BANCO DE ESPAÑA
Eurosistema

06.06.2017

Appearance by the Governor before the Senate in relation to the Draft State Budget for 2017

Luis M. Linde
Governor

Ladies and gentlemen,

In my appearance, which forms part of this Chamber's discussion and approval of the State budget for 2017, I shall begin by reviewing the current macroeconomic setting and outlook for the Spanish economy. I shall then analyse the main aspects of the State budget for this year, according to the draft Law approved by the Government on 31 March, and the Updated Stability Programme for the period 2017-2020, submitted by the Council of Ministers to the European Commission on 29 April.

The external environment of the Spanish economy

The current international economic setting is characterised by an increase in uncertainty, chiefly the outcome of the political changes in the past year in the United States and the United Kingdom. However, that does not appear to have exerted a significant influence, so far, on the real economy, or on the financial markets. Both have continued to perform favourably and, despite rising in the final months of 2016, interest rates are holding at still-moderate levels at all terms. The main exception to this climate of relative stability has been oil prices, which have been highly volatile in recent months.

Recent economic developments in the euro area show a firming in the recovery, which is progressively extending to more sectors and countries. Euro area inflation stood in May at 1.4%, after several months of high volatility, the result – among other things – of the oscillations in energy prices. In the medium term, the projections published in March by the ECB, the update of which will be released this very week, suggest a continuation of the recovery in activity and inflation across the euro area.

Performance of and outlook for the Spanish economy

The Spanish economy grew by 0.8% in 2017 Q1 and the latest indicators show that the rate of expansion remained high in April and May.

The increase in activity in Q1 continued to be underpinned by domestic demand, with an acceleration in investment in equipment and construction, and in government consumption, which offset the easing recorded in household consumption. The external sector was highly dynamic, with export and import growth slightly increasing their positive contribution to growth.

For 2017 as a whole, the consensus among analysts suggests GDP growth will once again clearly outpace the average for the euro area. Next week, the Banco de España will publish new projections for the Spanish economy and, on the basis of the latest indicators, it cannot be ruled out that the growth estimated for this year will be somewhat higher than anticipated some months ago, standing even above 3%.

The prolongation of the Spanish economy's current growth phase over the coming months will essentially be based on the strong pace of expansion of national demand, although the external sector will continue – as seen since 2016 – to maintain its positive contribution. In particular, buoyant employment and the favourable conditions of access to credit are boosting household consumption and the pick-up in spending on residential investment and on equipment.

In the medium term, there will foreseeably be a gradual convergence towards more moderate growth rates, as a result of the disappearance of certain factors that have contributed to boosting activity. Such factors have been the declines in oil prices, the moderation of financing costs, supported by the ECB's monetary policy, and the expansionary fiscal policy stance over the two-year period 2015-2016.

As in the euro area as a whole, since late last year the year-on-year rate of change of the CPI has been highly volatile; it stood in May at 1.9%, the outcome – as earlier stated – of energy price fluctuations and, also, of the effect of the Easter holiday week in April, given that in 2016 Easter fell in March. These temporary factors will progressively peter out in the coming months, although the average rate for the year is expected to stand at around 2%. In 2018 and 2019, in the absence of further shocks, the rate of increase of the CPI might settle below this reference.

The main risks and factors of vulnerability

The scenario I have outlined also poses risks to our economy.

Firstly, the improved international setting has been affected by higher global uncertainty, the result of recent proposals to curb trade, migratory movements and policy coordination. In this respect, mention should be made of the potentially adverse impact of the Brexit negotiations, given the highly significant trade and financial ties between Spain and the UK.

Secondly, the rise in US long-term interest rates in late 2016, which partly reflects certain changes expected in the stance of its economic policies, has already impacted the European markets. While it is premature to conclude that this is the start of the normalisation of monetary conditions, it should be recalled that such normalisation will come about if, as is expected, the recovery in the advanced economies takes root.

Within Spain, the level of public debt and of that of certain segments of the households and firms sectors remains at high levels, thereby generating high dependency on financing from abroad. This is a source of vulnerability, in particular to any future tightening in monetary and financial conditions on international markets.

Finally, from a broader time perspective, the sizeable structural component of the unemployment rate, population ageing and low productivity are the main constraints on the sustained growth of our economy.

