BANCO DE ESPAÑA
Eurosistema

28 January 2019

Testimony by the Governor of the Banco de España before Parliament in relation to the Draft State and Social Security Budget for 2019

Pablo Hernández de Cos
Governor

TESTIMONY BY THE GOVERNOR OF THE BANCO DE ESPAÑA BEFORE PARLIAMENT IN RELATION TO THE DRAFT STATE AND SOCIAL SECURITY BUDGET FOR 2019

Ladies and gentlemen,

For the first time I am appearing before you in this Chamber as part of the process to discuss and approve the State and Social Security Budget for 2019 (hereinafter "Draft Budget").

During my address I shall first be reviewing the developments in and the macroeconomic outlook for the Spanish economy, within the international context. I shall then offer my views on the main aspects of the Draft Budget for 2019. To conclude, I shall mention what are, in my opinion, the fiscal policy challenges our country faces over the coming years.

1 MACROECONOMIC FORECASTS FOR THE SPANISH ECONOMY

The Banco de España's latest macroeconomic projections for the Spanish economy were published on 14 December last year,[1] taking as a reference the information available at end-November. These projections were part of the joint exercise conducted by the Eurosystem central banks, whose results for the euro area were released by the European Central Bank (ECB) a day earlier.

1.1 External environment and financial conditions

The forecasts are produced drawing on information that characterises the context of the Spanish economy (in particular regarding the international environment and monetary and financial conditions) (see Table 1). According to these assumptions, the expected course of activity in and imports from the main geographical areas with which Spain trades were revised downwards over the course of 2018. The resulting growth rates for Spain's export markets in 2019 were estimated at slightly over 3%, a similar rate to that forecast for 2018, but significantly lower than that observed in 2017. The price of oil per barrel is expected to stand below $70 on average in 2019, 6% less than in 2018. Finally, I should stress that borrowing conditions for households and firms are expected to remain easy.

Allow me to go into greater detail on some of the above. Regarding the international environment, the world economy admittedly ended 2018 maintaining a broadly expansionary course. But the signs of an across-the-board slowdown are evident, albeit more marked in some regions than in others. Largely, this is in response to the partial materialisation of certain focal points of uncertainty, assailing the world economy since early last year. These include most notably the trade tensions between the United States and China, the uncertainty over the terms of the United Kingdom's withdrawal from the European Union (EU) and some tightening of global financial conditions. The first of these factors, namely trade tensions, have already been reflected in the lower growth of global trade in 2018 (4%, compared with 5.3% in 2017), which does not prevent them from continuing to pose a significant downside risk, subject to the future of the international negotiations currently under way.

1 See Macroeconomic projections for the Spanish economy (2018-2021): the Banco de España's contribution to the Eurosystem's December 2018 joint forecasting exercise.

FORECASTS FOR THE SPANISH ECONOMY: ASSUMPTIONS ON THE EXTERNAL ENVIRONMENT AND FINANCIAL CONDITIONS — **TABLE 1**

Annual rate of change (%) unless otherwise specified

	2013	2014	2015	2016	2017	2018	2019
International environment							
World output	3.4	3.5	3.3	3.1	3.6	3.6	3.3
Spain’s exports markets	2.7	4.4	4.1	2.3	4.9	3.1	3.3
Oil price in dollars/barrel (level)	108.8	98.9	52.4	44.0	54.4	71.8	67.5
Monetary and financial conditions							
Dollar/euro exchange rate (level)	1.33	1.33	1.11	1.11	1.13	1.18	1.14
Spain’s nomial effective exchange rate vis-à-vis the world including the euro area (2000 = 100 and percentage differences)	112.3	113.8	110.6	113.2	114.6	117.9	118.0
Short-term interest rate (3-month EURIBOR)	0.2	0.2	0.0	-0.3	-0.3	-0.3	-0.3
Long-term interest rate (10-year bond yield)	4.6	2.7	1.7	1.4	1.6	1.4	1.8

SOURCES: ECB and Banco de España.

