

The Spanish budget saga and what it means for markets

There is a deal between Spain's PSOE and Podemos on new fiscal measures for 2019, but that does not mean it will be passed in parliament. We actually think the chances of approval are low. The Spanish-German spread has already increased and we can expect more volatility in the days ahead



Spanish Prime Minister Pedro Sanchez, leader of the Socialist Workers' Party (PSOE)

The plan

A deal between Spain's PSOE and Podemos would raise spending, but also raise revenues. On the spending side, the two parties agreed to raise the minimum wage, public pensions and unemployment benefits and to reduce fees for university health care. On the revenue side, they propose increasing taxes on companies and wealthy individuals.

It is not yet clear if this plan would increase the planned budget deficit. The impact of the various measures on the spending side would total more than €5.5 billion. On the revenue side, the effects are not quantified.

Finding support

This plan needs to be agreed in parliament and in the senate. Both are difficult to achieve. In parliament, Prime Minister Pedro Sanchez (*pictured*) would need the support of the nationalist parties in Catalonia and the Basque country. The PSOE and Podemos together control 151 seats out of the 350 in parliament, 25 seats short of a majority. But pro-independent parties in Catalonia want to see progress in the case of some Catalan politicians who are now in jail. And Quim Torra, the Catalan regional premier, is demanding a referendum on self-determination. Both issues are difficult to accept for Sanchez. So it is unlikely that Sanchez will give concessions to the Catalans, thus depriving himself of Catalan support.

But it is also difficult to find a majority in the Senate. The PP has a majority there, and if Sanchez's plan has a larger deficit than originally planned by the PP in 2017, the PP won't support it.

We therefore conclude that the likelihood of Sanchez winning approval is low.

Uncertainty adds to market volatility

The European Commission is also putting pressure on Sanchez to agree to a budget. European law states that a draft budget for the coming year should be made public no later than 15 October. If a country is not able to do that, then it should submit to the Commission a no-policy-change draft deficit plan (i.e. a DBP that shows the projections of the government at constant policies). This would be seen as a defeat for Sanchez.

So what happens if Sanchez isn't able to find an agreement on the budget? One possibility is new elections. The PSOE is doing great in the polls and in that way Sanchez could get a firmer grip in parliament. Another possibility is that Sanchez rolls over the existing budget that was approved when the PP was in power. One drawback, of course, is that his supporters are expecting some rollback of austerity and so this is difficult to sell.

There is currently a lot of uncertainty about the final decision, so we can expect volatility in the market for Spanish government bonds. The Spanish-German spread has already increased to 120 basis points from about 100 at the end of September.