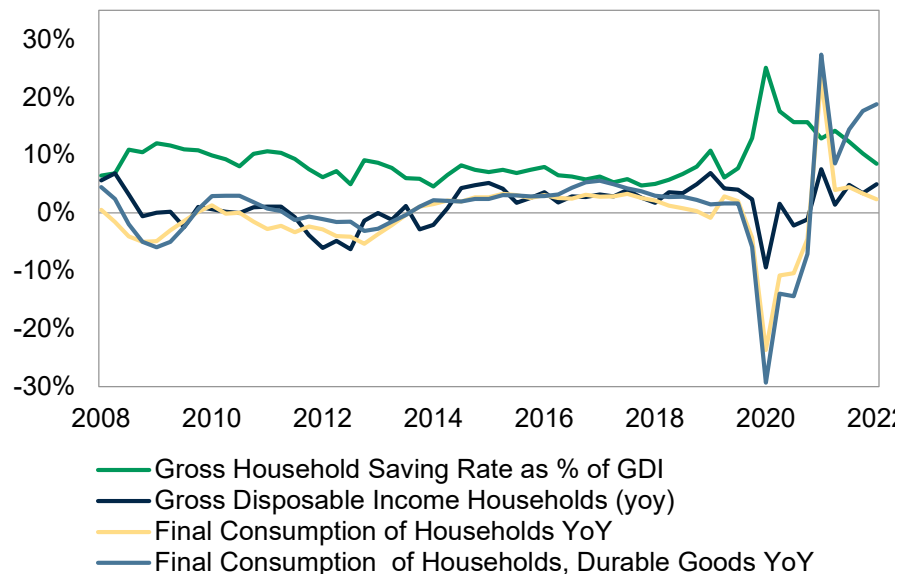
Sources: Ministry of Labour, Crédit Agricole SA / ECO

further (-33.1% y/y in August). Among permanent contracts, increased non-renewals of fixed-term and part-time contracts stood out, representing 22.6% and 24.4% respectively of the total increase in permanent employment. The unemployment rate stood at 12.7% in Q3 (12.5% in Q2). Inflationary pressure and the drop in activity driven by weaker domestic demand suggest that the decline in the unemployment rate will moderate. We expect unemployment to reach 13.3% in 2022 and 13.1% in 2023.

OUTLINE OF OUR SCENARIO

SLOWDOWN IN CONSUMPTION IN Q3

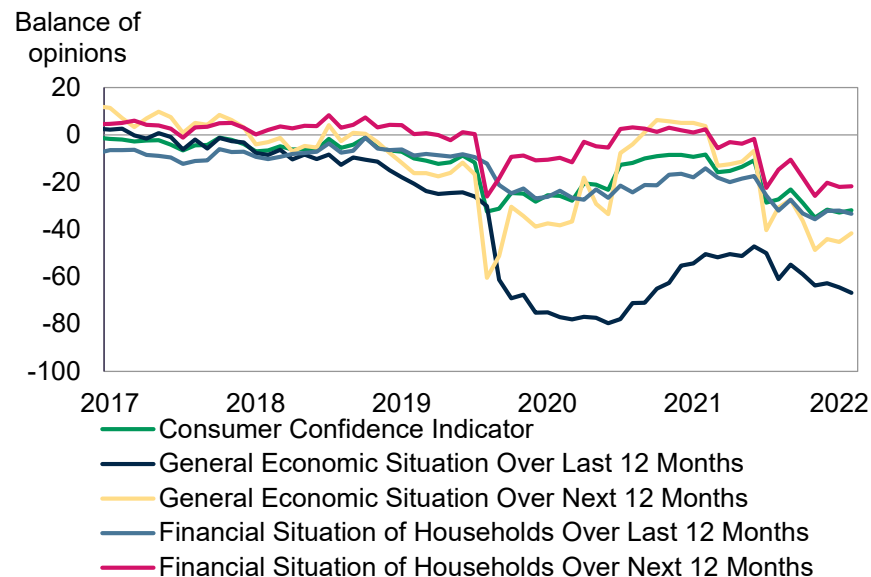
Change in gross disposable income and its components