Global financial conditions, which were exceptionally favourable in previous years, have begun to go into reversal. They have done so more acutely in certain particularly vulnerable emerging market economies, and relatively moderately – to date – in the advanced economies where share prices have fallen and corporate debt spreads have risen since mid-2018.

Against this background, consumer price indices have tended to post significant slowdowns in the final stretch of 2018, which are mainly due to the notable recent decline in oil prices.

In the euro area, the lesser pace of economic activity in the first three quarters of 2018 led the ECB, in December, to revise down its growth forecast for the year to 1.9%, 0.6 percentage points (pp) less than in 2017. Discounting the effect of certain transitory factors, such as strikes, bad weather and, more recently, the temporary difficulties in the automobile industry, especially in Germany, and the “yellow jackets” crisis in France, everything points to a significant slowdown in the pace of expansion of the euro area in 2018 compared with 2017. Of particular note is the sluggishness of exports, weighed down by the moderation of global trade and by the possible lagged effects of the appreciation of the euro. Conversely, domestic demand appears to have remained firmer, at least until the most recent period, underpinned by the favourable financial conditions and the growth of employment and of household and corporate income. According to the latest ECB forecasts, the expenditure of these agents will continue to allow GDP growth rates in the euro area to remain somewhat above their potential over the coming years. However, it cannot be ruled out that the increase in political and trade uncertainty may ultimately constrain the growth of business investment plans. This is especially the case in certain economies, such as Italy, where some signs of a tightening in financial conditions are already discernible, in a setting in which Italian public debt yields have, since spring last year, held at relatively high levels.

The lower rate of growth in the euro area has contributed to delaying the prospect of a pick-up in the core component of euro area inflation somewhat. And compounding this has been the effect of the recent decline in oil prices on overall inflation. In these circumstances, the ECB’s monetary policy maintains a markedly expansionary stance,

FORECASTS FOR THE SPANISH ECONOMY: OVERVIEW **TABLE 2**

Annual rate of change (%)

		December 2018 projections	
	2017	2018	2019
GDP	3.0	2.5	2.2
Employment	2.9	2.5	1.6
HICP (inflation)	2.0	1.8	1.6

SOURCES: INE and Banco de España.
Projections cut-off date: 28 November 2018.

aiming to prompt the convergence of inflation, in the medium term, towards rates of increase in prices that are below but close to 2%. Backing this trajectory is the foreseeable progressive widening of the output gap and the increase in labour costs observed in recent quarters.

At this moment, once the Eurosystem has ceased to acquire new assets under its purchase programme, the expansionary stance of the common monetary policy at the start of this year has been mainly determined by two developments: the ECB Governing Council's announcement that interest rates would remain unchanged at least until the summer of 2019; and the reinvestment over a prolonged period (in any event, for the time needed to prompt the sustainable convergence of inflation on its medium-term reference) of the financial securities acquired under the ECB's quantitative easing programme.

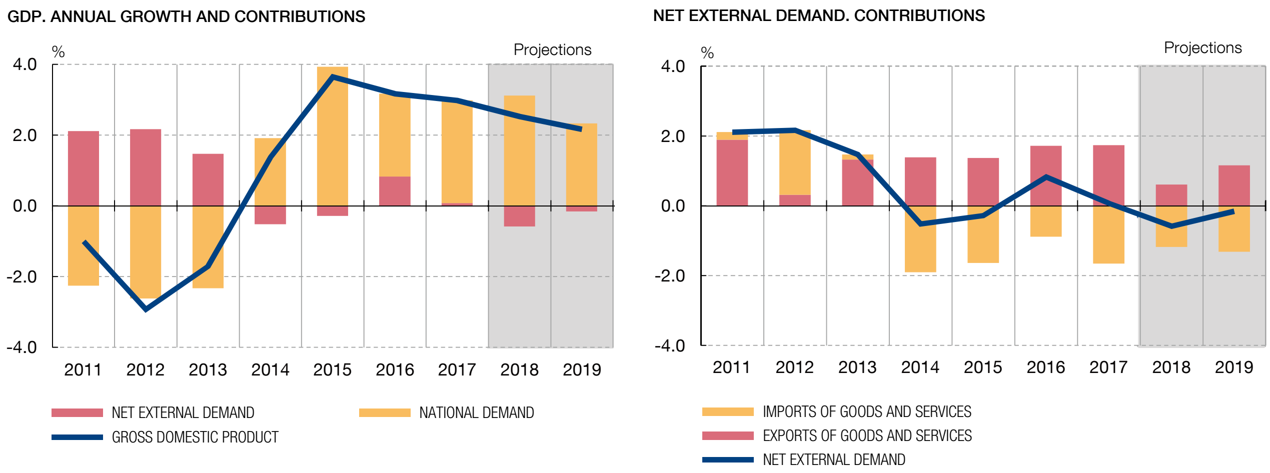
1.2 The Spanish economy: developments and outlook