Budgetary policy in 2017

Before going on to specify the broad outlines of budgetary policy for 2017, allow me to remind you that the State and Social Security budget provides only a partial picture of general government activity. In a country as decentralised as Spain, in which more than 40% of public spending is by local and regional government, it is essential to take a broader perspective.

Since my speech to the Parliamentary Budget Committee on 25 April, the Government has published (at the end of April) the Updated Stability Programme for the period 2017-2020. This document offers an overview of the budgets of central government agencies along with those of regional and local governments. Moreover, the Stability Programme, by adopting a broader time horizon, provides a medium-term plan, which is important for correcting public finance imbalances.

The macroeconomic projections accompanying the Stability Programme, which update those included in the draft budget for 2017, involve an extension of the current economic recovery to 2020, albeit with GDP growth gradually slowing from the 3.2% rate recorded in both 2015 and 2016. Specifically, real GDP is projected to grow by 2.7%, 2.5%, 2.4% and 2.4% in 2017, 2018, 2019 and 2020, respectively, while prices are projected to recover, so that nominal GDP growth would stand, on average, slightly above 4% throughout the period.

These projections thus incorporate a path of slowing economic growth, which is also present in the forecasts of the Banco de España. However, as mentioned, real GDP may behave more positively in the short term than in the Stability Programme.

As regards the budget, the path projected for the overall general government deficit is in line with the requirements of the Stability and Growth Pact: declining from 3.1% of GDP in 2017, to 2.2% in 2018 and 1.3% of GDP in 2019. In 2020 a budget deficit of 0.5% of GDP is projected. This path of reduction of Spain's budget deficit needs to be achieved if the excessive deficit situation (a deficit of more than 3% of GDP) is to end in 2018. Public debt, according to the Stability Programme, is expected to fall gradually, to reach 92.5% of GDP in 2020.

In the current environment of high economic growth and low general government financing costs, the budget consolidation required to achieve the deficit targets for the period 2017-2020 (as measured by the change in the primary structural balance) is relatively small.

The Stability Programme includes the stability objectives for 2017 – for each sub-heading of public expenditure – that were approved by Parliament in December last year and extends them to 2020; then, budget balance is projected for all levels of general government, except the Social Security system, which would still record a deficit of 0.5% of GDP. Central government, which currently has the largest deficit, will be responsible for making the bulk of the projected adjustment.

With regard to the composition of this adjustment, according to the Stability Programme the public deficit path projected for the period 2017-2020 will be achieved mainly through control of total primary public expenditure, i.e. without including public debt interest payments. Specifically, if the projections are fulfilled, the weight of primary public expenditure in GDP will be reduced by 3 pp over this period, to 36.6% in 2020. At the same time, government revenues are expected to grow moderately, by 0.9 pp of GDP over the programme's horizon, to 2020.

On the expenditure side, the Government projects moderate growth in its wage bill, basically reflecting the 1% rise in the remuneration of public-sector employees approved for 2017 and the impact of savings arising from reforms approved in previous years.

At the same time, the Stability Programme assumes that the downward trend in spending on unemployment will continue, in line with favourable labour market developments; that the application of the adjustment factor to pensions will continue to hold down pension spending, in a positive inflation environment; and that current spending on goods and services will continue to be firmly controlled over the coming years.

As for public investment, the Stability Programme projects an increase in general government investment of 10% in 2017. However, after deducting the effect of certain defence-related payments outstanding from previous years, as well as the possible spending arising from liability associated with legal proceedings relating to the insolvency of the toll motorways, this item is projected to grow only very moderately this year and over the next few years. Under these plans, therefore, the downward trend in public investment as a proportion of GDP, which has already lasted more than a decade, would continue.

Interest payments are expected to continue to decline as a result of the expected favourable developments in financing conditions, although at a more moderate rate than over the last two years.

The increase in revenues included in the Stability Programme is based mainly on the measures approved in December last year in Royal Decree-Law 3/2016. Notable among these is the amendment to corporate income tax to broaden the tax base, the increase in duties on alcoholic drinks and tobacco products, the increase of 3% in the maximum social contribution base and the 8% increase in the minimum wage. Notwithstanding the positive impact of these measures, achievement of the government's medium-term revenue target is subject to some uncertainty, as revenue will need to perform more favourably relative to activity than it would if the historical relationship between these two variables were to remain unchanged.

