CAN THE DRIVING FORCE BEHIND EUROPEAN GROWTH SUSTAIN ITS MOMENTUM?

Spain's outperformance is set to continue throughout our forecast horizon. Private consumption is expected to remain the driving force behind GDP growth, buoyed by slowing inflation and a strong labour market. The contribution of foreign trade is expected to fall due to an anticipated increase in imports and the potential second-round effects of higher US customs tariffs on Spanish exports. Investment is expected to recover, buoyed by NGEU funds and monetary easing. Finally, even though there is no draft budget for 2025, fiscal consolidation is expected to continue over the next two years.

NO CLOUDS ON THE ECONOMIC HORIZON

Spanish economic activity remained buoyant throughout the first half of 2024, mainly driven by foreign trade and the gradual recovery in private consumption. Based on the preliminary growth figures for Q3 and the initial data available for Q4, we expect growth to remain dynamic throughout the second half of the year. According to our forecasts, real GDP should grow 0.7% q/q in Q4, bringing average annual growth in 2024 to 3.1%, still significantly outperforming eurozone growth (0.8%).

Throughout our forecast horizon, we expect growth to be largely driven by private consumption, which itself is being boosted by the momentum of the labour market, growth in nominal wages and a slowdown in inflation, which are pushing up household purchasing power. In addition, investment should steadily recover, due to the gradual disbursement of funds from the European Union recovery plan, the monetary easing policy initiated by the ECB and the improving financial situation of non-financial corporations[1]. Public consumption will also be boosted by the release of European funds. The positive contribution of foreign trade to growth should gradually decrease. Service exports are likely to remain high in the coming years, due to continued high tourist flows, in particular. However, imports should also grow, buoyed by domestic demand. As a result, Spain would remain the eurozone's driving force over the next two years, even though its growth is expected to slow gradually (2.5% in 2025 and 1.8% in 2026).

Despite these good prospects, the balance of risks surrounding our central scenario is still negative. The implications of higher customs tariffs on exports to the United States (see box), global energy and geopolitical pressures and a potential economic downturn among Spain's main trade partners are uncertainty factors, which could adversely affect our scenario.

IMMIGRATION WILL CONTINUE TO BOOST THE LABOUR MARKET

The strength of the labour market, observable since 2021, remains one of the main sources of Spain's real and potential growth. The number of people registered with social security has been constantly increasing (21.3 million in October, i.e. +3.5% since the start of the year) and is expected to continue to do so in 2025 and 2026, mainly driven by the immigrant workforce (+5.8% year-on-year and 15.1% of the total number of registered employees in Q3). In addition, the unemployment rate has fallen sharply (11.2% in November, compared to 13.5% in November 2021). In the medium term, it should get close to its equilibrium level of 9.6% in 2026, according to the Spanish government's forecasts, which is still well above the eurozone average (6.3%[2]).

GROWTH AND INFLATION

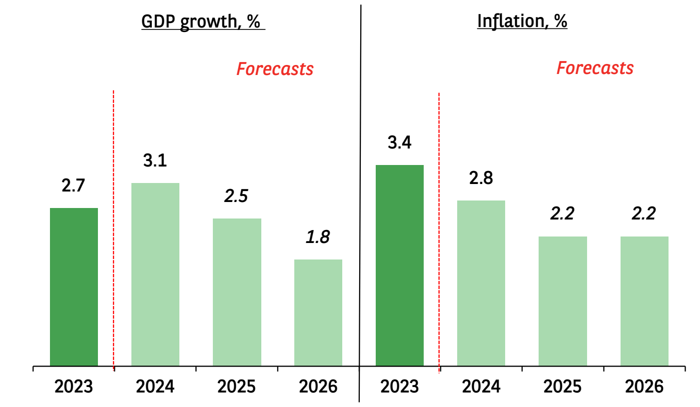

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

A GRADUAL SLOWDOWN IN INFLATION

Since peaking at 10.5% y/y in August 2022, harmonised inflation has slowed sharply (2.4% in November 2024, according to a flash estimate from Eurostat). Due to the continued deceleration in energy and food prices, this trend is expected to persist in 2025 and 2026 (2.2% on annual average, respectively). However, core inflation is expected to remain higher over the period due to pressures on service prices, caused by strong tourism demand and wage tensions (negotiated wages were up 3.0% y/y in Q3 2024).

THE LACK OF BUDGET FOR 2025 IS NOT DAMPENING THE OUTLOOK FOR PUBLIC FINANCES

Given its minority position in Parliament, Pedro Sanchez's government is struggling to pass its legislative initiatives. After extending the 2023 budget in 2024, the Public Treasury will do the same thing in the early months of 2025, as no budget proposal for the coming year has been presented. Therefore, there has been no clear announcement about the outlook for public finances. Nevertheless, we expect the budget deficit to decrease over the next two years, due to lower public spending (in particular, due to the end of support to the private sector in response to rising energy prices) and higher revenue (higher social-security-contribution revenue due to the increase in the number of employees and the end of reduced VAT on basic foodstuffs).