In this setting, in 2019 the Spanish economy will remain on the expansionary course on which it embarked six years ago. But there will be a further easing in its growth rate, to 2.2%, compared with the increase of 2.5% estimated for 2018 (see Table 2). The expected slowdown is largely in response to the weaker international setting I mentioned earlier. Nevertheless, the Spanish economy has, in recent quarters, proven significantly resilient, slowing to a lesser degree than our main area of reference, namely the euro area. The contributing factors include, among others, the boost to household income arising from the entry into force, in the second half of 2018, of certain measures included in the Draft Budget for 2018.

The continuation of the current upswing in 2019 will continue to rest on the expansion of domestic demand (see Chart 1). Underpinning this will be: financial conditions that are expected to remain relatively favourable; an improvement in the financial position of households and firms; the gains in competitiveness observed throughout the recovery; and the strength of the employment creation process. It is expected that employment creation will slow this year, partly owing to the lesser pace of activity, but also to the increase of more than 22% in the national minimum wage. In any event, according to the Banco de España's projections, the annual growth in numbers employed will stand at around 1.6% in 2019, providing for further reductions in the unemployment rate, to around 14% at end-2019 (see Chart 2).

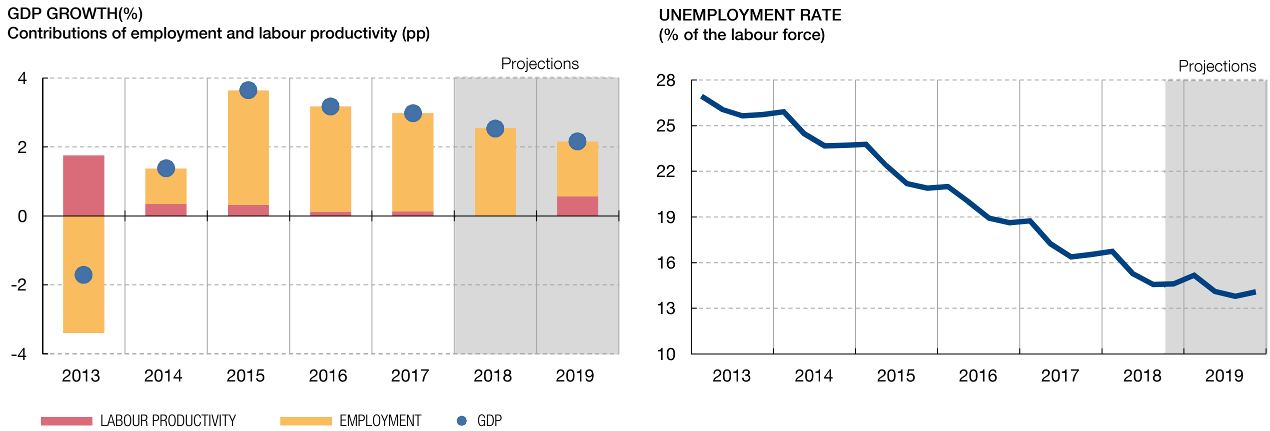
All told, there are grounds for a progressive slackening of economic growth in Spain over the coming years. These are, namely: the recent easing in global growth, which is proving

FORECASTS FOR THE SPANISH ECONOMY: COMPOSITION OF OUTPUT GROWTH — CHART 1



SOURCES: INE and Banco de España.

