

Focus

ECONOMY SPAIN

Spain: European Growth Engine?

Executive Summary

Spain stands out as a positive outlier in economic terms in 2023, while other European countries are obviously struggling more with economic challenges. In the first half of 2023, Spain recorded solid growth of 0.5% (Q1) and 0.4% (Q2). The Spanish central bank recently raised its growth forecast for 2023 significantly to 2.3%. Nevertheless, Spain still has some catching up to do compared with pre-crisis levels.

Industrial production is not providing strong impetus in Spain. Growth increased slightly in Q4 2022 and Q1 2023. This was followed in the second quarter by a sharp decline of 1.6% QoQ. Leading indicators are also signaling weakness.

Capital expenditure showed an encouraging trend for the first half of the year. For example, gross fixed capital formation increased by 1.9% QoQ in the first quarter of 2023 and picked up again by 4.6% QoQ in the second quarter. European funding from the NextGenEU project is playing a major role in investment activity.

Spain's external sector was positively influenced by booming tourism in 2023. Exports of goods were burdened by the Chinese economic weakness. The heat waves this year have not yet had a serious impact on exports.

The services sector, especially tourism, made a strong contribution to growth, while private consumption was positively impacted by declining inflation. At the same time, tighter credit conditions weighed on private consumption. Overall, private consumption fell by 1.4% QoQ in the first quarter, only to grow by 1.6% QoQ again in the second quarter.

Economic policy will be influenced by the political realignment following the July elections and the need to reduce deficits and debt.

As a result of the ruling PSOE party's election debacle in the regional and municipal elections in May, Prime Minister Pedro Sanchez brought forward the parliamentary elections scheduled for December 2023 to July. In this election, the opposition PP was able to win, but so far it has not managed to gain a majority in parliament. A political stalemate seems to be developing in Spain, which could lead to new elections around the turn of the year.

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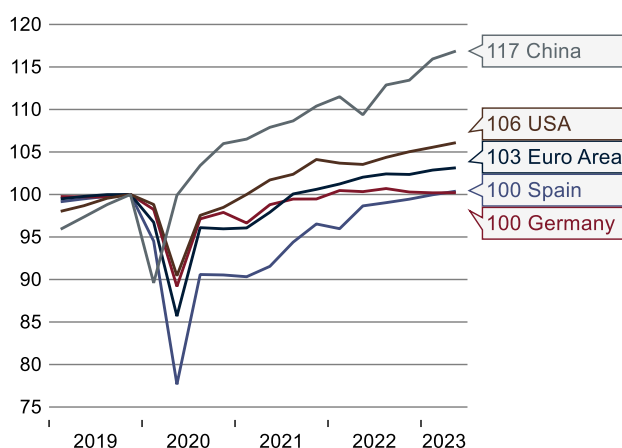
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Economic growth

In recent months, economic growth in the euro zone has weakened. Germany in particular is currently being questioned as "the sick man" of Europe, as Germany slipped into technical recession in the fourth quarter of last year and the first quarter of this year, and also showed stagnation in the second quarter. However, there is one European outlier that has shown solid growth so far and is outperforming its European neighbors. Spain. The country posted solid growth of 0.5% (Q1) and 0.4% (Q2) in the first two quarters of the year; analysts raised their 2023 growth forecasts sharply during the year. For example, the International Monetary Fund (IMF) adjusted its January forecast from 1.1% to 2.5% in July.

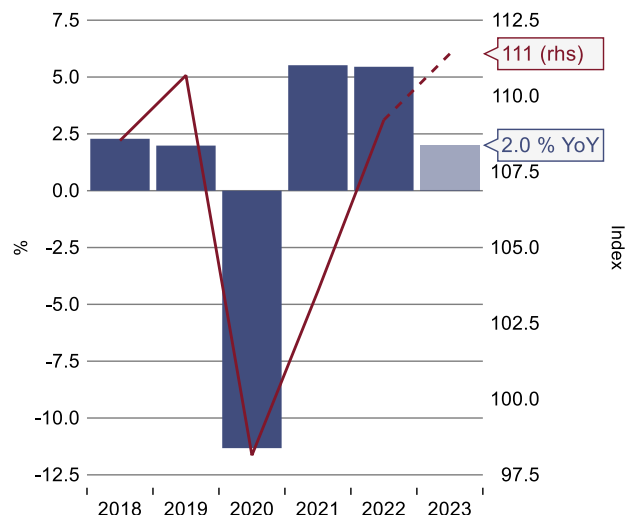
Gross Domestic Product, Constant Prices, rebased to Q4 2019 = 100



