European Views: A populist government in office in Italy, a change in leadership likely in Spain

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- **Italy** — *Lega* and the Five Star Movement (5SM) have agreed to form a coalition government. The new government will be sworn in this afternoon (June 1). The *Lega* / 5SM coalition will attempt to implement the programme that the two parties agreed last week. We would fade the recent market rally in Italian assets. First, based on recent political events, it is not clear how long the coalition will remain in power. Given the rise in support for the *Lega* indicated by recent opinion polls, there is an incentive for *Lega* to call for elections as early as the autumn. Second, based on its previously agreed coalition programme, we expect the new government will try to implement fiscal policies that could ultimately lead to rating downgrades as public debt would again be placed on a rising trend. Moreover, the same policies, even if implemented on a much smaller scale, would likely lead to a deteriorating relationship with the European Union, which could see investors regularly question the commitment of the new government to the Euro.
- **Spain** — A no-confidence vote against Prime Minister Mariano Rajoy (of Partido Popular (PP)) will take place today (June 1) in Parliament. We expect Mr. Rajoy to lose this vote, which would see him replaced as Prime Minister by Pedro Sánchez, leader of the socialist party (PSOE). The new government is likely to keep the 2019 budget broadly unchanged, as it was only able to secure the vote of Basque nationalist MPs by promising not to change budget plans. The change of government is unlikely, in our view, to disrupt the Spanish economy: we thus continue to forecast robust economic growth in Spain in 2018 and 2019. Over time, in preparation for future elections, the new government may have an incentive to make fiscal policy slightly more expansionary.

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Italy - Fade the rally

Lega and the Five Star Movement (5SM) have agreed to form a coalition government, which will be sworn in this afternoon. The new government will then set out to implement the coalition programme that the two parties agreed on last week. Markets have rallied in anticipation of the formation of such a government, on the basis that it removes the near-term risk and uncertainty associated with new elections as early as July. Based on recent polling, new elections could result in an even stronger victory for the populist parties, which we expect would raise investor concerns that a more aggressive populist agenda as embodied in the coalition agreement – possibly including risks to Italy's continued participation in the Euro area – could be in prospect.

In our view, a positive reaction to the potential formation of coalition government between *Lega* and 5SM is misplaced. First, based on recent political events, it is not clear how long the coalition government will last. At the very least, with opinion polls showing a substantial increase in support for *Lega* over the past week, Matteo Salvini (its leader) has a clear incentive to seek early elections in the autumn. Second, even though the coalition agreement between *Lega* and 5SM does not envisage Italy exiting the Euro area, in our view a more confrontational relationship between Italy and the European institutions and partners is likely to emerge under the new coalition government, especially as regards fiscal and immigration policy. Such confrontation would likely see investors continue to question the new government's commitment to respecting EU rules and thereby sustain uncertainty about Italy's participation in the Euro area. Third, if the coalition government carries out fiscal policies as indicated in the already agreed programme, we think any increase in economic growth would be limited, and public debt would again be placed on a rising trend again, which would increase investor concerns and potentially result in rating downgrades.

A number of immediate challenges will face the new government. First, to avoid an automatic increase in VAT (which existing legislation demands), the government needs to implement fiscal tightening measures worth EUR12bn in 2019 and around EUR19bn in 2020 and 2021. Second, the new government will need to prepare and discuss with the European Commission a budget law by early October. Third, the new government will participate at the European Summit in June, where developments on the institutional upgrade of the Euro area are on the agenda. At that time, the new Italian government might put forward its own proposals for reform of the European Union, likely involving less stringent design and application of fiscal rules, as well as strong measures to control and reverse immigration. The nature of its proposals and the attitude it adopts towards other Member States and the European institutions will be a litmus test of its approach to Italy's participation in the European project.

Spain - Not much change with the new leadership

Spanish Prime Minister Mariano Rajoy will face a vote of no confidence in his leadership on Friday. Members of his centre-right People's Party (PP) were recently convicted for corruption. Last week, the Socialist party called for the no-confidence vote and proposed their leader Pedro Sánchez as a replacement for Mr. Rajoy. At least 176 votes would be needed to win the no-confidence vote. The Socialist party (PSOE) holds only 84 seats of its own, but has secured additional votes from the far-left party *Podemos*, and other smaller parties, including the Basque Nationalist Party and two Catalan nationalist parties. For this reason, we expect the no-confidence vote to pass and Mr. Rajoy's government to fall.

In this event, Prime Minister Rajoy will be replaced by Mr. Sánchez, PSOE leader. The new government is likely to keep the 2019 budget broadly unchanged, as the support of Basque nationalist MPs for the no-confidence motion required a commitment to not change the budget. Looking beyond the no-confidence vote, a new Sánchez-led government could find it difficult to pass legislation given that it will lack an overall majority in Parliament and the parties supporting the no-confidence vote are disparate in nature and outlook.

In our view, the change of government is unlikely to disrupt the Spanish economy. We thus continue to forecast robust economic growth in Spain over our forecast horizon. Separately, the *Financial Times* reported that Mr. Sánchez would "re-establish dialogue" with the new pro-independence government in Catalonia.

The risk to this view is that Mr. Rajoy resigns before the no-confidence vote goes through, which would see new elections take place. Opinion polls taken in the past two weeks indicate that Ciudadanos (a liberal party) is leading (at 26.4%), with PP and PSOE neck-and-neck a little behind (at 21.2% and 21.9%, respectively) and Podemos at 17.5%. New elections would likely lead to another hung Parliament and, as a result, it could take time to form a new government. That said, in Spain we see no risk that parties potentially forming government would question the participation of Spain in the European Union. As such, political uncertainty stemming from a new election and its aftermath should not derail broadly positive market sentiment towards the country.

Disclosure Appendix

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