The pain in Spain: why the Rajoy government won't expect a honeymoon

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Summary

- As much as any European election in recent memory, the political economy for the new Spanish conservative government looks extraordinarily limiting. New Prime Minister Mariano Rajoy will have – and will expect to have -no political honeymoon either domestically or in Europe.

- He will be well aware that his government will have to contain profound resentment and unrest on the Spanish street, manage the expectations of Spanish voters and impress Spain's creditors enough to restore Spain's battered credibility and credit rating.

- Rajoy's PP conservative party has a unprecedented grip on both regional and national government, but the reality of austerity will be felt sharply at the regional level and the politics of this are likely to be complicated.

- In his first few months Rajoy face three immediate tests: the bond markets, the budget and the banks. It is hard to know which will be toughest. Rajoy electoral campaign has traded on calculated ambiguity. It is about to be replaced by painful specifics.

As polls predicted, the Spanish election on November 20 has produced a record win for a Partido Popular government under Mariano Rajoy and ended seven years of Partido Socialista Obrero Español (PSOE) rule. Rajoy wakes up this morning the leader of a country whose fiscal credibility and solvency are in question and that faces the prospect of a further wave of austerity after three years of painful contraction.

Vital tourism receipts have seen a small boost from travellers deflected from the volatility in North Africa but otherwise growth has stalled, unemployment is almost 23% and the balance sheet of the Spanish economy is crippled by a decade of rash borrowing and collapsing tax receipts.

As much as any European election in recent memory, the political economy for the new Spanish government looks extraordinarily limiting. Mariano Rajoy will have – and will expect to have - no political honeymoon either domestically or in Europe. He will be well aware that his government will have to contain profound resentment and unrest on the Spanish street, manage the expectations of Spanish voters and impress Spain's creditors enough to restore Spain's battered credibility and credit rating. This Global Counsel Insight note looks at three key economic constraints Rajoy and the Partido Popular face as they set out their reform plans: the bond markets, the budget and the banks.

The bond markets and the Eurozone

Elected at the end of a week in which Spain's ten-year borrowing costs rose to almost 7%, Mariano Rajoy's government will have little choice but to try and placate Spain's creditors. Tactically, Rajoy is likely to be guided by his political experience. He was a member of the 1996 Aznar government that implemented an unexpectedly dramatic fiscal tightening that challenged external perceptions of Spain's fiscal credibility and ultimately helped pave Spain's way into the single currency. Now, as then, he will be looking for a defining gesture. Partido Popular strategists have been planning a 100 day strategy for setting out fiscal plans, but the worsening Eurozone crisis and Spain's widening sovereign debt yields mean that this is likely to be heavily frontloaded.

Rajoy will, however, be well aware that he cannot count on the strong external demand and relatively limber corporate and household balance sheets of a decade ago (Chart 1). He will also rightly fear that the bond markets are looking for a Eurozone solution at this point rather than a Spanish one. Nevertheless he will not be complacent. During his campaign, Rajoy made little of his party's ties with Angela Merkel's fiscally conservative Christian Democrats. In government he will pitch aggressively for Merkel's support, under no illusion that securing early German endorsement for his government will be key, especially as he is likely to want to tap the European Financial Stability Facility for support in recapitalising some of Spain's ailing *caja* savings banks.

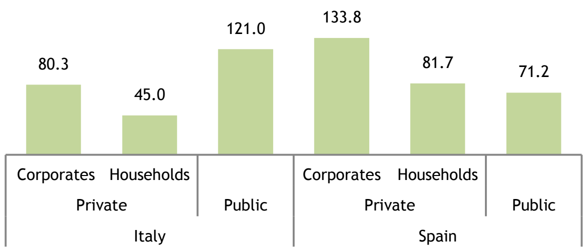

Chart 1 and 2: Debt burden Spain/Italy 2011 Q2 (%GDP) and unemployment Spain (%)

