Spain

The new coalition takes its first steps

Although Spanish growth remains solid, it is by no means sheltered from the European slowdown. In 2020, growth is expected to continue slowing to about 1.7%, after reaching 2% in 2019. The slowdown is also beginning to have an impact on the labour market. From a political perspective, Pedro Sanchez was the winner of November's legislative election, although he failed to strengthen the Socialist party's position. He was invested as a prime minister in early January by Parliament and he will lead a minority coalition government alongside the extreme left Podemos. The coalition will depend on the implicit support of some regional and nationalist parties, notably the pro-independence Catalan ERC party.

Spain is expected to continue to rank among the fastest growing major European countries this year. After reporting an average annual growth rate of nearly 3% for the past five years, the Spanish economy apparently grew nearly 2% in 2019, well above the eurozone average.

Soft landing

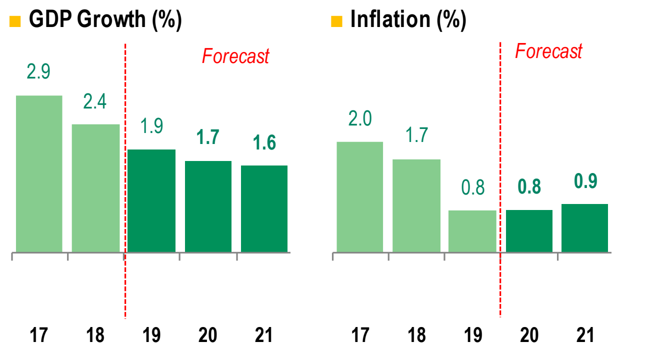
It goes without saying that the slowdown that has swept Europe has also hit the Iberian Peninsula, especially since its economy is much more open than in the past: exports of goods and services now account for nearly 34% of GDP in volume, up from 26% in 2007. Even so, the slowdown has been rather gradual so far, thanks notably to the resilience of domestic demand. Household consumption and corporate investment rose 1.4% year-on-year and 2.4%, respectively, in the third quarter. As to the year-end period, the Bank of Spain estimates that growth probably maintained a quarterly rate similar to that of the two previous quarters (0.4% q/q). Based on the information available so far, we expect retail sales to hold up strongly in the year-end period, while automobile exports rebound.

Purchasing manager surveys seem to concur with the idea of a growing decoupling of trends between the industrial and service sectors: industrial output has been contracting for the past few months while the service sector is much more resilient (see chart), buoyed notably by household demand, the turnaround in the housing sector and tourism. In the future, household income and behaviour will certainly play a key role in determining the resilience of Spanish growth. From this perspective, the news is mixed. Bolstered by job creations and wage increases, nominal disposable household income has increased by more than 3% year-on-year for the past two years, and continued to accelerate in mid-2019. As a result, Spanish households have been able to rebuild their savings. Spain's household savings rate is low compared to the European average, but it has picked up strongly since the beginning of 2018. This newfound manoeuvring room could prove to be handy just as the slowdown is beginning to have an impact on the labour market. With nearly 2.5 million job creations since the job market bottomed out in year-end 2013, job growth fell to just 1.8% year-on-year in Q3, the lowest level in the past five years, while the unemployment rate has levelled off in recent months at a very high level of 14%.

A fragile coalition

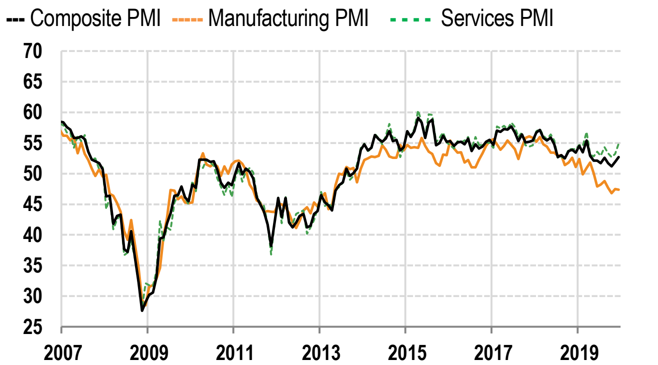
As polling data suggested, Pedro Sanchez came in first in the 10 November legislative elections, albeit without bringing together

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Activity in services is resilient
PMI (points)



Source: Markit

Spain's fragmented political landscape. This fragmentation has increased constantly since Podemos and Ciudadanos burst onto the political scene (around 2015), bringing to an end the bi-party system.

Divisions have only increased with the four general elections the country has held over the past four years. On the left, the balance of power was basically unchanged by November's election compared to the April 2019 results, with the Spanish Socialist Party (PSOE) winning 120 seats, or barely a third of the total in the new assembly, and Podemos winning 35 seats. On the right, the election was mainly marked by the collapse of the centrist party Ciudadanos, which lost four fifths of its seats to the Popular Party (89 seats), and by a new surge in the extreme right Vox party, which more than doubled its number of seats. Vox is now the country's third largest political power.

