The economic impact of Spain's political uncertainty

Political turmoil in Spain on the back of the regional elections increases uncertainty about the economic outlook and public finances. Whoever wins the upcoming national elections, the new prime minister faces important challenges

Spanish Prime Minister Pedro Sanchez has called a general election for 23 July

Political turmoil in Spain as governing party suffers electoral blow

In Spain's recent regional and municipal elections, the Socialist Workers' Party (PSOE), led by Prime Minister Pedro Sanchez, suffered significant losses. In response, Sanchez on Monday announced his intention to dissolve parliament and proposed bringing forward national elections to 23 July. The Conservative Party emerged as the big winner in the regional elections, indicating that it has a good chance of success in national elections.

Political uncertainty could further cloud the economic outlook

Although Spain's economy started the year strongly with 0.5% growth in the first quarter, largely driven by a strong performance in the tourism sector, interest rate hikes by the European Central Bank will increasingly bite over the rest of the year, gradually slowing growth. The recent local elections this weekend could trigger a period of political instability, which could further impact the country's economic momentum.

Uncertainty about future government policies is likely to undermine investor confidence, resulting in a decrease in both domestic and foreign investments. This, in turn, could have a negative effect on job creation and economic growth. In this context, the decision to bring forward national elections is perhaps a positive step as it will hopefully bring some clarity. However, the result of the local elections also suggests that the Conservatives, should they come first in the national elections, may have to rely on other parties, such as the far-right Vox (which doubled its votes compared to the 2019 municipal elections), to form a coalition. This may prolong post-election uncertainty.

The focus shifts back to Spain's fiscal position

Spanish Prime Minister Sanchez has put in place many support packages to address the energy crisis and support the economy. As the energy crisis gradually subsides, attention turns to Spain's public finances, which are far from rosy, with public debt at 113.2% of GDP in 2022 and a deficit of 4.8% of GDP. Although the European Commission forecasts a gradual reduction of the deficit in 2023, it will still amount to 4.1% of GDP. This puts Spain well above the 3% limit, which the European Commission considers an excessive deficit. So, European pressure for fiscal consolidation measures will increase

Ongoing political turmoil and a possible difficult government formation could hamper the progress of fiscal reforms and worsen the state of public finances. While the still relatively better Spanish growth than in the rest of the eurozone is supportive for the Spanish bond market, the prevailing political uncertainty may increase the risk perception of Spanish government bonds, leading investors to demand higher yields.

New government faces significant challenges

Regardless of who wins the national elections, Spain's new government faces important challenges, not least on the fiscal side so public finances remain stable. In addition, many people say that major reforms are needed in several sectors to increase productivity, as the country lags behind its European competitors in terms of productivity growth. On top of that, the energy transition is coming, and that is prompting calls for more labour market reforms. Although unemployment is historically low by Spanish standards, Spain still has one of the highest unemployment rates in Europe. All these potential changes will need to be carried out in the context of moderate economic growth, a growth that's struggling largely because of an ageing population.