Sources: Eurostat, Crédit Agricole SA / ECO

Private consumption increased by 1.2% in Q1 2022 compared to Q1. Growth in consumption of non-durable goods and services (+3% over the quarter) was less robust than durable goods consumption (7%). The household savings rate came out at 8.5% of gross disposable income (10.3% in Q1 2022). Consumption is expected to have moderated in Q3 amid rising uncertainty, high inflation rates, tighter financing conditions and deteriorating consumer confidence. This slowdown in household spending is expected to, at least in part, reflect a slowdown in purchases of goods, particularly durable goods. For

Household survey



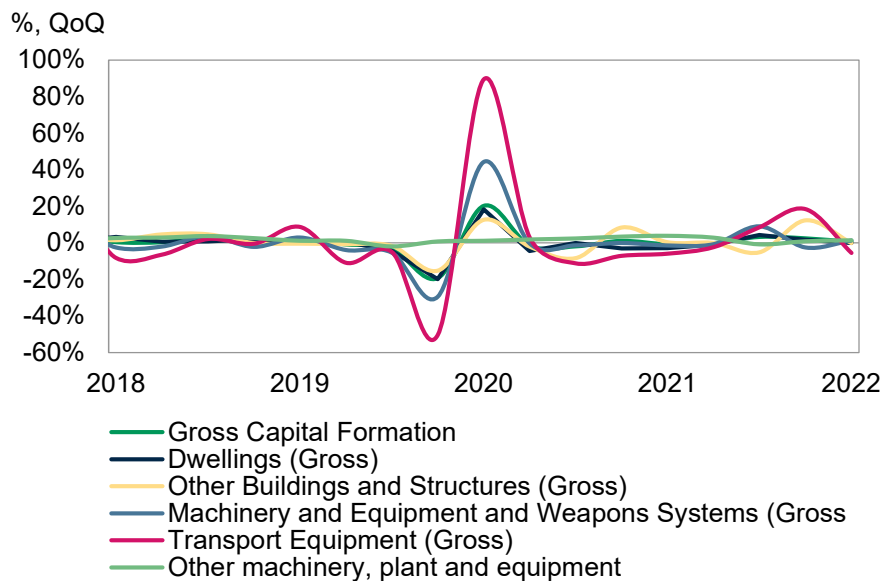
Sources: European Commission, Crédit Agricole SA / ECO

example, passenger vehicle registrations declined significantly between July and August. On the other hand, various service spending indicators suggest that the recovery trend in hospitality spending is likely to have continued in Q3, albeit at a slower pace than in the previous quarter, helped by the removal of pandemic-related restrictions. The increase in inflation, which will reduce households' purchasing power and increase uncertainty, makes it more difficult for households to anticipate the future trend in their real incomes. We expect private-sector consumption to climb 0.2% in Q3 2022, slowing down sharply from the growth seen in Q2.