After several weeks of negotiations, Pedro Sanchez finally won approval in early January to head a PSOE-Podemos minority coalition government, thanks to the support of the Basque Nationalist Party PNV and the fortuitous abstention of the regional parties, notably the pro-independence Catalan Republican Left party (ERC).

Economic and institutional policies: walking a tight rope

What sort of policies, direction and scope of action will this minority coalition take? The investiture vote shows that Pedro Sanchez can only count on a very small majority of just 2 votes in the house of deputies[1]. Consequently, we can expect to see frequent power struggles throughout his mandate, as his various partners test the strength of the coalition. On the Catalan question, to win the ERC's support, Mr. Sanchez had to agree to open talks with the regional government and to submit its conclusions to voters in the region. Although renewing a dialogue is good news, a long and winding road lies ahead, because the two parties do not seem to have the same vision of the content and objectives of the talks (the Socialist want to reform its autonomous status while the ERC wants the right to self-determination).

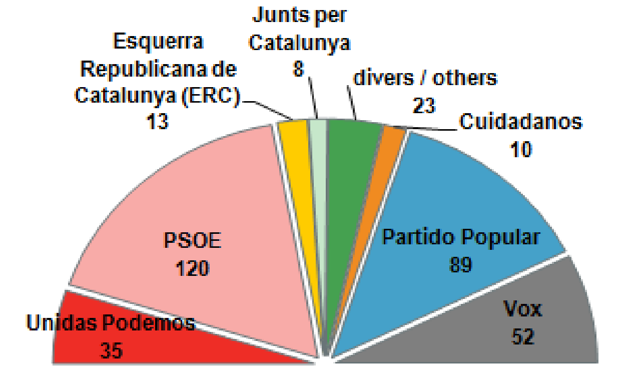
As to economic policy, it is worth recalling that after the April 2019 elections, Pedro Sanchez refused to form a coalition government with Podemos. He finally agreed to do so because this was the only feasible option after November's election. The coalition agreement between the two parties calls for higher taxes for big wage earners and major companies, and a minimum wage increase. To be more specific, the income tax rate on individual households would be increased by 2 percentage points for those making more than €130,000 a year, and by 4 points for those earning more than €300,000. Above €140,000, the capital gains tax would also increase by 4 points to 27%, from 23% currently. Lastly, the corporate tax reform would ensure a minimum tax rate of 15%, which would be raised to 18% for banks and oil companies.

In terms of spending, the coalition agreement calls for increased spending on public services, including healthcare, education and housing. Certain family benefits would be raised and pensions would be indexed to inflation again. Lastly, even though unemployment has levelled off at a very high rate in recent quarters, the government also plans to continue raising the minimum wage (after +8% in 2017, +4% in 2018, and +22.3% in 2019), gradually increasing it to 60% of the average wage within the next four years, (equivalent to another increase of roughly 30%).

At this stage, the 2020 budget has not been officially announced yet, much less approved. Pedro Sanchez still wants to guarantee a certain degree of fiscal responsibility, although a resolutely

3- Minority coalition

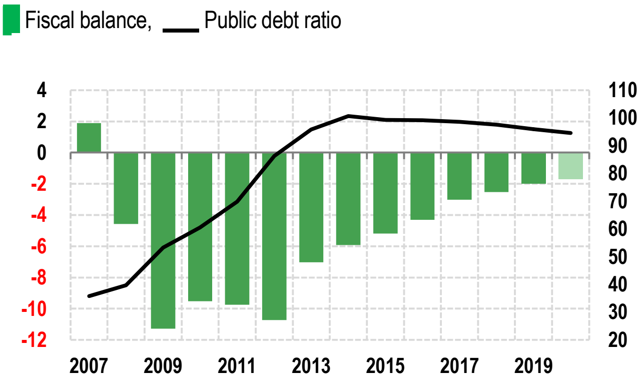
Political groups in parliament following the November 2019 elections, by number of seats



Source: Wikipedia

4- Budget forecast

% of GDP



Source: European Commission, 2020 fiscal plan dated October 2019

restrictive economic policy is highly unlikely[2]. He will be walking on a tight rope, especially in the midst of an economic slowdown. In 2019, the country already fell short of its targets, and the fiscal deficit apparently levelled off at 2.5% of GDP according to the Bank of Spain, compared to last October's forecast of 2%.

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[1] Pedro Sanchez did not win investiture until the second round of voting, during which he needed only a simple majority of deputies to win. Thanks to the abstention of a certain number of deputies, the Socialist was able to win the investiture and form a minority government, with 167 votes in his favour and 165 against.

[2] Despite European Commission recommendations to the contrary. As part of the preventative framework of the Stability Pact, the EC recommended that Spain continue to pursue fiscal consolidation efforts as long as the structural public finance deficit was not near an equilibrium.