

European economy

Spain: Electoral stalemate will weigh on the economy and on Spanish assets

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Chief Investment Office WM

Roberto Luis Scholtes Ruiz, CFA, economist, roberto.ruiz-scholtes@ubs.com; **Thomas Wacker**, CFA, analyst, thomas.wacker@ubs.com

- The national election failed to deliver a clear outcome. The ruling Popular Party (PP) received 28.7% of the vote and 123 seats (out of 350), but even support from Ciudadanos (13.9% and 40 MPs) won't be enough to overcome opposition from left parties. *Podemos* surpassed expectations at 20.7% and 69 seats but can't reach an absolute parliamentary majority with the Socialist party (22.0% and 90 seats).
- Options for political alliances are wide open. Protracted negotiations are expected and may only produce a last-minute agreement. The chances of a minority PP government and of a left coalition seem similar at this point. A stalemate that would force new elections next spring is conceivable.
- The political fog could harm the Spanish economic recovery. Growth forecasts, particularly for 1Q16, now appear optimistic. After a moderate widening of risk premiums today, the market will likely react adversely to continued uncertainty.

House view

The Spanish political outlook has become much more complicated than what polls had suggested. There is a significant probability of a stalemate in the Congress of Deputies that will force new elections in the spring. Chances for a market-friendly center-right coalition have waned, and a left coalition is at least as likely as a PP minority government. In neither case would the government command an absolute congressional majority, and passing any law would require tough negotiations involving at least three of the four major parties. The legislature will probably end prematurely and political uncertainty will weigh on the Spanish economy and assets. Growth forecasts now appear ambitious, in particular for the first quarter of next year.

The additional structural reforms the country needs, in our view, will be more difficult to implement now. Budget deficit targets will likely not be reached on time, and the potential rate of GDP growth will probably not be raised. Financial markets and the European Commission (EC) are expected to increase the pressure on the next Spanish government to revive certain structural reforms and to tighten fiscal policy.

Even if a government is formed, policy uncertainty will remain high and the risk premium is likely to rise. The Spanish sovereign spread, which had tightened in recent weeks on market-friendly opinion polls and European Central Bank (ECB) purchases, should widen moderately. The current spread over Italian bonds seems warranted, in our view, given the uncertainty. In addition, the IBEX index could underperform Eurozone equities even more.



Source: iStock

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Source: UBS

Election outcome fails to deliver a clear majority

Left-leaning parties fared better than polls had forecast in recent months. *Podemos'* 20.7% of the vote and 69 congressional seats beat projections, and the Socialist party (PSOE) met expectations with 22.0% and 90 seats. The ruling Popular Party's (PP) 28.7% and 123 seats (out of 350) were also in line with forecasts, though the centrist party *Ciudadanos'* (C's) 13.9% and 40 seats fell far short. United Left got two MPs and the Catalanian and Basque nationalist parties kept 25 seats.

Apart from an improbable PP and PSOE grand coalition, no other two-party combination could muster an absolute majority. The previously expected center-right coalition of PP and C's is unlikely to emerge. It falls well short of the 176 seats needed for an outright majority, and a minority PP-led government would be opposed by some leftist pro-independence parties. C's itself might be unwilling to support such a government since many of its initiatives would be blocked by the leftist opposition. The only chance PP has to continue governing is if PSOE and *Podemos*, with their combined 159 seats, cannot agree to terms and the Socialist party decides to abstain in a vote.

But a left coalition will not be easy to form either. A PSOE-*Podemos*-United Left grouping wouldn't have enough votes to win the day if C's chose to join PP in voting against it. Gaining the support of the remaining left parties (Catalanian ERC with nine seats and Basque EH Bildu with two) would involve agreeing to measures toward Catalan/Basque independence that are unpalatable to PSOE. The most feasible way of forming a left government is convincing C's to abstain from opposing it. To do so, PSOE and *Podemos* would have to water down their economic proposals and focus on institutional reforms like the electoral law and/or the constitution.

To complicate matters further, PP has managed to retain a Senate majority, winning 143 of the chamber's 266 seats. It would be able to veto any congressional law. This veto could be overridden by the lower house, but only with an absolute majority that PSOE and *Podemos* will probably be unable to attain. In practice, any law proposed by the left coalition would require the consensus of C's or would die a legislative death.

If no coalition can be formed and no prime minister elected, a hung parliament would result. New elections would have to be called in the spring.

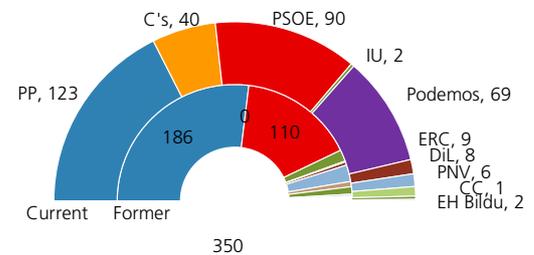
Next steps

Both houses of parliament will be constituted on 13 January. Two weeks later or so, the king, after consulting with representatives appointed by the political parties, will nominate a candidate for prime minister (formally called President of the Government). After explaining the political program of the government that he intends to form, the candidate needs to receive, in an initial vote, an absolute majority of congressional votes (i.e. those of at least 176 of the 350 members) to be named.

