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Testimony of the Governor of the Banco de España before the Spanish Parliamentary Budget Committee in relation to the draft State Budget for 2017

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Ladies and gentlemen,

I appear before this Committee at the start of the discussion and approval of the State Budget for 2017, the draft legislation for which, was approved by the Government on 31 March.

Let me begin by referring to the international setting and the outlook for the Spanish economy, after which I will move on to the core aspects of the draft Budget and conclude with some reflections on the relationship between fiscal policy and our economic recovery.

The external setting of the Spanish economy

In recent quarters, the international economic setting has been marked by a high level of uncertainty, both in the United States, where there are doubts about the timing and scope of the new Administration's measures, and in Europe, as a result of Brexit and the elections scheduled for this year.

For the moment, this uncertainty has hardly been reflected in financial indicators. The markets have continued to perform favourably and longer-term interest rates, which rose in late 2016, have stabilised at still moderate levels. Oil prices remained stable in the early months of the year, after the rise observed in the wake of the agreements reached by oil producing countries at the end of November 2016, although recent data show a higher degree of volatility.

As for global economic activity, the figures for the last quarter of 2016 show higher-than-expected GDP growth in advanced economies, except in the United States; in emerging economies there were clear differences with robust growth in Asia, that prompted a moderate rise in international trade, and a further slowdown in Latin America. Similarly, indicators published in the first quarter have been somewhat more favourable than expected.

In the euro area, despite the presence of the above-mentioned factors of uncertainty, the most recent economic developments show a firming of the recovery, although its strength across countries is uneven. The ECB's most recent projections in March indicate that the current phase of recovery will persist and that GDP growth in the euro area will continue to be underpinned essentially by domestic demand, with forecast growth rates of 1.8% and 1.7% for 2017 and 2018, respectively, similar to that observed in 2016.

Euro area inflation climbed to 2% in February, mainly reflecting temporary factors linked in particular to energy prices, which will unwind over the year. In fact, headline inflation in the euro area slowed to 1.5% in March and core inflation (excluding energy and unprocessed food) stood at 0.7%. From a medium-term perspective, the ECB projection exercise points to inflation moving on a very gradual upward path, with the result that, towards the end of 2019, it would still stand below 2%.

Against this background, in March the ECB Governing Council decided not to change benchmark interest rates and repeated its commitment to continue net asset purchases at a monthly pace of €60 billion until the end of December 2017 or beyond, if necessary, and, in any case, until a sustained adjustment is seen in the path of inflation consistent with its medium-term objective of a rate of close to but below 2%.

The monetary policy measures of recent years have resulted in a significant improvement in financing conditions, which has been particularly visible in the case of the Spanish economy, both as regards the low cost of new funds and the gradual normalisation of lending conditions. This reduction has been particularly significant in terms of the cost of financing public debt.

Performance of and outlook for the Spanish economy

The Spanish economy grew 0.7% in the last quarter of 2016 and the latest indicators show that the growth rate in the opening months of 2017 could have been slightly higher.

According to the Banco de España's projections published at the beginning of April, GDP growth is estimated to be 2.8% in 2017 as a whole, which is somewhat lower than in 2016, but continues to be significantly higher than the euro area average.

Turning to its composition, domestic demand remains the main engine of economic growth. Household consumption remains robust, underpinned by the improvement in the outlook for employment, and favourable developments in household disposable income and in lending standards. Real estate market indicators show an ongoing recovery in the sector which, albeit uneven in terms of market segments and geographical areas, is also contributing to the buoyancy of household spending and employment. Although investment has decelerated in recent quarters, it remains firm given the favourable situation of financial conditions and final demand.

The Banco de España's projections anticipate that the current growth phase of the Spanish economy, dating back to the second half of 2013, will persist over the next few years and that it will continue to be supported by gains in competitiveness, the ongoing favourable financial conditions, and the expected positive performance of international markets. The foundations of the recovery in the Spanish economy are, in fact, the correction of certain macroeconomic and financial imbalances, which had built up previously, most notably the improvement in international competitiveness, the progress made in the financial position of households, firms and financial institutions, without forgetting the improvement in employment, with a significant decline in the unemployment rate in the last four years, although it still remains at very high levels.

However, it should be noted that GDP growth in recent years has also received a significant boost from factors of a more temporary nature such as lower oil prices, the fiscal impulse which gave rise to an expansionary budgetary policy stance in 2015 and 2016, and the ECB's expansionary monetary policy. Lower growth of activity can be expected as the effect of some of these factors fades.

As in the euro area as a whole, inflation rose notably at the beginning of the year to levels of 3% in January and February, according to the year-on-year rate of change in the CPI, and declined to rates of close to 2% in March. Its quickening in January and February responded, in particular, to the strong increase in electricity prices and the base effects of oil prices. Consequently, this increase is expected to be temporary and will begin to fade as the impact of the acceleration of the energy component dissipates. Thus, after an average increase of 2.2% in 2017, the CPI will foreseeably slow to 1.4% and 1.6%, in 2018 and 2019, respectively.

