Spain

Growth slows but the economy continues to recover

The current slowdown is in keeping with the European economic cycle. Prospects are still looking relatively good, and Spain's expected growth rate is among the highest of the big eurozone countries. Unemployment is falling rapidly but it is still massive, especially long-term unemployment. Prime Minister Pedro Sanchez just presented his 2019 budget proposal to Parliament, but he is not sure it will pass. In any case, the deficit most likely slipped significantly below 3% of GDP in 2018, and Spain is preparing to exit the excessive deficit procedure that was launched 10 years ago.

A slowdown is underway

In line with the eurozone economic cycle as a whole, Spanish growth is slowing. At 0.6% q/q in Q3 2018, quarterly GDP growth was stable for the third consecutive quarter, but fell slightly below the growth rates reported in 2017. On a year-on-year basis, growth fell steadily to 2.4% y/y last summer, the lowest level in nearly four years. Data available for the fourth quarter suggest that growth was still relatively robust at the end of the year, driven by domestic demand, and household demand in particular. Retail sales were sluggish last summer but rebounded during the year-end period, thanks apparently to the drop-off in inflation, from 2.3% in October to 1.2% in December. Survey data, especial the purchasing manager indexes, support this image: after declining in Q3, the activity index for the services sector rebounded in October and has held at a high level (54) through the end of the year. In manufacturing, in contrast, the activity index has steadily weakened to 51.1 in December, reflecting the slowdown in foreign trade.

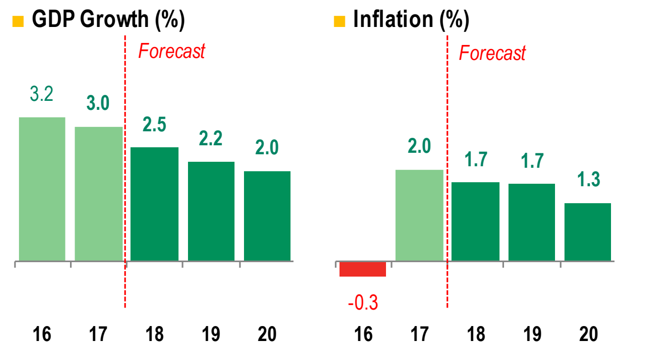
On the whole, after an annual growth rate of more than 3% over the past three years, GDP growth is estimated at about 2.5% in 2018. Though slowing, this is still one of the most robust growth rates of the big eurozone countries. It is also much higher than the country's long-term potential growth rate, as estimated by the various international institutions (which is currently closer to 1%). According to these estimates, the Spanish economy is on the verge of closing the output gap. Apparently, a few more quarters will be needed before we see the first signs of pressure on production capacity, prices and wages[1]. Buoyed by domestic factors, GDP growth is currently being hampered primarily by foreign demand. Ultimately, however, slowing international trade and uncertainty over changes in the European and global economic environment could end up straining investment spending. As in 2018, Spanish growth is likely to hold at about 2% in 2019.

A labour market in transition

The labour market still faces major challenges. From an overall perspective, the labour market is in the process of recovering: employment dynamics are keeping pace with activity. Up 2.5% a year since 2015, employment increased nearly 2% in 2018, which is undeniably a solid pace. Since the cyclical trough in late 2013, nearly 2.1 million jobs have been created according to the national accounts. Thanks to these job creations, the jobless rate has declined by more than 11 points in 5 years, to 14.7% in November 2018. Nonetheless, this is still one of the highest jobless rates in Europe.

The scope of unemployment does not sit well with the idea of an economy nearing its long-term growth potential. A look at detailed data paints a highly contrasted picture of the labour market, which shows signs of both dynamic momentum and rising pressures, but also the impact of the crisis. In terms of unemployment, the number of short-term unemployed (unemployed for less than a year, see

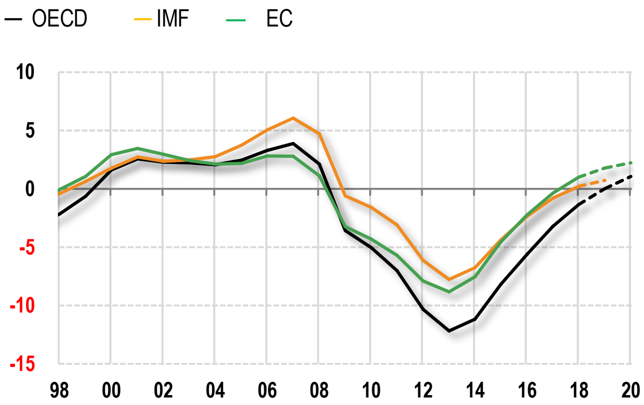
1- Growth and inflation outlook



Source: National accounts, BNP Paribas

2- The turnaround is nearly complete

Estimations of the output gap (% of potential GDP)



Source: European Commission, IMF, OECD

[1] The volatility of headline inflation should not be allowed to mask the great stability of core inflation, which has fluctuated around 1% since spring 2018, with no signs of accelerating.

chart 3) is falling very slowly now and is about to return to the pre-crisis average. This suggests that a certain "cruising speed" may have been reached for the mobility of new entrants, and that tensions could emerge in certain sectors and skills levels. Long-term and very long-term unemployment (between 1 and 2 years, and more than 2 years), in contrast, is now falling rapidly, although it still accounts for more than half of the unemployed (54%), or 1.7 million individuals[2].