OUTLINE OF OUR SCENARIO

INVESTMENT: THE OUTLOOK IS GETTING WORSE

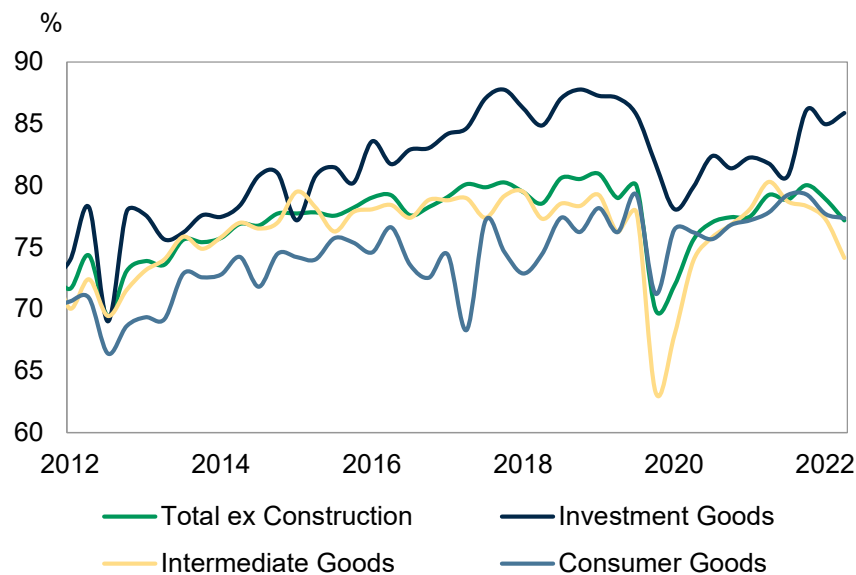
Components of investment



Sources: INE, Crédit Agricole SA / ECO.

Investment increased 2.5% qoq in Q2 2022 (vs. 3.3% in Q1), due to the increase in construction (6.5%), but mainly due to spending on machinery and capital goods, which rose by 2.5%. Several factors suggest that the momentum of business investment could have moderated in Q3, even though we are seeing some improvement in supply shortages. First, the industry confidence indicator was dropping until September, reflecting greater uncertainty and the deterioration of the domestic and external economic outlook. Second, data on credit

Capacity utilisation rate



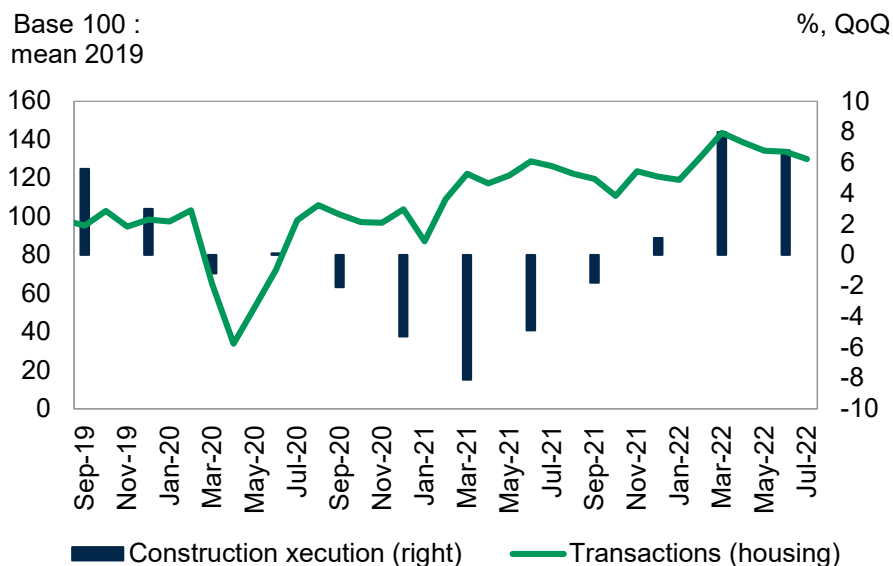
Sources: Ministry of Industry and Commerce, Crédit Agricole SA / ECO.

granted to non-financial companies is showing a contraction, in line with the gradual tightening of financing conditions for businesses. Finally, investment projects associated with the Next Generation EU programme are being delayed. We expect investment to grow 1% in Q2 and 5.5% on average in 2022.