FORECASTS FOR THE SPANISH ECONOMY: EMPLOYMENT AND UNEMPLOYMENT — CHART 2



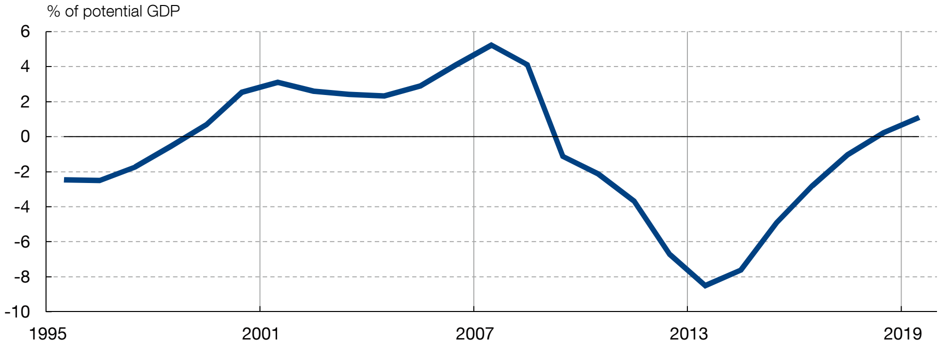
SOURCES: INE and Banco de España.

particularly marked in the euro area; the progressive normalisation of monetary and financial conditions; and the very limits on the growth of domestic demand, such as, for example, those derived from the current, historically low levels of the household saving rate. On Banco de España estimates, the Spanish economy's already positive output gap will widen during 2019 (see Chart 3).

The recent course of consumer prices in Spain has once more been greatly influenced by the behaviour of oil prices. These fell strongly in the closing months of 2018 and account for the decline in the year-on-year rate of change in the harmonised index of consumer prices (HICP) to 1.2% in December. Relative to expectations, moreover, the latest November and December figures were a surprise on the downside, largely – but not exclusively – due to the behaviour of energy prices (see Chart 6). Conversely, core inflation, which excludes the more volatile elements such as energy and fresh food, continues to stand at around 1%, but it is expected to begin to rise in 2019 as GDP growth rates remain above potential. The opposing trajectories of the energy and core components will determine how prices trend in the coming years. In terms of the overall indicator, prices will slow in 2019 (see Table 2).

FORECASTS FOR THE SPANISH ECONOMY: CYCLICAL POSITION CHART 3

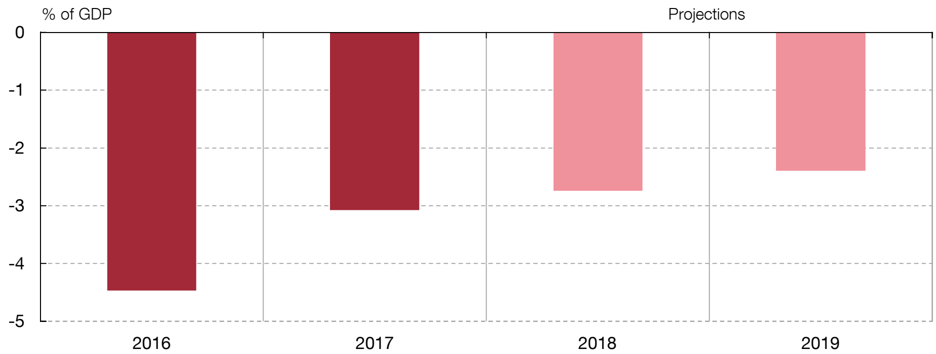
SPANISH ECONOMY'S OUTPUT GAP



SOURCE: Banco de ESpaña.

FORECASTS FOR THE SPANISH ECONOMY: BUDGET DEFICIT CHART 4

GENERAL GOVERNMENT BALANCE



SOURCES: IGAE and Banco de España.

The projections report published in December also included a forecast of the Spanish general government deficit for 2019, consistent with the macroeconomic and financial picture I have just described, with the deficit then being estimated at 2.4% of GDP (see Chart 4). Nonetheless, as indicated in the report, this estimate was subject to greater than usual uncertainty, as a result of the indefiniteness surrounding the budgetary cycle at the information cut-off date for the exercise, in late November. In particular, at that time neither the Draft Budget for 2019 nor the plans for the creation of the new taxes announced in the October 2018 draft budgetary plan had been submitted to Parliament, meaning that uncertainty over the scope and details of the new measures persisted.