Source: Macrobond, HCOB Economics, Spanish National Statistics Institute (INE), German Federal Statistical Office (Statistisches Bundesamt), Eurostat, U.S. Bureau of Economic Analysis (BEA), China National Bureau of Statistics (NBS)

The good impression is put into perspective somewhat if we compare its development in an international context and take as our starting point the data for the fourth quarter of 2019, shortly before the start of the Covid 19 pandemic. It is striking that Spain was one of the last developed countries to return to pre-crisis levels only now. It thus occupies one of the last places, together with a beleaguered Germany, which, however, already reached pre-crisis levels in early 2022 and has been stagnating since then. This means that the Spanish economy has certainly shown good momentum since 2022 and 2023, but this can still be interpreted as the result of catch-up effects in the wake of the pandemic.

Spain, Gross Domestic Product, YoY



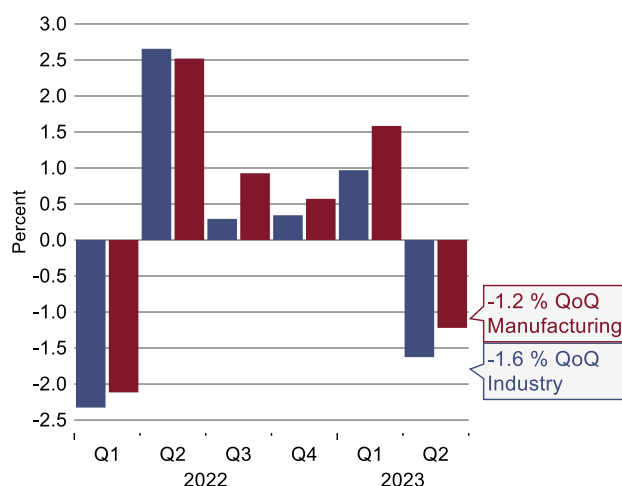
Source: Macrobond, HCOB Economics, Spanish National Statistics Institute (INE)

Manufacturing industry

Industrial production in Spain has suffered from the exogenous factors that have affected both the overall Spanish economy and the European economy in recent years, starting with the Covid 19 pandemic in 2020 and the associated supply chain problems that have affected it until the end of 2021, the Russia-Ukraine conflict and the energy crisis, as well as the inflation dynamics since 2022 and the subsequent tightening of financial conditions due to the interest rate hikes by the European Central Bank (ECB). Growth momentum picked up in 2021 after contraction in 2020.

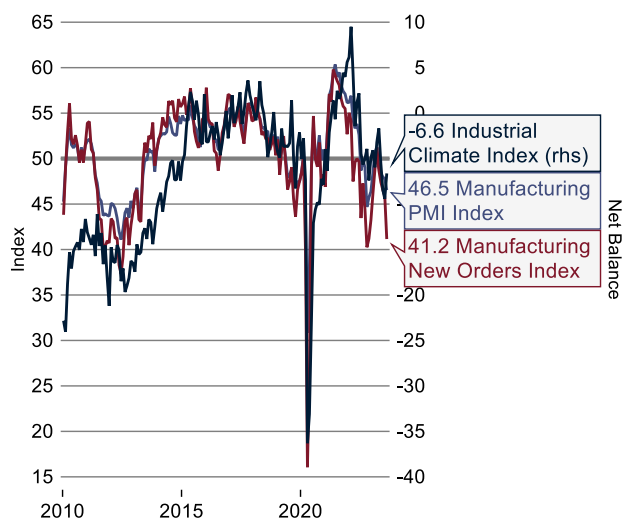
Manufacturing grew by 8.9% in 2021 and industrial production also showed recovery effects, growing by 6.6%. In 2022, the momentum in the manufacturing sector continued with a growth of 3.8%. Industrial production recorded growth of 3%. Growth in 2023 has been volatile so far, but the latest data suggest that a recession will be possible this year. The first quarter saw slight growth in industrial production (1.0% QoQ) and also in manufacturing (1.6% QoQ). However, this was followed by a sharp decline in growth in the second quarter.

