Spanish elections unlikely to hamper growth outlook

The outcome of the Spanish elections could lead to changes in economic policy. However, the reactivation of European fiscal rules in 2024 limits the extent to which fiscal policy can be adjusted, limiting the risk to our growth outlook

Continued growth in the tourism sector will be the main driver of Spain's higher growth rates.

Uncertainty surrounding Spanish elections

Following major losses in the recent regional and local elections on 28 May, Prime Minister Pedro Sanchez of the Socialist Workers' Party (PSOE) has called for early elections in Spain. Although the latest polls indicate a shift to the right side of the political spectrum, the outcome of the upcoming elections remains uncertain. If the polls are correct, the conservative People's Party (Partido Popular) will get the most votes, but not the majority to form a government. In such a scenario, the third-largest party, the far-right Vox, will play a decisive role in forming a government.

As elections approach in Spain, the political landscape is characterised by high fragmentation and polarisation. Over the past decade, the Spanish political landscape has undergone a significant transformation, with a remarkable increase in the number of parties. This fragmentation has led to greater instability as coalition governments must now be formed, which often rely on a fragile consensus. Based on the latest polls, it seems likely that another coalition government will have to be formed.

How the Spanish election could affect the economic outlook

Spain's economy has outperformed that of other eurozone countries over the past year, but is still weighed down by structural weaknesses such as high debt, low productivity and a rigid labour market. Despite a historically low unemployment rate, it is still among the highest in the eurozone and youth unemployment is alarmingly high. Moreover, the country has still not fully recovered from the pandemic, despite last year's impressive growth figures.

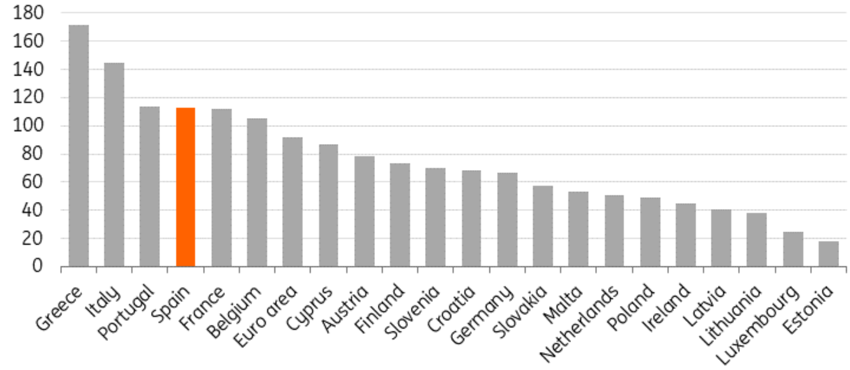
The elections could also be the starting point of a longer period of political instability, although this is not our baseline scenario. This could happen if the election results make it difficult to form a stable majority, leading to protracted government negotiations. In addition, there is still a real possibility that a clear majority cannot be formed, which would lead to a hung parliament necessitating new elections and prolonging political uncertainty. In such a scenario, crucial structural reforms needed for the economy may be delayed, reinforcing existing weaknesses. Persistent uncertainty about future government policies could also undermine investor confidence and hamper investment activities.

If a new right-wing government comes to power, it could bring about a change of course in economic policy. Conservative leader Feijóo has already announced plans for more business-friendly policies and tax cuts, including a proposed income tax cut for people earning less than €40,000 a year. There is also a real chance that the planned closure of nuclear power plants in 2027 will be postponed to secure energy supplies. The extent of these policy shifts will depend on the consensus among coalition partners and the strength of their majority. If the right-wing Conservatives and Vox form a comfortable majority, they will feel more supported to reverse certain previous government policies.

Despite a possible change of direction in economic policy, there is little room to shift to a more stimulative fiscal policy. Spain's public debt ratio is one of the highest in the eurozone at 113.2%. Spain ranks below Greece (171.3%), Italy (144.4%) and Portugal (113.9%). According to current forecasts, Spain will overtake Portugal in the ranking this year. This shift is due to a lower expected government deficit in Portugal combined with slightly better growth prospects.

Spain recorded a deficit of 4.8% of GDP in 2022, and both our forecast and that of the Bank of Spain suggest that the deficit will remain above the 3% threshold at least until 2025. This level is considered an excessive deficit by the European Commission. The reactivation of European fiscal rules in 2024 will increase pressure on fiscal consolidation measures. Regardless of the election outcome, addressing public finances will be inevitable, further limiting the government's flexibility to pursue more expansionary fiscal policies.

Government debt to GDP ratio, 2022



Source: Eurostat

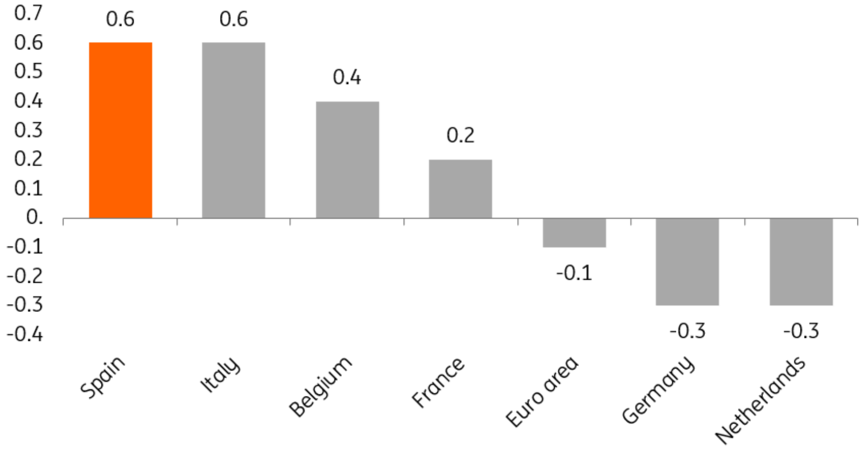
New government will take office amid a slowing economy