OUTLINE OF OUR SCENARIO

BUOYANT CONSTRUCTION SECTOR

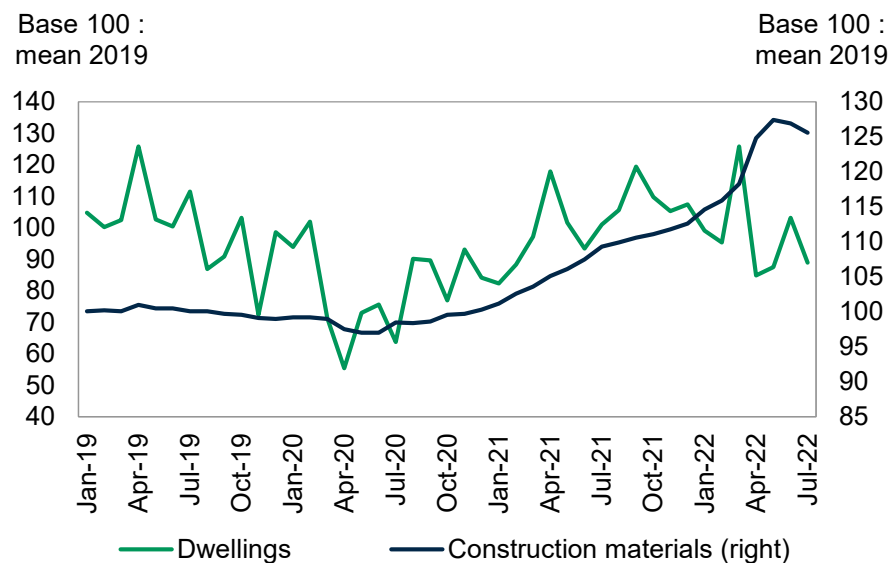
Construction indicators



Sources: INE, Crédit Agricole SA

Housing investment rose 1.8% in Q2 2022. However, despite the fact that transactions remain well above pre-pandemic levels, the slowdown in the construction execution indicator observed over the last few months points to a probable slowdown in Q3. Given the tightening of financial conditions, the loss of momentum in new building permits and the increased cost of building materials, it is possible that this slowdown in housing investment will continue

Change in transactions



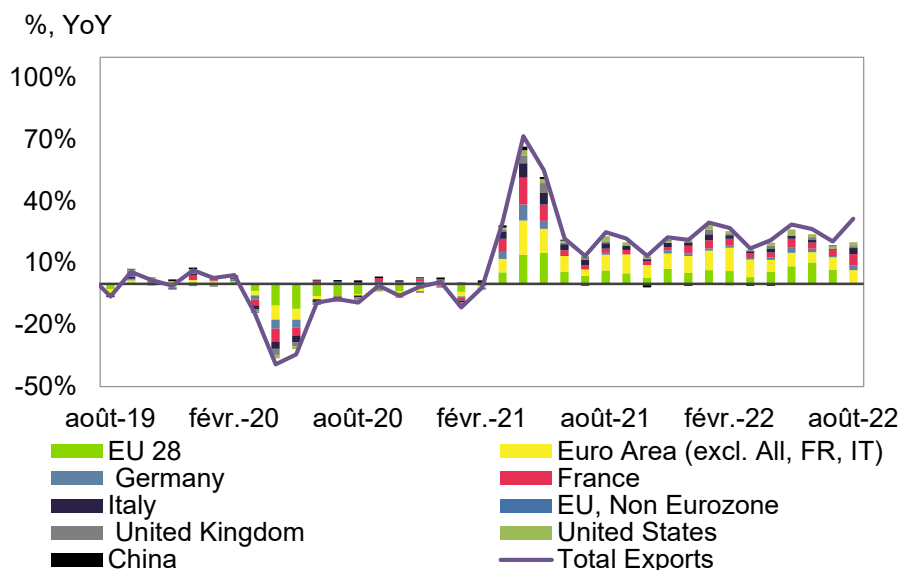
Sources: INE, Crédit Agricole SA Base 100 = Dec. 2019

throughout the rest of 2022 and the first quarters of 2023. House price growth moderated slightly in the second quarter, but still increased significantly year-on-year—8% according to the Spanish National Statistics Institute (INE)—due to insufficient supply to meet relatively strong demand.

OUTLINE OF OUR SCENARIO

INTERNATIONAL TRADE SAVED BY TOURISM, BUT WHAT NOW?