1 Non-financial corporations debt levels are at their lowest in 22 years (81.3% of GDP in Q2 2024).
2 European Commission Forecast.

HIGHER US CUSTOMS TARIFFS: THE IMPACT ON SPAIN WILL BE LIMITED

Unsurprisingly, Spain will not be the eurozone country hardest hit by higher customs tariffs on exports to the United States. On the one hand, its strong dependence on the services sector (75% of gross value added) significantly protects it from increases in customs tariffs; on the other hand, Spain's direct exposure to the United States is quite low (the share of total Spanish goods exports to the United States only accounts for 5.4% of total Spanish exports, i.e. 2% of GDP), so the first-round impact, via the trade channel, will be small.

Nevertheless, it seems clear that second-round effects of the slowdown in growth of its main European trading partners (Germany, France and Italy) will affect Spanish exports to these countries and adversely affect domestic activity over the next two years.

This reduction in the public deficit[3], combined with the strong nominal GDP growth anticipated in the coming years, should help to reduce the public debt ratio further. However, it is expected to most likely remain above 100% over the forecast horizon.

SPAIN'S NET INTERNATIONAL DEBTOR POSITION CONTINUED TO IMPROVE IN 2023

Over the past decade, Spain's current account has remained in surplus (1.7% of GDP on average between 2012 and 2023). After declining due to the pandemic, this surplus increased in 2023 (2.7% of GDP) thanks to the sharp drop in energy prices and the significant surplus in the services balance (caused by the boom in the tourism industry). This recovery, combined with strong nominal GDP growth, has helped Spain's net international investment position to improve since 2021 (from -72.1% of GDP in Q3 2021 to -45.3% in Q3 2024).

STRUCTURAL VULNERABILITIES: CHALLENGES IN THE LABOUR MARKET

Although it has proved somewhat robust since the 2021 reform, the labour market is still one of the black spots in the Spanish economy. The youth unemployment rate (26.7% in October) is still high compared to the eurozone rate (15%), illustrating that the mismatch between education and the market's needs is more significant than elsewhere. In addition, the number of long-term unemployed people has settled at a high level of approximately 1 million since Q2 2023. Against the backdrop of an ageing working population, this suggests that Spain has an older workforce that cannot be easily reintegrated into the labour market. Therefore, further structural reforms are seemingly needed in order to improve productivity and reduce unemployment.

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UNEMPLOYMENT RATE IN THE EURO AREA

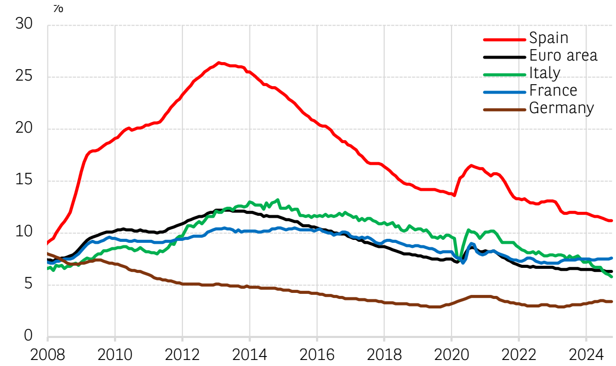

CHART 2

SOURCE: EUROSTAT, MACROBOND, BNP PARIBAS

SINCE 2023, SPANISH PERFORMANCE HAS MAINLY BEEN DRIVEN BY POPULATION GROWTH, WHILE GDP PER CAPITA HAS REMAINED RELATIVELY FLAT

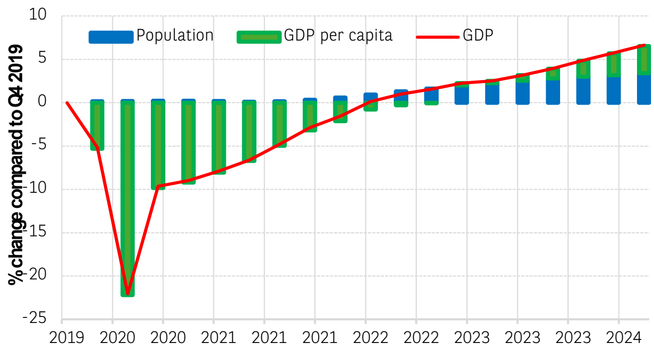

CHART 3

Note: productivity mesured by GDP per capita
SOURCE: EUROSTAT, MACROBOND, BNP PARIBAS

3 Estimated at -3.0% of GDP in 2024, -2.6% in 2025 and -2.7% in 2026 by the European Commission.