

Spain

In search of a majority

Spanish growth is still robust, but that does not mean it is totally immune to the European slowdown. Although growth is expected to slow this year, it should have no trouble holding above an average annual rate of 2%. After winning April's legislative elections, Pedro Sanchez is still seeking a majority that would enable him to head the executive branch and form a new government. Spain officially exited the European excessive deficit procedure recently. Although a budget has not been formally adopted for 2019, the authorities are aiming for a primary surplus.

■ Solid growth is bound to slow

As survey data suggests, Spanish growth has proven to be quite resilient to the downturn in the international environment and the European slowdown in early 2019. Activity even accelerated slightly on a quarterly basis, with Q1 GDP up 0.7% q/q, the strongest growth since year-end 2017. Moreover, the breakdown of growth is favourable, and better balanced than we expected. First-quarter growth benefited from a net rebound in productive investment (+6.8% y/y in Q1 2019), and seems to be less dependent than we feared on household consumption (+1.4% y/y) and residential investment (+3.8% y/y), which is still looking upbeat.

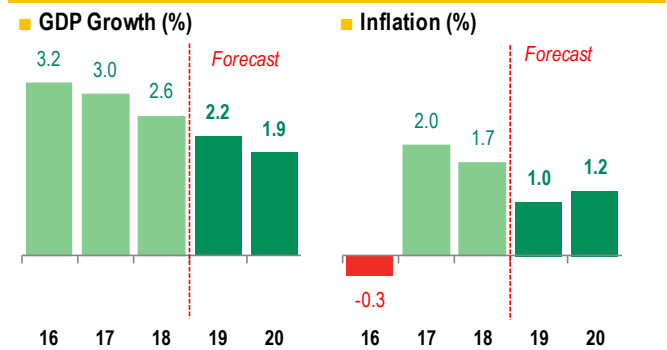
Foreign trade, in contrast, has continued to contract, a trend that began in H2 2018. Although the decline in exports of goods and services (-0.5% y/y) was limited by the strong performance of tourism, there has been an increasingly sharp drop in imports (-1.2% y/y), which limits the widening of the trade deficit observed last year. All in all, Spanish growth reached 2.4% y/y in Q1, compared to a eurozone average of 1.2%. According to the most recent survey data, a slowdown is very probable as of spring. This slowdown could extend somewhat into the quarters ahead, since the erosion of confidence is no longer limited to manufacturing and has now spread to the services sector. In general, however, GDP growth should have no trouble surpassing an average annual rate of 2% in 2019.

Under this environment, job creations have been very dynamic so far, up 2.5% y/y in Q1 2019, the biggest increase since year-end 2017. After employment bottomed out in late 2013, Spain has created 2.5 million jobs. The unemployment rate has just fallen below 14% of the active population for the first time in ten years, after rising above 26% in 2013, and it should continue to decline in the quarters ahead, albeit at a somewhat slower pace. Job creations, combined with mild inflation (which boosts household purchasing power), are the main source of resilience of domestic demand.

■ Seeking a majority to govern

Unsurprisingly, Pedro Sanchez came in first in the early legislative elections held on 28 April, with 28.7% of the votes cast. PSOE, the Spanish socialist party, won 123 of the 350 seats in the Chamber of Deputies, the lower house of parliament. This is nearly twice as many as its main opponent, the People's Party (66 seats), whose support evaporated with the milder wing shifting its support to the centre-right party Ciudadanos (57 seats) and the more radical wing to Vox, the extreme right party (24 seats).

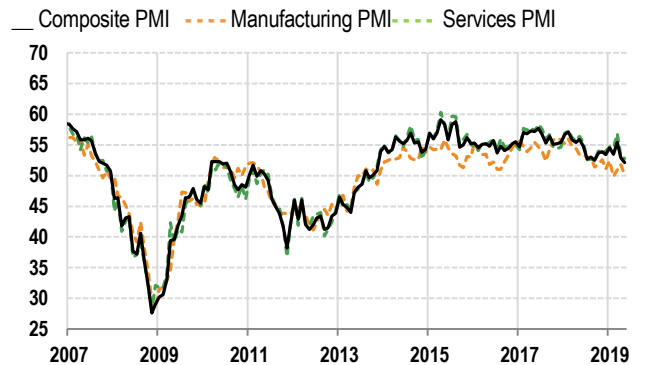
1- Growth and inflation



Source: National accounts, BNP Paribas

2- Slowdown ahead

Purchasing Manager Index (PMI, points)



Source: Markit

The PSOE victory will not necessarily reinforce Spanish political stability. In its new configuration, the Chamber of Deputies is no less fragmented than the previous one, and the party leader benefits from only 35% of the seats in parliament¹, compared to 39% for Mariano Rajoy and the People's Party following the 2016 elections.

In this situation, Pedro Sanchez has patiently awaited the outcome of the European elections as well as the municipal and local elections before starting the necessary deal making to form a new executive team. The elections revealed that the leader of

¹ The PSOE benefits from an absolute majority in the Senate, where most of the Senators are elected via a majority vote.