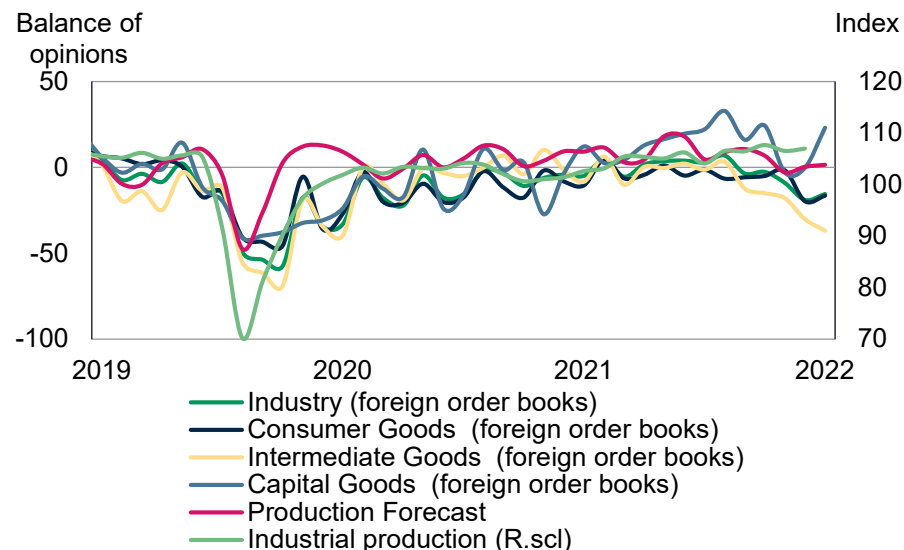
Exports by destination



Sources: Bank of Spain, Crédit Agricole SA / ECO

During the summer months, tourism activity converged towards pre-pandemic 2019 levels more quickly than expected, due to the removal of almost all international travel restrictions. The recovery in tourism by non-residents varied based on geographical origin: European tourist arrivals in July were 7.1% lower than in 2019, while arrivals of longer-haul approached 2019 levels later, particularly in the case of Asian tourism. Nominal spending by non-resident tourists returned to pre-pandemic levels throughout the summer, despite tourist flows not recovering completely. This recovery reflects an increase in spending

Export order books



Sources: Business confidence survey, Ministry of Industry and Commerce, Crédit Agricole SA / ECO

due to higher prices and a longer average stay. On the other hand, despite some improvement in bottlenecks affecting global supply chains and the competitiveness gains linked to the depreciation of the euro, international trade of non-tourist goods and services is expected to have slowed in Q3. Imports of goods—driven by intermediate, energy and non-energy goods—increased more than exports. Until July, the balance of goods deteriorated sharply in nominal terms, recording a deficit of 4.5% of GDP over the 12-month cumulative period, with a notable deterioration in the energy and non-energy components.