The risks

The scenario which I have just outlined is not without both external and internal risks.

Noteworthy on the external front is the higher degree of uncertainty concerning global economic policies and their possible impact on world trade and the capital markets. In particular, the current buoyancy on financial markets reflects, at least partly, the expectation that the new US Administration will apply economic policies favouring higher growth and inflation in the short term – such as a possible fiscal expansion – perhaps underestimating the effect of such policies on the pace of the monetary normalisation in the United States, as well as other less favourable aspects, such as the shift towards the lower international mobility of goods and people.

A trend towards consideration of the introduction of protectionist barriers in certain developed economies has been observed recently. Should such barriers actually be introduced, there would be a negative impact on world trade that could affect an economy, like Spain's, whose recovery has been largely export-led.

In the same vein, uncertainty about the implications of the United Kingdom leaving the EU remains high, in a setting in which the Spanish economy has significant exposure to this country in terms of services exports and financial ties. This uncertainty is also affected by the context of low returns in Europe's financial system and of the fragility of certain institutions.

On the domestic front, several factors of vulnerability persist. One of them arises from the level of public indebtedness (which I will refer to later) and that of certain segments of the household and corporate sectors, which entails high reliance on foreign saving and represents a source of weakness in the face of possible increases in the cost of borrowing.

Also, despite efficiency improvements, our economy remains highly sensitive to potential increases in commodities prices, particularly, oil prices. From a medium-term perspective, the high structural component of the unemployment rate, an ageing population and low productivity are the main factors limiting the sustained growth of our economy.

I shall now review the main features of the budget.

Budgetary policy in 2017

The macroeconomic forecasts accompanying the draft State and Social Security Budgets for 2017 involve the prolongation of the current expansionary phase. Specifically, they estimate real GDP growth of 2.5%, accompanied by a recovery in prices, so that nominal GDP growth is slightly above 4%.

The macroeconomic projections used in the preparation of the draft budget are broadly compatible with the scenario that I have just referred to, which forms the backdrop to the latest forecasts of the Banco de España, and also with the consensus scenario of private analysts. Real growth in 2017 under the consensus scenario is somewhat lower than projected by the Banco de España (2.5% as against 2.8%), but the nominal GDP growth forecasts are in line with each other.

The deficit target for general government as a whole is 3.1% of GDP for 2017, which is compatible with the requirements of the Stability and Growth Pact and involves a projected reduction of 1.4 pp of GDP. Achievement of this target is essential for Spain to resolve its situation of “excessive deficit” (more than 3% of GDP) in 2018.

Public debt, according to the draft budget, will be 98.8% of GDP in 2017, down 0.6 pp of GDP from 2016. The slight downward trend of recent years, from the peak of 100.4% in 2014, is therefore extended.

In this macroeconomic context, it should come as no surprise that the improvement in the deficit in 2017 stems mainly from the favourable cyclical situation and the reduction in interest rates on public debt. In this respect, the budgetary adjustment required to make further progress with fiscal consolidation, as measured by the change in the primary structural balance, is very small. This is in line with the latest Updated Budgetary Plan for 2017, which anticipates a slightly contractionary fiscal policy stance for the current year, in contrast to the expansionary stance of the last two years. Naturally, any downward deviation in growth or inflation, or any increase in financing costs, would make fiscal consolidation more demanding.

With regard to subsectors, the draft budget includes the stability targets approved by Parliament in December 2016.

The budget deficits projected for central government and the Social Security system are 1.1% and 1.4% of GDP, respectively, as against the actual deficits of 2.7% and 1.6%, respectively, recorded in 2016. The deficit targets for regional and local government are 0.6% in the case of regional government (0.8% in 2016) and a balanced budget in that of local government (as against the surplus of 0.6% recorded in 2016). According to these plans, central government agencies will account for most of the improvement in the total deficit in 2017.

Achievement of the budget deficit target is a result, first of the State spending ceiling, approved in December, which excludes spending under the financing arrangements for local and regional government; and second, of the growth in public revenue.

The most important measure on the expenditure side, in relation to personnel costs, is the increase of 1% in the compensation of public sector employees, in line with that approved last year. With regard to public sector employment, it is proposed that temporary employment be reduced to 8%, over the next three years, from its current level of 23%. According to the draft budget, this would involve converting 250,000 temporary employees into permanent employees within this period. Also, there will be an increase in the number of sectors allowed to increase their replacement rate to 100%. For general government as a whole, this measure will mean, according to the budget, that there will be 67,000 public sector vacancies in 2017.

Overall, these measures would result in growth of 1% in the wage bill in the State budget, as compared with the decline of 1.2% in 2016. At the same time, the restriction is maintained on current spending on goods and services, which declines by 14%.

As regards public investment, real investment is projected to increase by 23%, with respect to the initial budget for 2016. However when the effect of certain defence-related payments outstanding from other years is taken into account, State investment is budgeted to fall by almost 20%, which is accompanied by a significant reduction in business investment in the public sector.