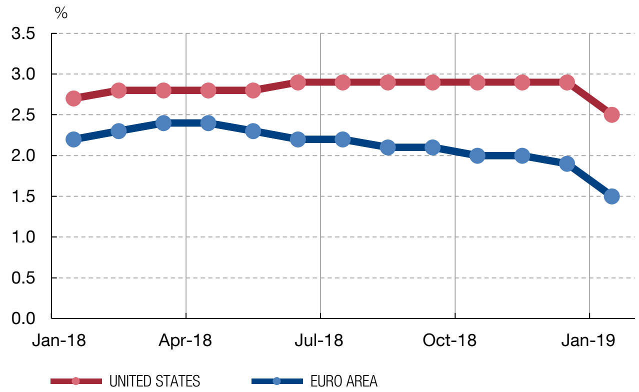
Consequently, the assumptions for budgetary policy in 2019 did not include these new measures. The only exceptions were those measures that had already been approved (the tax reductions in Royal Decree-Law 15/2018 of 5 October 2018 on urgent measures for the energy transition and the protection of consumers, and the impact of the Supreme Court ruling of 5 October 2018, which stipulates exemption for maternity benefits for personal income tax purposes), or those that were more clearly defined since they were in response to specific agreements (the inflation-linked rise in pensions, and those relating to public-sector employment and wages).

In the fiscal policy arena, moreover, I should like to point out that the latest budgetary outturn figures appear to confirm an exit scenario from the Excessive Deficit Procedure in

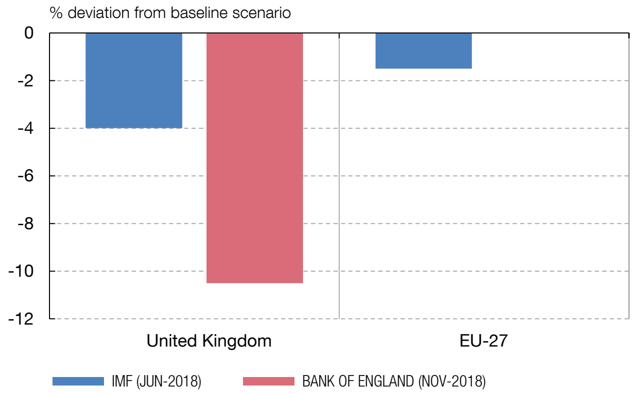
FORECASTS FOR THE SPANISH ECONOMY: MAIN RISKS. A MORE UNFAVOURABLE EXTERNAL ENVIRONMENT

CHART 5

GDP GROWTH FOR 2019



LONG-TERM IMPACT OF A "NO-DEAL" (a)



SOURCES: Consensus Forecasts, IMF and Bank of England.

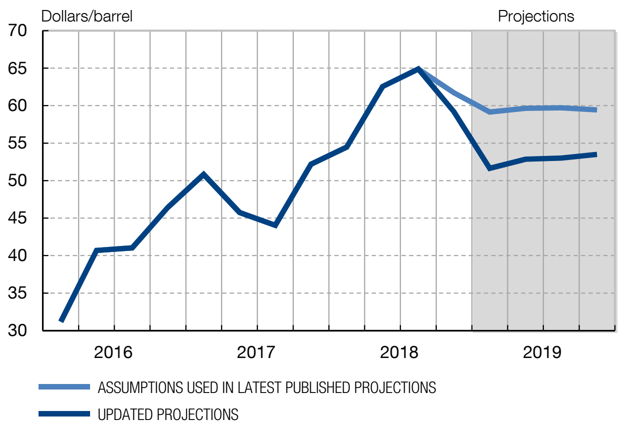
a Deviation in the level of cumulative GDP in 5 years, the time considered necessary to reach the new "long term". The two simulations assume a "no-deal" that includes a long-term scenario under WTO rules.