Spain, Production Approach, Gross Value Added, QoQ



Source: Macrobond, HCOB Economics, Spanish National Statistics Institute (INE)

Leading indicators also paint a gloomy picture: The HCOB-PMI index for manufacturing has been falling steadily since March and, with an index value of 46.5 in August, is in contraction territory. Similarly, the Industrial Climate Index of the Spanish Ministry of Economy has been falling since the end of the first quarter. Leading indicators as well as external factors suggest that there will be no major growth stimulus in the manufacturing sector in 2023. For example, order backlogs provide only 4.8 months of employment, down from 5.9 months at the beginning of the year. In a report dated June 21, 2023, analysts at Caixa Bank take a somewhat more positive view of the situation in the manufacturing sector, although they also point to weakening demand in the global economic context. In addition, especially the data of the current margin give reason to give a weaker outlook.

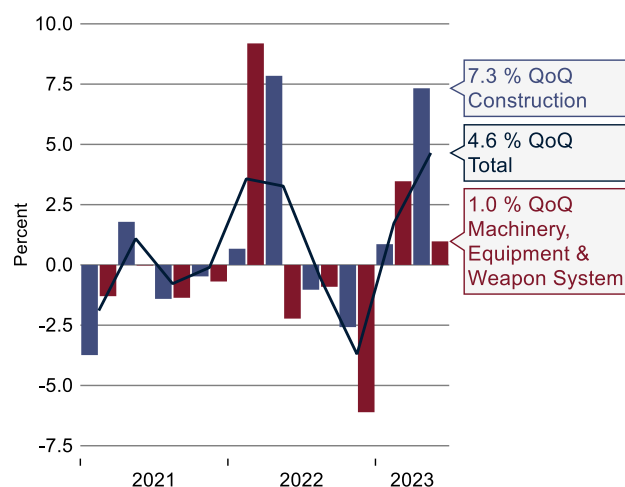


Source: Macrobond, HCOB Economics, S&P Global, Spanish Ministry of Economy & Business

Investments

After investment grew by 2.5% YoY in 2022 as a result of catch-up effects following the Covid 19 pandemic, the trend for the first half of 2023 is also encouraging. For example, gross fixed capital formation grew by 1.9% QoQ in the first quarter of 2023 and increased again by 4.6% QoQ in the second quarter. Investments in the construction sector ensured particularly high growth in the second quarter, rising by 7.3% compared with the previous quarter.

Spain, Expenditure Approach, Gross Fixed Capital Formation, QoQ



Source: Macrobond, HCOB Economics, Spanish National Statistics Institute (INE)

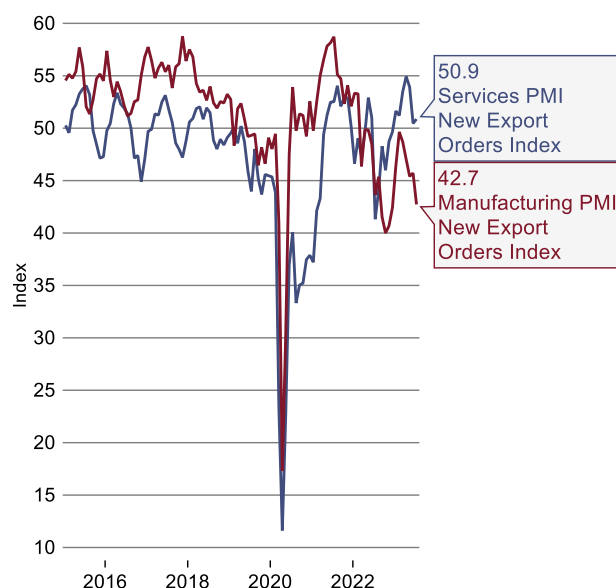
A major role is played by investments from the Next Generation EU (NGEU) projects, which will have an increasing influence on investment activity. This becomes clear when analyzing the totals. Gross fixed capital formation amounted to €135.5 billion in the first half of 2023, and the budget that Spain is entitled to through the pots of the NGEU project amounts to an additional €35.4 billion in 2023. It now depends on the ability of Spanish companies and regional governments to act, to what extent these European funds can be exploited, as the subsidies are conditional to achieve the goals of sustainable transformation (decarbonization, digitalization). In 2021 and 2022, about 40% of the budget of EU funds has been disbursed to companies. Nevertheless, the outlook for investment activity in the near future is uncertain, as players struggle to cope with higher interest rates and the general ongoing uncertainty in the global economic environment.