As a result, the performance of revenue and the impact on spending of the plans announced for public-sector employment will need to be monitored over the next few years, so that, in the event of any deviation from the projections, action can be taken in time to avoid the risk of failure to achieve deficit commitments.

The importance of budgetary consolidation

Finally, it seems to me necessary to stress the importance of completing the budgetary consolidation process.

The current environment of high growth and low interest rates is a very favourable one in which to reduce the structural budget deficit and public debt to levels more in line with those in the main euro area economies, and this opportunity should not be wasted. The cost of financing public debt (which still stands at 100% of GDP) would be reduced and there would be some scope for fiscal policy to respond to possible adverse scenarios. Moreover, consolidation is essential to address the challenge that an ageing population will pose for spending on health, dependency and, above all, pensions.

In this respect, the magnitude of the adjustment needed to achieve sound public finances in Spain is still significant. Hence the need to comply with all the domestic and European budgetary framework requirements. Following their strengthening in recent years, this means not only that the budget deficit (defined in total and structural terms) and public debt must be progressively reduced, but also that the so-called spending rule must be observed.

The spending rule is especially important in the case of those government entities that have already achieved budget balance.

Under the rule, neither the budgeted nor the actual spending of the government entity can exceed the Spanish economy's nominal potential growth rate. Since government revenues have an elasticity with respect to nominal GDP of approximately one, the spending rule involves linking its growth to that government revenues. Spending growth may only exceed this reference rate if there is an increase in revenues that is recurrent in nature; likewise, legal changes involving permanent losses of revenue should automatically lead to a downward revision in the spending threshold. One of the advantages of this rule is that increases in government revenues above their normal trend must be saved, such as during the upswing prior to the last crisis, when very significant extraordinary revenue increases associated with the real estate boom were recorded. Also, by linking spending to the economy's potential rather than its actual growth, and by excluding from its definition non-discretionary spending on unemployment benefits, public spending should grow more slowly than GDP and revenues during economic upswings (when actual GDP and, therefore, revenues are growing at above their potential rate), while in recessions the opposite should occur.

Thus, the spending rule requires general government to accumulate budgetary savings during economic upswings that may be used during downswings, allowing the behaviour of public finances to be disciplined and automatic stabilisers to function at the same time. Obviously, if the starting point is a structural budget deficit, then the return to budget balance will require spending to grow more slowly than nominal growth or else a discretionary increase in revenues, until balance is achieved. Evidence suggests that the application of a rule of this type during the upswing prior to the last crisis would have substantially curbed the public spending permitted each year, allowing the generation of significant room for manoeuvre that would have limited the deterioration in public finances during the crisis.

Finally, pressing ahead with the various pending reforms would raise the economy's growth potential which – through its effects on employment and productivity – is one of the basic determinants of reductions in public debt. These reforms include, in the regulatory area, revision of regulations that hinder the market entry of new firms or that limit their growth; in the labour market, reforms to reduce the degree of duality and to improve the employment prospects for the long-term unemployed; and the need to increase the efficiency of the legal system and of the education system and to promote the accumulation of technological capital, among others. Accordingly, any delay in their implementation or, worse still, a hypothetical reversal of reforms already introduced since the start of the crisis, would significantly worsen the prospects for economic growth and would make the fiscal consolidation still needed more costly.

Conclusions

Let me conclude by recalling the challenges and risks for the economy as a whole raised by the current fiscal imbalance in Spain.

High volumes of deficit and public debt over long periods are usually associated with higher interest rates and, therefore, lower rates of private investment and growth in the medium term. Also, correcting a very high debt-to-GDP ratio normally requires significant primary budget surpluses, which must be achieved through higher taxation or lower spending, other than on interest payments.

Large deficits and high levels of public debt reduce the scope for fiscal policy to play a countercyclical role in adverse economic situations, a particularly necessary and valuable lever in a monetary union. Also, the need to resort constantly to the financial markets to refinance a substantial level of debt and the current deficit increases the vulnerability of the economy to potentially adverse reactions by investor sentiment, as seen in recent years.

Facing up to these challenges and minimising these risks requires completing fiscal consolidation, by gradually correcting the budget deficit and reducing public debt. This must be one of the main priorities of economic policy in the coming years.

Thank you very much for your attention.