FORECASTS FOR THE SPANISH ECONOMY: MAIN RISKS. SURPRISES ON THE DOWNSIDE FOR INFLATION

CHART 6

OVERALL INFLATION

OIL PRICES



SOURCES: ECB, INE, Reuters and Banco de España.

which Spanish general government has been immersed since 2009, as part of the "corrective arm" of the EU's Stability and Growth Pact. Specifically, the budget deficit is expected to be below 3% of GDP both in 2018 and 2019.

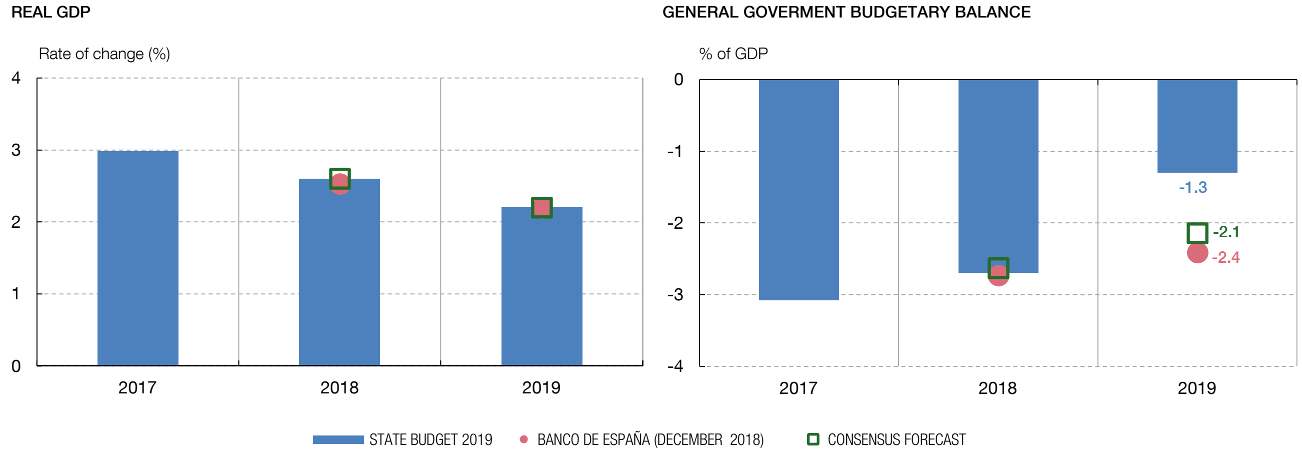
1.3 Main risks and elements of vulnerability

The macroeconomic and financial scenario I have just sketched, which prolongs the expansionary phase of the Spanish economy, is, however, subject to certain downside risks. It should also be added that these risks have tended to increase recently and are being reflected in sharper downward revisions of analysts' opinions on the outlook for the global economy in 2019 (see left-hand panel of Chart 5).

In the international sphere, as I have already mentioned, some of the elements which have already adversely affected activity in recent quarters may have even more unfavourable effects in the future. Such is the case, for example, of the possible adoption

THE MACROECONOMIC PROJECTIONS FOR THE DRAFT BUDGET

CHART 7



SOURCES: Consensus Forecasts, IGAE, INE, State Budget 2019 and Banco de España

of additional protectionist measures by some countries and of the potential responses to them by other economies. Nor can we rule out fresh tensions linked to the changes in US monetary policy, particularly in those economies with a high dollar-denominated debt and, in general, in the international financial markets. Also, the final terms of the UK's exit from the EU continue to be highly uncertain, with possible adverse effects on the euro area (see right-hand panel of Chart 5), where, moreover, uncertainty regarding the fiscal policy of certain countries persists. All these elements may contribute to a strengthening of the decelerating trend in world trade and activity which is already under way.

In Spain, this deceleration has already caused some deterioration in the economy's current-account deficit. The compatibility of strong domestic demand with an ongoing external surplus has unquestionably been one of the most positive features of the current upturn, compared with previous ones. However, some of the factors which favoured the strong performance of the external balance have tended to lose steam recently, as is the case of the higher energy bill during much of 2018 due to oil price rises and the weaker tourism flows from the rest of the world. In the future, persistence of the recently observed moderation in activity on a global scale, particularly in the euro area, or a hypothetical increase in the cost of funding Spanish external debt will pose risks for the performance of the external balance. At the same time, the need to reduce the still-high external debt makes it essential for the Spanish economy to keep running external surpluses in a sustained manner.