OUTLINE OF OUR SCENARIO

PUBLIC FINANCES: UNEXPECTED REVENUES IN 2022

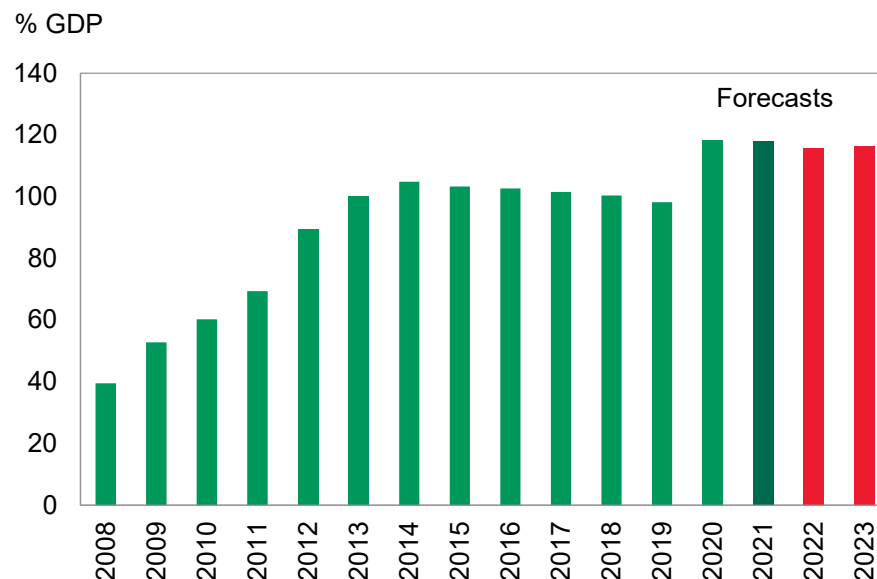
Government deficit



Sources: Stability and Growth Programme, Crédit Agricole SA / ECO

Until July, government revenues maintained very high growth rates, underpinned by significant growth in activity and prices. This momentum combined with the expected slowdown in spending led to a reduction in the general government deficit, to 4.3% of GDP in July (cumulative over 12 months), 2.6pp below end-2021 and also below the 5% benchmark set out in the stability programme for this year as a whole. For the rest of 2022, we expect the improvement in the

Government debt



Sources: Stability and Growth Programme, Crédit Agricole SA / ECO

government deficit to slow, due to the deterioration in the macroeconomic environment and the measures taken by the authorities to counter the negative effects of rising prices and the consequences of the war in Ukraine. These measures are expected to have a fiscal cost in 2022 equivalent to 1.3pp of GDP, of which 0.8pp would be realised from July onwards. Our government deficit forecasts are -4.8% in 2022 and -4.4% in 2023.