Ciudadanos, with whom a majority coalition is numerically possible, has rather decided to join the opposition alongside the People's Party, and was prepared, in some cases, to lend its support to local candidates of the Partido popular who were also supported by Vox.

On the left, no majority coalition is possible without the support of the Republican Left group, which includes the Catalan independence representatives of the ERC. Apparently, Pedro Sanchez would prefer to form a minority government based solely on the Socialist party, while seeking extra support from different sources depending on the issue. Yet this project runs against Podemos' plans to integrate the government as part of an official coalition with the Socialist Party. So far, nothing has been decided yet and the two parties are exploring the creation of a "co-operation" government. A first investiture vote is scheduled on July 23rd, but we cannot rule out the possibility that talks will extend beyond the summer break². Despite his electoral victory, Pedro Sanchez's future government may well have to rely on the support of a coalition as fragile as the one that backed the previous administration.

■ A smaller deficit despite the lack of a 2019 budget

Note that it was precisely after the previous parliament was unable to adopt a 2019 budget that Pedro Sanchez was forced to call April's early elections. Consequently, the 2018 budget has been automatically renewed for 2019, at least for now, and a series of additional measures were adopted by decree, notably in December 2018.

In terms of spending, these measures validated a general 1.6% increase in pensions, which is well above the legal minimum of 0.25%, and bolstered social welfare and local spending (including the extension of paternity leave, better benefits for unemployed seniors, and an extra boost for small pensions). According to the stability programme submitted to Brussels, increased spending will total about 0.4 percentage points (pp) of GDP, and will be financed by a slightly higher increase in revenues (0.5 pp) through higher social contributions and other taxes.

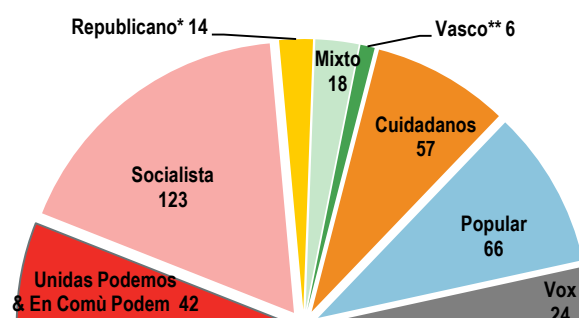
On the whole, fiscal policy will be slightly restrictive this year according to the authorities, and virtually neutral according to the European Commission. Once again, deficit reduction will be ensured through economic growth and the decline in interest charges. The decline, estimated at 0.1 pp compared to 2018 (interest charges declined from 2.5% of GDP to 2.4%), could be even bigger than expected given recent developments: Spanish 10-year sovereign rates have fallen sharply in recent weeks to 0.4% at the end of June.

All in all, the executive branch expects Spanish public finances to reach a primary balance in 2019, with the public deficit as a whole narrowing to about 2% of GDP, from 2.5% in 2018. In the stability programme submitted to Brussels last spring (prepared by the outgoing interim government), the authorities intended to strengthen

² In this first vote of confidence, an absolute majority is required to appoint the head of government. In the event of failure, a new vote is held two days later, where only a simple majority is required. If, within two months of this first election, no candidate has won the nomination of the Congress, new elections will be held.

3- Seeking a majority

Political groups in the lower house of parliament after the 28 April 2019 elections (number of seats)



* ERC Catalan nationalists

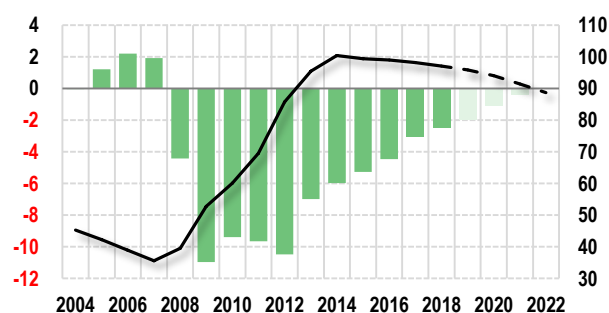
** PNV Basque nationalists

Source: Wikipedia

4- Fiscal outlook

% of GDP

Fiscal balance, Public debt ratio



Source: European Commission, 2019-2022 Stability Programme

structural adjustment measures over the course of the 2019-2022 fiscal programme (for a cumulative total of 1.5 pp of GDP over 4 years), and to reach a public finance equilibrium by 2022 (chart 4). In 2020, fiscal savings measures have already been announced for a total of 0.5 pp of GDP³, but it is uncertain whether the upcoming minority or coalition government will be in a position to pass them.

Frédérique CERISIER

frederique.cerisier@bnpparibas.com

³ Including corporate tax reforms to limit the fiscal optimisation of major corporations and to lower the rate applied to SME (0.1 pp); a financial transaction tax (0.1pp); an income tax on digital activities (0.1pp) and measures to fight tax evasion (0.1).