Bank of Spain, Bank of Italy, Global Counsel calculations

Partido Popular strategists will reach for a combination of fiscal tightening and supply side reform that is as dramatic as they can make it. Rajoy told the *Washington Post* in late October that he saw no alternative to accelerating the austerity programme set out by the Zapatero government in 2010. As most analysts do not expect Spain to meet its 6% deficit targets for 2011, this is likely to focus on restoring the trajectory towards its 4.4% target for 2012, especially applying additional pressure to the key slippage in regional budgets. Even meeting these targets at current trajectories will require more than €25bn in cuts or new revenues. Measures to try to exceed the 2012 and subsequent targets are possible, but against downgraded growth expectations, they would have to be eye-wateringly tight.

On the supply side, the Partido Popular can be expected to attempt serious further reform of the Spanish labour market by reducing statutory levels of severance pay, and aiming to permanently break inflation-linked pay rises for public servants, which were frozen by the PSOE government. It will also push for further reform of the collective bargaining system that has defined Spanish labour relations since the Franco era, especially strengthening the ability of individual company agreements to legally trump regional and sector-wide agreements. The previous Partido Popular government retreated from such reform: they will be counting on external economic pressure to avoid that now.

The Partido Popular will instinctively resist tax rises, and it has in fact campaigned on a reduction in corporate taxes for SMEs. The PSOE raised both VAT and higher rates of income tax in their 2011 budget, and Partido Popular strategists will be both politically and economically uneasy about squeezing further. Ten of the eleven Partido Popular-controlled regions – including wealthy Madrid - have signalled their intention not to apply the wealth tax reinstated by the PSOE government in November 2011, although whether such gestures are sustainable if Rajoy chooses not to scrap the tax – something on which he has remained coy - is an open question. Higher taxes on tobacco and alcohol may be an easier sell.

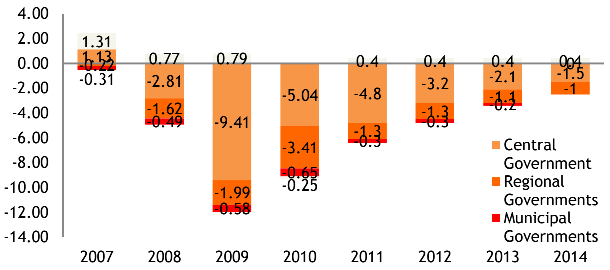

Chart 3: Public deficits by level of government, actual and projected (%GDP)

Source: Bank of Spain, Spanish Ministry of Finance, Global Counsel calculations

The scope for revenues from asset sales remains significant, although the privatisation of a 30% of the Lotterias state lottery was shelved in September by the PSOE government after pressure from the Partido Popular. The Partido Popular have also suggested they will also review the sale of concessions at Madrid and Barcelona airports and the part privatisation of the state airport operator AENA, both of which will require complex political handling with regional governments.

However, provided bidders can secure finance – a real question - these privatisations are unlikely to be reversed. Analysts close to the Partido Popular have mooted the possibility of leasing the operation of the national lottery rather than full privatisation. Spain's regions will also be encouraged to sell smaller assets such as their indebted public television stations, Madrid's Canal Isabel II water utility and the network of *paradores* tourist hotels.

The pain in Spain falls mainly on the regions

Rajoy's political grip on regional spending will be key to his fiscal credibility. Spain's highly devolved political system makes its autonomous regions responsible for around 35% of public spending and more than half of Spain's public sector employment. A splurge of cheap borrowing for property and infrastructure spending at the height of the boom and the collapse in property taxes that came with the crash have also made them the source of a around 35% of Spain's public deficit and around 18% of its debt (Chart 3). Despite tighter restrictions on their ability to borrow, the delaying of budget cuts until after the Spring 2011 regional elections meant that regional deficits actually widened in 2010 and they are very unlikely to achieve targets for 2011.