If such a majority is not obtained, a simple majority, or plurality (more yes than no votes), is enough for investiture in a second vote two days later. If, after this vote, confidence has not yet been obtained, successive proposals will be voted upon in the same manner. If it becomes impossible to name a prime minister within two months of the first vote, the king dissolves the parliament and new elections are called. Most probably, as the party receiving the most votes, PP will have the first chance to form a government. If it fails to win support, PSOE would get the opportunity

Fig. 1: A divided congress makes it difficult to form a government

Allocation of the 350 seats in the congress in the new and former legislature



Sources: Ministry of Internal Affairs, UBS

to gather a majority. Further iterations would be possible at a later stage during these two months.

High probability of a minority government and a short parliamentary term

The election outcome leaves legislative options wide open. Protracted negotiations are expected to start over the holidays, but agreement might only be reached at the last minute. The chances of a minority PP government and of a left coalition seem about the same at this point. The main consequence of the inconclusive result is that the legislature will probably end prematurely: a weak government will be facing harsh economic options if it tries to achieve fiscal targets. It will also likely face pressure from markets and the EC if it doesn't adopt additional tightening measures. Our main scenarios (with their probabilities in brackets) are:

- **PP in a minority government with C's and PSOE abstention (30%):** PP proposes some institutional reforms demanded by the other national parties while PSOE is unable to come to an acceptable agreement with *Podemos*. As a result, both C's and PSOE abstain in the voting and the PP candidate (it remains to be seen whether this will be Prime Minister Mariano Rajoy or another MP) forms a minority government. Laws would be negotiated one by one and a parliamentary commission to reform the constitution could be created. The amount of fiscal tightening measures needed would make it difficult to reach an agreement on the 2017 budget, and early elections could be called in late 2016 or early 2017.
- **PSOE and *Podemos* left coalition (35%):** Both parties agree to some institutional reforms and economic measures while leaving aside the most contentious issues so as to persuade C's to abstain and not oppose them. Apart from some symbolic social measures, few radical economic policies are passed since they need C's support to overcome vetos from the PP-led Senate. As in the former scenario, disagreements would arise when the 2017 budget is discussed, which could lead to a break in the coalition and early elections being called.
- **PP in a minority government with PSOE's external support (10%):** The Socialist party realizes that *Podemos'* demands are unpalatable (regarding economic policies or national unity). So it comes to a broad agreement with PP on key institutional issues (like reforming the regional financing system and the constitution to solve the Catalan challenge). Not a grand coalition in strict sense, the agreement nonetheless would make a PP minority government viable for some time. A formal coalition seems improbable at this stage but cannot be ruled out.
- **Hung parliament (25%):** No pair of parties receives enough votes to elect a prime minister. The king would have to dissolve the parliament after two months of stalemate. Opinion polls during the negotiations could influence parties to either try to reach an agreement to form a government or to push for a new election.

Political uncertainty to weight on the economic recovery and on Spanish assets

Investors will probably regard this outcome as negative, and market reaction is expected to be adverse over the coming weeks. Political uncertainty and a lack of further economic structural reform will likely harm the Spanish economic recovery. Household consumption and capital expenditures could decline while foreign investors might shy away from committing to Spanish assets. GDP forecasts, in our view, now seem optimistic from 1Q16 on. The momentum of recent months has led to strong growth in 4Q15 but it could easily fall below 0.6%, in particular in the first quarter 2016.

Spain, despite its strength of late, still faces daunting economic (fiscal deficit, public pensions, regional finances) and political (Catalonia and potential constitution reform) challenges. Putting further structural reforms in place will become more difficult, the government will become less stable, policy uncertainty will remain high and the risk premium is likely to rise. Political stalemate would keep Spain in structural budget deficit, weight further on poor potential growth rates and leave the current account surplus unable to lower external debt.

Nevertheless, the risk of the structural reforms that have already been implemented by the current government being reversed or of a significantly more expansionary fiscal policy being adopted seems low in the event of a left coalition. The Socialist party has stated that it wants to comply with deficit targets, although it would try to postpone deadlines by a couple of years. In addition, PP's ability to veto laws in the Senate would require that they receive support from either PP or C's, which would avoid any backtracking in the progress achieved thus far.

Another source of pressure will be the EC, which in its assessment of the 2016 Spanish budget already warned of the risk of continued and growing noncompliance with the deficit targets. The EC is expected to request amendments to the budget as soon as a new government is seated. Due to heightened political uncertainty, the Spanish sovereign spread, which had been tightening before the election due to market-friendly opinion polls and more ECB bond purchases, should rise only moderately after the muted initial reaction today. The current spread over Italian bonds seems warranted, in our view, as long as the political uncertainty remains. In addition, the IBEX's underperformance against Eurozone equities overall could increase.

Appendix

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