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Europe

Spain: a tale of two halves

- **Review:** In January, euro area M3 money supply increased 4.1% yoy. The final prints for January headline and core inflation were unrevised, at -0.6% yoy and 0.6% yoy. In 4Q 2014, GDP growth for Germany and Spain was unchanged from initial estimates at 1.4% yoy and 2.0% yoy, respectively.

- **Preview:** Next week, we expect the final prints for 4Q GDP growth to be unrevised from the flash estimates, at 0.3% qoq and 0.9% yoy. February headline and core inflation should come in at -0.6% yoy and 0.5% yoy.

- **Hot topic:** We expect strong growth in Spain this year, but some structural challenges persist, which makes the economy vulnerable to shocks in the medium run. The political outlook will make it hard to deliver on what is needed to correct those challenges.

Top GDP growth performer, but risks remain

Spain has been one of the top performers in terms of GDP growth over the past few quarters, and we expect this new status to be maintained throughout 2015. We forecast GDP growth of 2.2% in 2015. We think domestic demand (particularly private consumption) will be the engine of growth throughout 2015 given fiscal easing on the back of the tax reform, the evolution of oil prices, and the improvement in labor market dynamics. We expect policy uncertainty to weigh on sentiment in 2016 driven by what we expect will be a very fragmented parliament, creating a difficult and volatile environment for policy-making. We forecast GDP growth of 1.9% for 2016.

While there has been some rebalancing, this seems insufficient for a sustained correction of external imbalances. The flow problem (current account) has been corrected substantially, but we are far from a solution for the stock (net international investment position). In the medium run, this still leaves the Spanish economy susceptible to potential shocks, among them, political. The recovery is also unequal and, despite the good performance in terms of labor quantity, quality remains an issue. It will take time before the population feels the recovery; growth is unlikely to fully reverse the drop in the support for traditional parties.

There has been some impressive progress on reforms and fiscal adjustment in recent years. Still, it is not clear to us whether there will be the political consensus in the future to keep pushing in the right direction. The Spanish economy still needs to address low productivity and trend growth, large rigidities in some markets, fiscal imbalances, poor education performance, duality of the labor market, reallocation of the large pool of unemployed across sectors, and the pending deleveraging of the household sector.

The results of the next Spanish election due in November 2015 are highly uncertain. The imperfect proportionality of the Spanish electoral system, the small sample size of current polls, the hidden vote, and the appearance of new parties all leave room for surprises. Despite this, the clear picture that has emerged from the polls is one of fragmentation. In our view, it will likely be hard to form a strong government able to deliver on the (still) needed fiscal adjustment and structural reforms. Absent tail-risk scenarios (an outright majority for left wing political party Podemos that would be intent on restructuring debt), markets should be assured by ECB QE. But risks are more biased to the downside in the case of equities