Rajoy knows that it was the weakness of regional balance sheets that drove the downgrading of Spain's credit rating in November 2011. His strategy for dealing with this is likely to be a combination of tightening regional borrowing freedom and restricting the scope for overlap between regional and national budgets, especially in key areas such as health and education. If he is able to keep his campaign promise of preserving national spending in health, it will only be at the expense of restricting regional provision to basic services.

In this respect, the Partido Popular's leadership of 11 of 17 of Spain's regional governments is both an opportunity and a potential point of tension. The alignment of Partido Popular leadership at both the national and regional in principle creates a powerful political coalition for reform that straddles the tense divide between Madrid and the autonomous regional governments.

However the retrenchment agenda is also likely to see serious trade-offs between regional and national government that are unlikely to be resolved in favour of the regions, especially where this implies a loosening of Madrid's grip on fiscal probity. The burden of service cuts and further public sector pay discipline will be imposed and felt widely, but above all at the regional level. Pressure on regional governments to privatise short term revenue-generating assets could also be a source of resentment. Whether party loyalty will trump intensely regional Spanish politics remains to be seen.

The *cajas*: overvalued and undercapitalised

Even after a wave of consolidations and recapitalisations under the PSOE government, Spain's network of regional savings banks remains heavily crippled by bad property debts and significantly undercapitalised. The previous Government's assessment that the savings banks need around €20bn in additional capital is less than a third of most private estimates. Although Spanish regulators criticised the methodology of the European Banking Authority's last round of stress tests, five Spanish banks fell below the core tier 1 capital requirements, and seven were close enough to cause concern (Chart 4). These institutions between them carry around €70bn of exposure to the Spanish government.

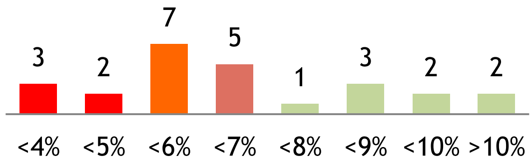

Chart 3: Spanish Banks Core Tier 1 Capital adverse scenario stress test, 2011 (number of banks)

Source: European Banking Authority

Where the previous government and the Bank of Spain have focused on building up capital levels the instincts of the Partido Popular are to focus on realising losses to enable valuations and sales, including of the five nationalised *cajas*. Senior Partido Popular advisors worry about the impact of higher capital standards on already shrinking lending. They also believe that the Bank of Spain has consistently underestimated the level of bad property loans in the system - a suspicion reinforced by the levels of bad debt ultimately revealed in institutions taken into state ownership, and by the fact that the stagnant Spanish property market almost certainly still has further to fall. While the Partido Popular have not ruled out the prospect of further nationalisations, but are more likely to seek to use a combination of forced write downs followed by recapitalisations through the European Financial Stability Facility to enable institutions to merge or be acquired by either the larger Spanish retail banks or international competitors.

From calculated ambiguity to painful specifics

The basic political tension for the new Spanish government lies in the balance of expectations between Spanish voters and Spain's creditors and Eurozone partners. Rajoy campaigned on a platform of lowering unemployment. He will govern as an austerity Prime Minister and there is a strong likelihood that the reform measures the Partido Popular believe necessary will push up unemployment in the short term.

Rajoy may have little patience with the '*indignados*' who have protested across Spain against austerity over the last year, but they are likely to be a feature of his government and a key test of his nerve. He will be counting on a general resignation and pragmatism among voters, especially as the PSOE government has already borne the brunt of unpopular decisions to raise consumption and income taxes, freeze public sector pay and revive the labour market reform agenda.

Rajoy's reputation for ponderousness belies a pragmatic conservative with a private reputation for self-assertion, who has held on to the leadership of the Partido Popular despite having led it to two election defeats. He will be well aware that he is the Eurozone's third new national leader in as many weeks, and he is under no illusion that he will need to act quickly. His campaign strategy was to say as little as possible, especially about the hardship to come, and to allow deep public disillusionment with the PSOE to push it out of power. That strategy of calculated ambiguity is about to be replaced by one of painful specifics.

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