	2021	2022	2023*
Initially budgeted	24.198	26.900	28.691
Final budget	24.198	28.471	35.387
Authorised (activated projects)	22.128	25.143	15.663
Committed (projects allocated to firms&sub-state public administrations)	20.976	21.647	9.826
Disbursed	11.003	11.271	2.871

*until May 2023
Figures in bn. €
Source: IGAE.

Foreign Trade

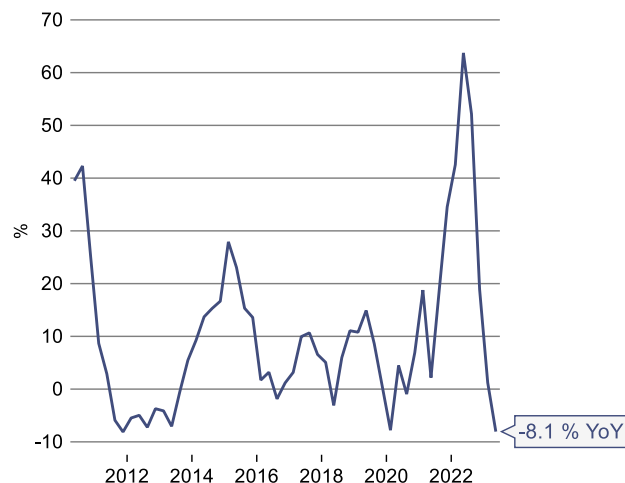
After exports slumped by almost 20% year-on-year in 2020, a recovery has started in 2021 and 2022, so that exports recovered by 14.4% in 2021 as well as in 2022, and imports also increased by 14% (2021) and 7.9% (2022). In 2023, the growth of imports and exports is expected to slow down. After rising sharply in the first quarter (5.6% QoQ), exports also fell sharply in the second quarter by 4.1% QoQ.



Source: Macrobond, HCOB Economics, S&P Global

Nevertheless, Spain's external sector has continued to contribute positively to growth in recent months. This was mainly due to strong service exports or tourism and competitive price advantages. HCOB PMI indicators for new export orders show a clear difference between stagnating goods exports and strong services exports, characterized mainly by travel services. In addition, inflation in Spain is noticeably lower relative to its main European trading partners. As a result, export prices have risen relatively more weakly than those of competitors, which may have created a comparative advantage for Spain in the euro area.

Spain, Foreign Trade, Countries, Import, China



Source: Macrobond, HCOB Economics, Spanish Ministry of Economy & Business

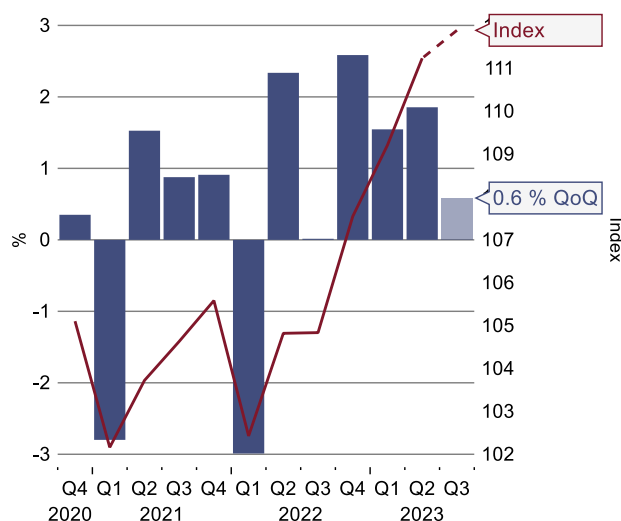
Despite the ongoing extreme weather that has hit Spain this year in the form of extreme heat, floods and forest fires, this has not affected food exports so far. In June, exports of food, beverages and tobacco increased by 10.3% YoY.