CONTENTS

1 SUMMARY

2 RECENT ECONOMIC TRENDS

3 OUTLINE OF OUR SCENARIO

4 | FOCUS: TREND IN INFLATION

5 FOCUS: 2023 BUDGET

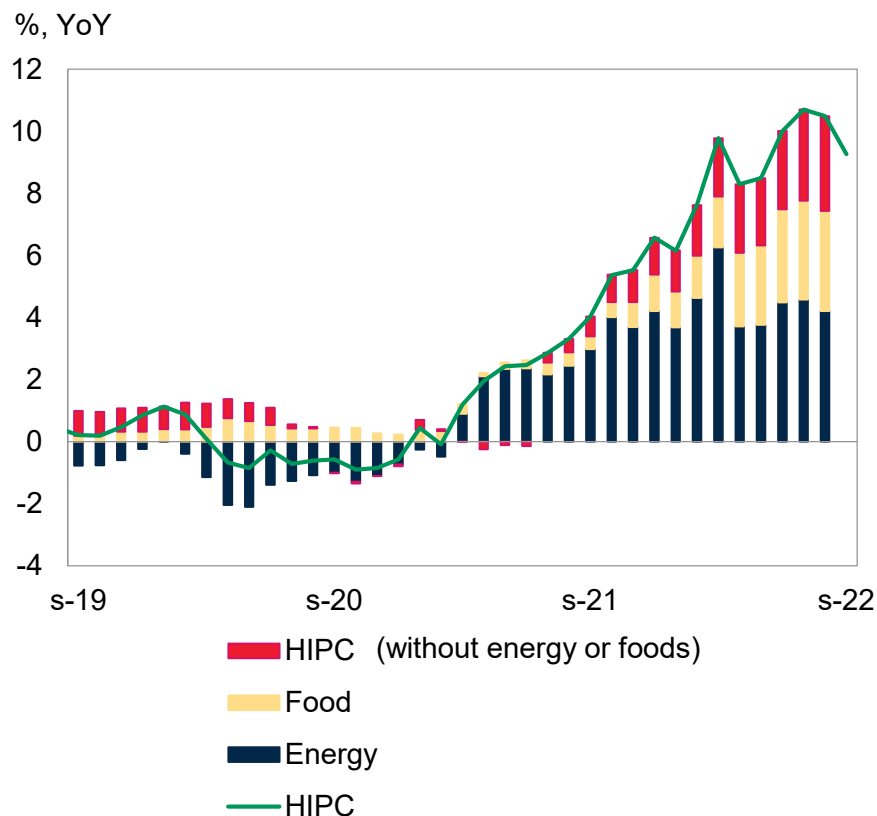
DETAILED LOOK: INFLATION ON THE RISE

INFLATIONARY PRESSURE REMAINS VERY HIGH AND IS SPREADING

Although the HICP indicator shows that the monthly headline inflation rate of the Spanish economy declined to 8.9% in September, in Q3, the average rate of year-on-year price increases was just over 1pp higher than in the previous quarter. Restaurants, leisure services, hotels and tourism were key contributors to this quarter-on-quarter rise in inflation. Core inflation reached 6.2% in September, 0.3pp and 1pp higher than in July and June, respectively. In August, more than half of HICP items and more than 40% of core inflation items recorded price increases above 4% year-on-year, compared to 25% and 15% respectively in January. This reveals the broad-based nature of inflationary pressure in Spain. The inflation rate would be even higher without the measures implemented by the authorities. In particular, the actions approved to contain the rise in electricity prices are believed to have reduced August's inflation rate by just over 2pp according to the Bank of Spain's estimates. The mechanism that limits the price of gas used in electricity generation is estimated to have contributed 1pp.

Data up to August on collective agreements shows an average wage increase of 2.6%. This increase mainly reflects changes in contracts already signed, but wage increases for new contracts also remained contained, at 2.9%. The percentage of workers covered by inflation safeguard clauses has risen to nearly 25% from 16.1% in 2021, increasing the risks that second-round inflation shocks are more severe than those observed to date. On the other hand, we are seeing slightly higher wage increases in the service sectors, which have seen a better trend in employment since the start of the pandemic.

Inflation: trend and contributions



Sources: INE, Crédit Agricole SA / ECO

CONTENTS

- 1 SUMMARY
- 2 RECENT ECONOMIC TRENDS
- 3 OUTLINE OF OUR SCENARIO
- 4 FOCUS: TREND IN INFLATION

- 5 | FOCUS: 2023 BUDGET

DETAILED LOOK: 2023 BUDGET

THE 2023 BUDGET TAKES ON INFLATION

On 4 October, the coalition government approved the 2023 draft budget. It focuses on social justice and economic efficiency combat broad-based price increases caused by the Russian invasion of Ukraine.

Under the effects of inflation (+4.1% in 2023 according to the text) and the improvement in activity (GDP is expected to increase by 2.1% next year), the budget forecasts a 7.7% increase in tax revenues to €262.8bn. On the other hand, non-tax revenues are expected to decrease by 2.8% to €44.6bn, generating a net balance for all non-financial income of €307.4bn, up 6% compared to 2022. Income tax and corporate tax receipts are expected to increase by 7.7% to €113.1bn and €28.5bn, respectively. Meanwhile, VAT should increase by 5.9% to €86bn. With this increase, Spain should be able to reduce the government deficit to below 4% in 2023, to 3.9%. Our government deficit forecasts are slightly less optimistic than those of the government due to a more moderate growth forecast in 2023 (around 0.9%) and a lower volume of European funds actually spent in 2022 and 2023, and stand at -4.8% and -4.4%, respectively. As for public debt, it will remain high, 115% of GDP in 2022 and 114% in 2023, far from its 2019 levels (95%).

The budget is based on increased tax pressure on high earners and relief for low-income taxpayers and small businesses. The executive introduced a temporary change in corporate tax, which penalises large companies, while the minimum income tax exemption increases from €14,000 to €15,000. With this measure, a €1.8bn decrease in tax revenue is expected over two years. In addition, the government has

designed a temporary tax on high net worth individuals. The tax will apply to 23,000 taxpayers with more than €3m in net assets, increasing inflows by €1.5bn. On the corporate side, the budget includes a decrease in corporate tax from 25% to 23% for small businesses that generate revenue of less than €1m, i.e. around 407,300 businesses, according to the Treasury. The impact on tax revenue will be nearly €300m. The executive decided to halve the allowance under which large groups of companies to offset losses at subsidiaries. In total, 3,609 companies (0.2% of tax filers) will be affected by a measure that will increase tax revenue by €2.5bn in 2023 and 2024. In addition to these measures, we must add the €7bn that the Treasury intends to collect in two years thanks to temporary windfall taxes on banks and large energy companies.