Turning to the Social Security system, the increase of 0.25% in pensions, arising from application of the indexation formula in force following the 2013 reform, is notable. The projected growth in expenditure on contributory pensions in 2017 is rather higher (3.1%), as a result of the projected increase in the number of pensions and the substitution effect arising from the new pensions that replace those that are terminated, so that the weight of expenditure on pensions in total consolidated State and Social Security expenditure increases to 40.7% (as against 38.5% in 2016). Also, the reduction in expenditure on unemployment benefits, of 7%, should be noted. This is explained by the fall in unemployment and in the coverage rate of contributory benefits.

On the revenue side, the main measures included in the draft budget are those that were approved on 2 December 2016 in Royal Decree-Law 3/2016. Notable among them is the amendment to corporate income tax in order to widen the tax base. As regards VAT, limits are placed on the conditions for granting deferrals, and a new system is set up for immediate supply of information. As for excise duties, the rates on alcoholic drinks and tobacco products are raised. In the case of Social Security system revenues, an increase in the maximum contribution base of 3% was approved in the above-mentioned Royal Decree-Law.

Overall, tax revenues, before the transfer to local and regional government, are projected to increase by 7.8% in 2017, while social contributions are projected to increase by 6.3%, which, given the macroeconomic forecasts and the impact of the tax reforms mentioned above, would entail a greater response by revenues to growth in activity than in the past, especially in the case of social contributions, which are projected to grow by more than their bases (employment and wages), even taking into account the effect on revenues of the legal changes mentioned above. If the uncertainties surrounding the estimates of the impact of the legislative changes on taxation are also taken into account, it is clear that revenue growth needs to be monitored constantly over the course of the year, so that a timely adjustment can be made to spending or revenue in the event that the risks to the deficit target materialise.

Moreover, in such a decentralised country as Spain, where more than 40% of public spending is made at the local and regional level, the State and Social Security budgets give merely a partial view of the budgetary policy of the public sector as a whole for next year.

From this perspective, the Updated Stability Programme to be published in the next few days is particularly important, since it consolidates the budgets of central government agencies with those of regional government and local government. This document should enable a complete analysis of budgetary projections to be performed and is, in fact, that used by the European Commission as a basis for its assessment of Spanish fiscal policy.

The importance of budgetary consolidation

Before concluding my address, I should like to offer some reflections on the importance of completing the budgetary consolidation process.

Spain's public debt-to-GDP ratio remains very high. Despite its recent stabilisation, it is close to 100% and more than 60 percentage points above its pre-crisis level. Moreover, the budget deficit (both the total deficit and the structural deficit) is also very high and exceeds that of most of our European partners. The outstanding adjustment is still significant, despite the current context of a high pace of growth and low interest rates, that is relatively conducive to reducing the structural budget deficit and the public debt-to-GDP ratio.

Reducing fiscal imbalances is important in order to moderate the future financial costs associated with public debt, and also to reduce the vulnerability of the economy to a possible tightening of financial conditions, without forgetting the need to restore scope for a fiscal policy response in the event of possible adverse growth scenarios.

For all these reasons, it is crucial to adopt a time perspective that goes beyond the annual budgetary exercise, with a detailed and credible deficit correction plan geared towards gradually reducing public debt. The Updated Stability Programme, which I have already mentioned, provides an opportunity to define such a plan, incorporating the budget plans of all tiers of government within the framework of medium-term public finance developments.

Moreover, I should also point out that budgetary consolidation is fundamental for achieving the aim of placing our public finances in a better position from which to face the challenges of an ageing population. Demographic developments are currently (and in future will be even more so) a fundamental determinant of the growth in certain public spending items, such as health, care for the elderly and, in particular, pensions. They must be taken into account in the short, medium and long-term consolidation strategy.

Finally, we should not forget that, apart from the pace of reduction of the budget deficit, the intensity and duration of the public sector deleveraging will also hinge on macroeconomic factors and, in particular, on the economy's growth potential.

Indeed, the problems of sustainability of public finances may be relieved if employment and productivity behave favourably. The improvement in the outlook for economic growth and employment in the Spanish economy still requires pressing ahead with various structural reforms. Delaying the implementation of such reforms, or the reversal of any of those introduced since the start of the crisis, would undoubtedly damage the growth outlook.

Conclusions

I will now conclude.

The Spanish economy continues to record high rates of GDP and employment growth and is showing notable resilience in the face of gradual disappearance of the so-called "tailwinds". These positive developments are occurring against a background in which, moreover, competitiveness gains are being sustained, our exports continue to gain market share and the substantial external surplus persists. That said, this favourable situation should not be understood as meaning that Spain has managed to completely overcome the imbalances built up during the previous expansion and during the crisis that began in 2007, as demonstrated by the figures for unemployment, public debt and external net borrowing, among others.

Persevering with reforms to increase the economy's growth potential, maintaining competitiveness gains and fiscal consolidation policies are a prerequisite for progress in making the reductions required in the budget deficit and public debt, controlling the economy's financing costs, improving the balance of payments and, last but not least, increasing the Spanish economy's capacity to generate employment.

Thank you for your attention.