Spain's economy was the fastest-growing of all larger eurozone countries in the first quarter, growing 0.6% quarter-on-quarter. Like other southern countries, Spain benefited from growth in net exports driven by a continued rebound in tourism. In addition, the Spanish economy benefited from some structural differences, such as a relatively smaller industrial sector compared to, for instance, Germany. It is precisely this energy-intensive industry that has suffered the most from higher energy prices and tightening financial conditions. Finally, Spanish energy prices, partly due to the introduction of the gas price cap, have not risen as much as in several other countries.

Despite the good start, maintaining this positive momentum may be challenging. Although several factors such as a pick-up in wages, improvements in global supply chains, falling energy prices, and government support packages are giving some tailwind, the tightening of financial conditions will increasingly cast a shadow on the economy. It is hard to imagine that the rapid and significant increase in policy interest rates will not significantly slow economic growth.

The external environment is also expected to weaken further, with the eurozone experiencing a technical recession over the past two quarters, China's economic recovery falling short of expectations and US growth expected to slow. This could also affect Spain's tourism sector. A slowdown in the global economy could lead to less international travel, limiting the growth of the tourism sector in 2024.

Spain recorded the strongest growth among larger euro countries in the first quarter



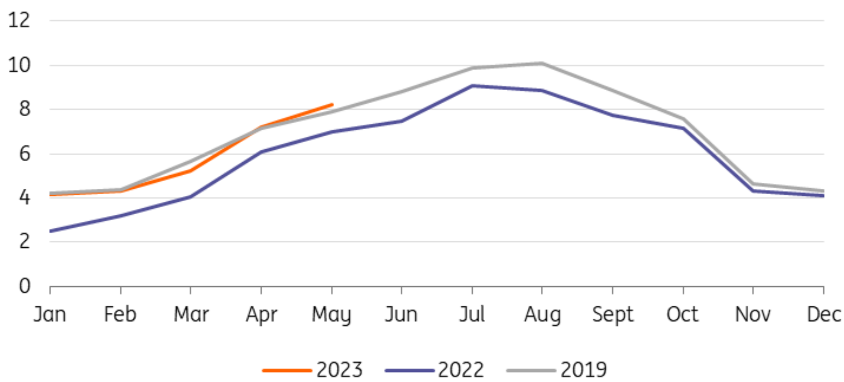
Source: Eurostat

Tourism will be the main growth driver this year

The slowdown in the Spanish economy can be attributed to the overall deceleration of the global economy. Nevertheless, Spain is poised to become the best-performing economy among the larger eurozone countries this year. We forecast average growth of 2.2% for Spain this year, well above the eurozone average of 0.4%.

Continued growth in the tourism sector will be the main driver of Spain's higher growth rates. Although the number of international tourists entering Spain in 2022 was still 14% below pre-pandemic levels, the gap may be closing this year. In May, the number of international visitors had already risen to 104% of the pre-pandemic level, compared with 88% in May 2022. Strong travel demand points to a promising tourist season ahead. Contributing about 15% to GDP, the tourism sector will remain one of the main catalysts for economic growth throughout the year.

The number of foreign tourists increased above pre-Covid levels in April and May (in millions)



Source: INE

Spanish headline inflation reaches 1.9%

Spanish inflation has fallen faster than in other eurozone countries. In June, Spanish inflation stood at 1.9% year-on-year, while the eurozone recorded 5.5%. These positive developments can be attributed to more favourable base effects from energy prices, which rose faster in Spain than in other countries last year. However, if these favourable base effects fade in the coming months, Spanish headline inflation could rise again. In addition, the phasing out of several government measures by early 2024 is expected to have an upward effect on inflation.

Spanish core inflation, excluding energy and food prices, remains remarkably high at 5.9% and is even above the eurozone average of 5.4%. Core inflation is expected to remain at a high level throughout the year and gradually decline. Yet there are indications that core inflation is also on a sustained downward trend. For instance, inflation in the buoyant hospitality sector, which accounts for 14% of the inflation basket, is cooling markedly despite strong sustained demand on the back of a strong tourist season. Core inflation is expected to remain at high levels throughout the year and only gradually decline.

Slowing momentum despite tourism recovery

For 2023, we expect growth of 2.2%, well above the eurozone average of 0.4%. Although the economy performed strongly in the first quarter, momentum is expected to wane as financial conditions tighten. The main driver of growth will be net exports, supported by the continued recovery of the tourism sector, which surpassed pre-pandemic levels in May and April. Although headline inflation fell to 1.9% in June, it is expected to rise in the coming months due to less favourable base effects for energy and persistent core inflation.

Spanish economy in a nutshell (%YoY)

	2022	2023F	2024F	2025F
GDP	5.5	2.2	1.0	1.9
Private Consumption	4.4	0.1	2.1	2.1
Investment	4.6	1.5	2.1	2.3
Government consumption	-0.7	0.6	0.7	1.3
Exports	14.4	7.1	1.5	2.7
Imports	7.9	3.4	3.9	3.0
Headline CPI	8.4	3.6	2.7	2.1
Unemployment rate (%)	12.9	13.1	13.3	12.9
Budget balance as a % of GDP	-4.8	-4.1	-3.7	-3.4
Government debt as a % of GDP	113.2	109.8	109.1	108.6

Source: ING research

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