The Sanchez government nonetheless decided to raise the minimum wage by 22%, from EUR 858 to EUR 1050 a month, at the beginning of 2019. Although this leaves Spain in an intermediate position in terms of minimum wage levels in Europe (chart 4), it is nonetheless a big increase and follows on increases of 8% and 4%, respectively, in 2017 and 2018. Past increases seem to have had only a small gearing effect, and the turnaround in wages as a whole has been very mild so far[3]. The increase in nominal wage costs per capita was nil or negative in 2016 and 2017, and remained moderate before accelerating a little last summer, to 1.9% y/y, mainly in the services sector. Although it will probably accelerate again this year, at this point in any case, a minimum wage increase might seem surprising due more to the massive unemployment described above rather than to wage cost fluctuations (even relative to the other European countries).

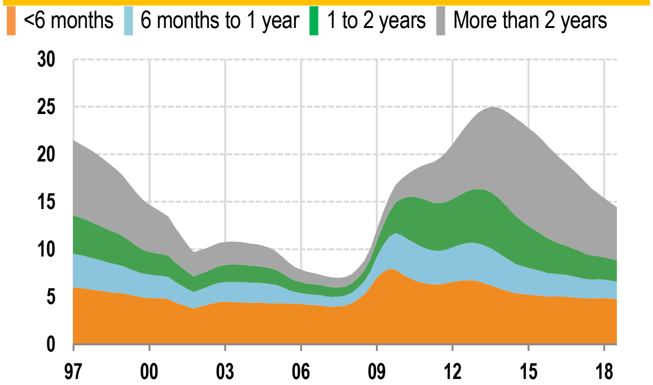
While awaiting the 2019 budget

The massive increase in the minimum wage is part of a broader economic policy that the Pedro Sanchez government has put forward in its 2019 budget proposal. It calls for an increase in social expenditures and pensions, along with higher taxes for high income households and major corporations.

Presented to Parliament in mid-January, the budget proposal might very well fail to pass due to the lack of a majority. The Sanchez government is in a minority position and must rely on the support of representatives from Podemos and the Basque and Catalonia pro-independence parties in order to pass legislation. The budget bill incorporates measures to boost investment spending in Catalonia, but this might not suffice to win their support as long as political negotiations over the Catalonia question are at an impasse. Until a new budget bill is passed, the previous year's budget is automatically renewed. Note that there is nothing new about this situation, which has already occurred twice since the latest legislative elections: the 2017 budget was not adopted until May 2017 and the 2018 budget until June 2018.

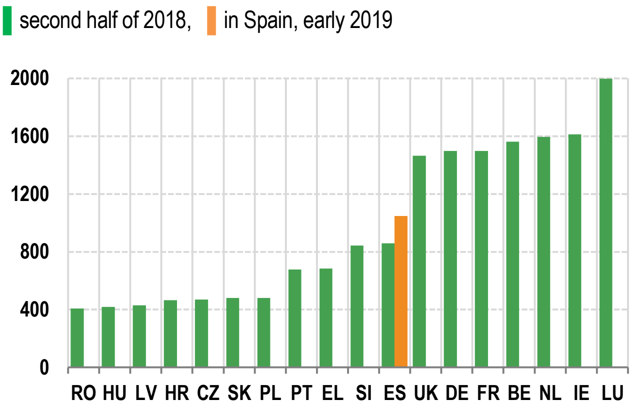
In any case, Spain's budget deficit fell below the 3% threshold last December (probably to 2.7% of GDP) for the first time since 2007, and it should officially exit the European excessive deficit procedure this spring. Spain is the last European country still subject to this special procedure. Low financing costs and vigorous growth should continue to reduce the deficit this year, masking yet again the probably expansionist nature of fiscal policy.

3- Lasting unemployment
Breakdown of the unemployment rate by duration, % of the active population



Source: INE

4- Minimum wages in selected European countries
Gross monthly wages (12 months), in euros



Source: Eurostat, government

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[2] It is tempting to compare the scope of long-term unemployment with the number of jobs that were eliminated in the construction sector during the crisis: nearly 1.5 million workers (between early 2007 and today).
[3] According to OECD data, in 2007 the minimum wage in Spain amounted to only 40% of the median wage, which is one of the lowest levels in the OECD. Only the United States reports a lower level of 34% of the median wage. In France, the minimum wage amounted to 62% of the median wage in 2007.