Imports show a downward trend over the last three quarters. Intermediate goods in particular have declined, while consumer goods and capital goods have remained constant. This is due in particular to the weakness of China. Imports from China slumped by 17.7% YoY in June. Spain is definitely dependent on China as a trading partner, as Spain imports around 10% of its goods and services from China, making it one of Spain's most important trading partners alongside Germany and France.

Services

The services sector has been the pillar of Spanish economic growth in recent months. To analyze the growth of services, it is worth looking at retail, which accounts for around 20% of activity in this sector. In 2022, retail growth was 0.8% adjusted for inflation. In 2023, retail growth rates appear strong. Retail is still showing resilience, with growth of 1.5% QoQ in the first quarter followed by growth of 1.8% QoQ in the second quarter. Leading indicators as well as growth in July indicate that momentum is likely to slow somewhat in the third quarter.

Spain, Retail Trade



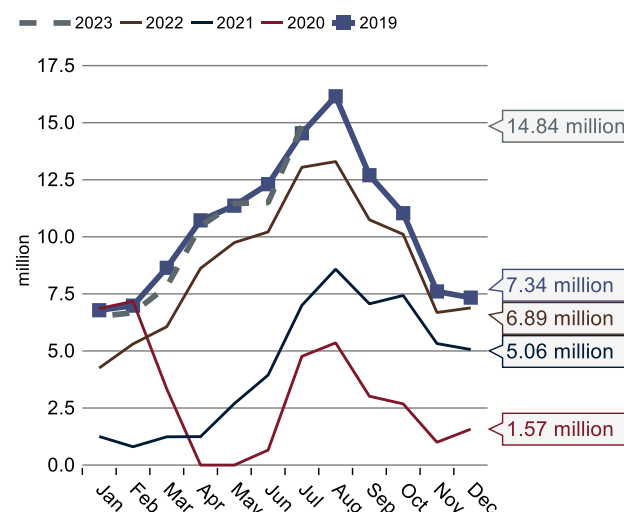
Source: Macrobond, HCOB Economics, Spanish National Statistics Institute (INE)

When looking at the services sector, the tourism industry stands out in particular, which still accounted

for 12.6% of GDP in Spain in 2019, the year before the Covid 19 pandemic began. Huge recovery effects occurred here in 2022 and 2023. This year, the number of international visitors to Spain is leveling off again at pre-crisis levels, with companies able to push through significantly higher prices that tourists are also accepting. Average per capita tourist spending, for example, is at a new high of €188 per day.

The service sector continues to be supported by the trade and repair of vehicles, the technology sector and the transport sector. The sectors showed moderate growth in the second quarter.

Spain, International Arrivals, Total



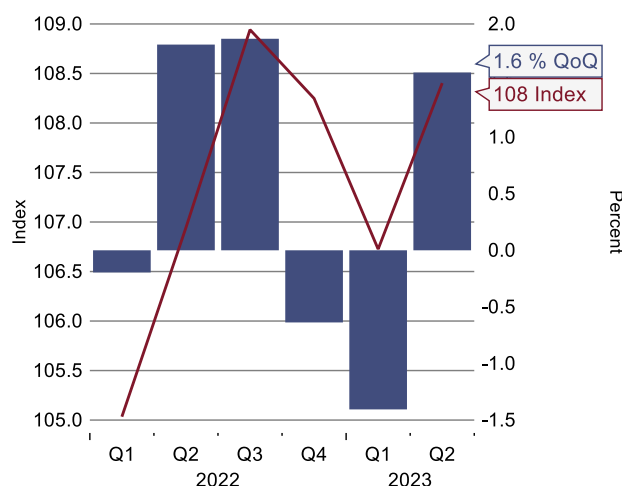
Source: Macrobond, HCOB Economics, Spanish National Statistics Institute (INE)

The HCOB PMI for services fell from a two-year high of 59.4 points in March to 49.3 points in August. As the values of this index show expansion from a score >50, growth can still be expected in Spain's services sector in the third quarter, however, as with negative growth rates in wholesale trade, the PMIs show that the strength of the services sector is gradually waning.