On the spending side, the budget has a total non-financial expenditure limit of €198.2bn, an increase of 1.1% compared to 2022. One of the main objectives is to mitigate the impact on low-income sectors of higher prices caused by the invasion of Ukraine. As such, pensions are expected to increase according to the CPI (around 8.5%). Civil servants' wages will increase between 2.5% and 3.5% in 2023 (+3.5% in 2022). In addition, given the rise in energy prices, a 65% increase in the social thermal premium is expected (€259m). Youth, one of the sectors most affected by the crisis, saw its budget increase by 13.2% to €12.7bn. The budget maintains the €250 monthly rental subsidy and the annual €400 culture pass. Also of note is the 25.7% increase in the transport subsidy to €3.4bn. Part of the increase is due to the extension of the free public transport initiative.

DETAILED LOOK: 2023 BUDGET

THE 2023 BUDGET TAKES ON INFLATION

The government is making European funds a key source of support to stimulate investment and support growth. The executive has included €25bn in spending of EU funds in the draft budget. According to reports from the Comptroller General of the State (IGAE), payments made were €11bn in 2021 (compared to €26bn in the 2021 budget) and reached €5.6bn this year until the end of August. However, this does not necessarily imply that they have reached their final beneficiaries, since transfers to other administrations or to railway infrastructure manager Adif, for example, are included in the calculation. One of the largest investments in 2023 is the Spain's 2030 industrial policy, with €4.5bn, up 43.1% compared to 2022, including €2.4bn allocated to industry and energy and €1.8bn in R&D and digitalisation. The housing rehabilitation plan accounts for €3bn, a 5.8% increase, with programmes to promote access to housing and the promotion of construction, as well as energy efficiency. Digital connectivity, the promotion of cyber-security and the rollout of 5G account for €2.6bn in 2023 (+69.3%). €2.1bn is allocated to the modernisation and digitalisation of public administrations, including the education system. Executing these investments is crucial to sustaining growth amid deteriorating private investment and consumer confidence, as well as high inflation.

Faced with criticism from the opposition and businesses about slow implementation and delays in funds reaching the real economy, the government argues that the implementation of the Recovery Plan has reached its "cruising speed" this year and that 2023 will be the time when the maximum deployment of EU funds will occur. IGAE data do not reflect these comments. Nevertheless, the recovery in construction in Q2 is a first positive sign and, indeed, spending of EU funds is expected to accelerate significantly at the end of 2022 and in 2023. As for the expansion of social spending, it seems

natural to us in one of the economies hardest hit by inflation and should help offset, in part, the decline in consumer spending. The increase in pension spending is justified by the fact that, in Spain, 70% of retirees earn less than €1,400 and 50% less than €1,000. Price inflation therefore has a major impact on these incomes.

Main items of expenditure	%, 2023 vs 2022
Management and administration of social security	114,1
Defense	26,0
Transport subsidies	25,7
Access to housing and property development	23,0
Culture	22,6
Education	21,8
Social services and social promotion	17,7
Infrastructure	15,3
Pensions	11,4
Other economic actions	9,6
Promotion of employment	8,9
Financial and tax administration	8,8
Justice	7,7
Other economic benefits	6,3
Citizen security and penitentiary institutions	5,7
Transfers to other general government	5,1
Health	4,5
Public debt	3,6
Agriculture, fishing and food	0,9
Foreign politic	-1,2
Industry and energy	-2,7
Unemployment	-5,3
Trade, Tourism and SME	-12,6
General services	-14,7

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Ticiano BRUNELLO

ticiano.brunello@credit-agricole-sa.,fr



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