Private consumption

Private consumption was still declining in the winter months. This can be attributed to the loss of purchasing power among private households during the phase of particularly high inflation as well as the more restrictive lending conditions imposed by banks, especially on highly indebted households.

Spain, Expenditure Approach, Final Consumption Expenditure

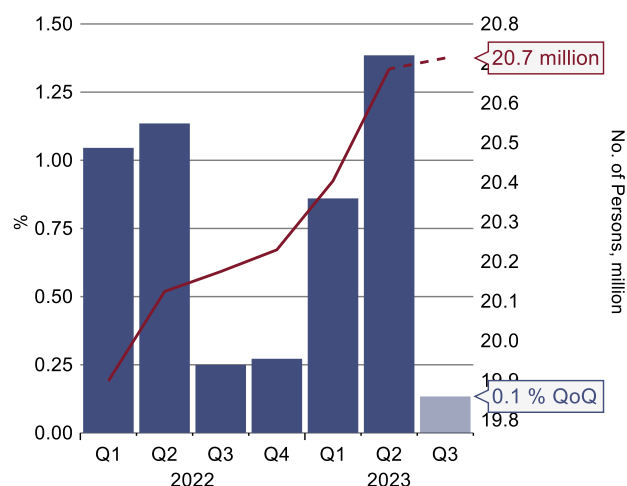


Source: Macrobond, HCOB Economics, Spanish National Statistics Institute (INE)

Private consumption continued to decline in the first quarter (-1.4% QoQ). This was followed by a recovery in the second quarter, with growth of 1.6% QoQ. Several reasons can be cited for this growth in recent months. Firstly, there has been an easing of price pressure. Spain, as one of the pioneers in Europe, has managed to push the inflation rate back to the level of the ECB's target of 2% YoY. As a result, households can be encouraged to consume, as the deterioration in purchasing power during the inflation period has been halted. Consumer confidence is also sending positive signals. Since inflation leveled off from its peak of over 10% YoY in Q2 2022, consumer confidence indicators have steadily improved, as indicated, for example, by the Consumer Confidence Indicator of the Spanish Ministry of Economy.

The labor market also appears to be supporting consumption. The number of jobs subject to social security contributions rose by a seasonally adjusted 0.9% in the first quarter and by 1.4% QoQ in the second quarter. The spring saw particularly strong increases in new hires in the service sector, especially in the tourism and technology and telecommunications industries. The unemployment rate fell from 13.2% to 11.6% in the second quarter. This may already show the first results of the labor market reform initiated by Pedro Sanchez. It includes converting temporary jobs into permanent contracts after six months. In addition, seasonal contracts will be made permanent. This ensures that seasonal workers keep their jobs for the following year and thus creates security.

Spain, Employment, Males & Females, Affiliation to Social Security System



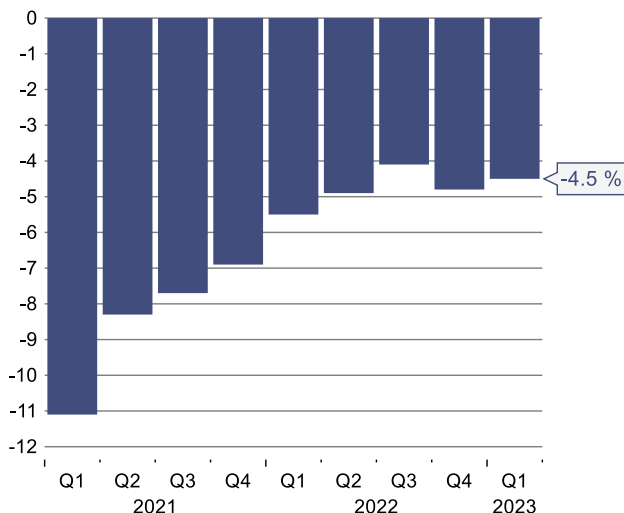
Source: Macrobond, HCOB Economics, Spanish Ministry of Economy & Business

In the coming quarters, the decisive factor for private consumption will be whether inflation remains at the current low level. The rise in interest rates and debt servicing could also prompt households to increasingly use savings and reserves to repay loans instead of consuming. Consumer confidence, which surveys households on expectations, among other things, recently indicated rather positive signals. Households expect their economic situation to improve and savings to increase over the next twelve months.

Government consumption

In the first quarter, the momentum of government spending declined by -1.5% QoQ. In the second quarter, government spending again increased by the same amount. The government deficit shows encouraging news. In the first quarter, according to data from the Central Bank of Spain, it amounted to only 4.5% of GDP for the public sector.

Spain, General Government Budget Balance, Percent of GDP



Source: Macrobond, HCOB Economics, Bank of Spain, IGAE

Spain's public sector is performing a balancing act in reducing the budget deficit while supporting activity (see chart above). Much of the support provided in the wake of the energy crisis was extended in 2023, and public sector wages were also increased. Combined with the NGEU funds, there appears to have been a fiscal boost to the Spanish economy. However, this boost can only be partially explained by the budget deficit, as the European funds have no impact on the general government balance.

Economic policy plans

After the regional and local elections on May 23, 2023, which ended in a debacle for incumbent Prime Minister Pedro Sanchez, Sanchez had the parliamentary elections scheduled for December 2023 brought forward to July 23. The results of this election created a new balance of power, with the conservative Partido Popular improving by 12.2 percentage points to 33 % and winning the election just ahead of the Socialist PSOE party with 31.7 %. It now has the task of forming a coalition. This is proving difficult, however, because even together with the right-wing populist VOX in the coalition, the alliance would not have a majority. An alliance of PSOE and PP is traditionally absurd in Spain. This political situation creates uncertainty regarding economic policy plans. If the PP came to power, it would probably cut taxes and try to cut spending. In general, future Spanish governments face the mammoth task of reducing the budget deficit and the debt level (112 % of economic output). However, the election campaign has recently been dominated by

sociopolitical issues such as the "yes-only-means-yes" law or the so-called "trans" law, which would allow gender reassignment without a preliminary medical examination from the age of 16.

At the moment, the economy is supported by packages of measures to counter the effects of the Ukraine conflict: Spanish citizens can continue to use public transport trains free of charge, VAT on basic foodstuffs is currently suspended, and taxes on energy have been reduced.

Whether the direction of economic policy will change fundamentally in the coming years, for example toward a stricter austerity course, depends on which government is formed.

Jonas Feldhusen

Junior Economist

Tel.: +49 151 22942945

IMPRINT

Hamburg Commercial Bank

Hamburg

Gerhart-Hauptmann-Platz 50
20095 Hamburg
Phone 040 3333-0
Fax 040-3333-34001

Editing & Shipping

Dr. Cyrus de la Rubia
Chief Economist
Tel.: +49 160 90180792

Christian Eggers
Senior FX Trader
Tel.: +49 171 8493460

Jonas Feldhusen
Junior Economist
Tel.: +49 151 22942945

Norman Liebke
Trainee Economics
Tel.: +49 171 5466753

Dr. Tariq Chaudhry
Economist
Tel.: +49 171 9159096

Nils miller
Junior Economist
Tel.: +49 1713534492

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The glossary to our publications can be found on the Hamburg Commercial Bank homepage at http://www.hcob-bank.de/publikationen_glossar.

Other contact persons**Institutional & Liability Sales**

Thomas Benthien
Tel.: +49 151 14833046

Corporate Treasury Sales

Fritz Bedbur
Tel.: +49 151 14651131
Boris Gettkowski
Tel.: +49 175 2281619

Syndicate & Credit Solutions

Tim Boltzen
Tel.: +49 151 15244845

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