1.4 Macroeconomic projections of the Draft Budget

The Draft Budget is based on macroeconomic projections of real GDP growth in Spain of 2.2% in 2019, down 0.4 pp from the 2.6% projected by the government for 2018, while the increase in nominal GDP is estimated at around 3.8%. This growth projection and its composition are generally consistent with the baseline scenario of macroeconomic projections for Spain published by the Banco de España in mid-December and with those of most analysts (see left-hand panel of Chart 7).

However, I would like to point out the two risks which I consider most significant for the macroeconomic scenario of the Budget.

First, the macroeconomic projections of the Budget include an adjustment to the budget deficit clearly exceeding that expected by other analysts (see right-hand panel of Chart 7). In particular, the deficit target for general government as a whole stands at 1.3% of GDP in 2019, which is a reduction of 1.4 percentage points (pp) with respect to the envisaged final figure of 2.7% for 2018. By contrast, the projections of the Banco de España and of most analysts, as reflected by the Consensus Economics Forecasts, put the deficit for 2019 above 2%. Therefore, if the greater fiscal efforts required to meet the deficit target for general government as a whole included in the Draft Budget, amounting to 1.3% of GDP, were included in the projections of other analysts, their economic growth estimates for this year would be liable to a risk of downward revision.

Second, as I noted when looking at the macroeconomic scenario, the overall economic slowdown is becoming stronger, particularly in the euro area, which poses downside risks to the macroeconomic scenarios of the Draft Budget and of the Banco de España.

I now review the main courses of action defined by the Draft Budget for budgetary policy in 2019.

2 DRAFT STATE AND SOCIAL SECURITY BUDGET FOR 2019

Meeting the deficit target of 1.3% of GDP for general government as a whole included in the Draft Budget depends largely on the projected growth of taxes and social security contributions. On official estimates, the additional revenue would be sufficient to finance a significant portion of the proposed increase in the spending of the State (observing the ceiling set by the Council of Ministers), the social security system and regional and local government.

Regarding the behaviour of government spending, many, albeit not all, of the measures in the Draft Budget, were included in the budgetary plan published by the government in October 2018, which moreover provided the expected broad outline of the budgets for the rest of general government. The budgetary plan projected an increase in overall government expenditure in 2019 of 3.1% (in National Accounts terms), below nominal GDP growth for that year, thus allowing a corresponding reduction of the budget-deficit-to-output ratio.

2.1 Main public spending measures

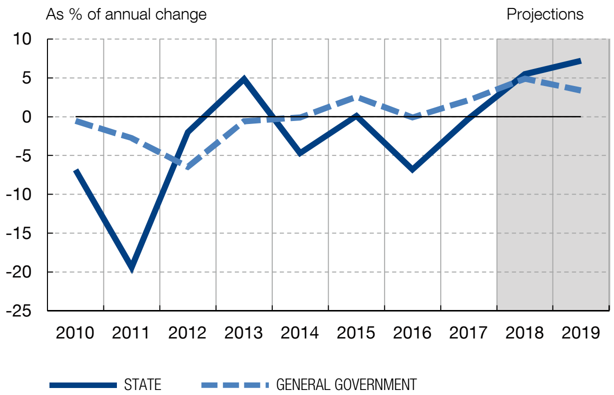
The Draft Budget includes an increase in public-sector employee compensation of 2.25% in 2019, plus an additional 0.25% if GDP growth in 2018 is equal to or higher than 2.5%, and other additional funds for specific targets and bodies. The hiring policy of the past two years remains in place, with replacement rates being increased in some sectors and additional measures being taken on working hours and temporary contracts. As regards social benefits, the Draft Budget includes a rise of 1.6% in State pensions and growth of 3% in minimum and non-contributory pensions in 2019, and an increase of 4 pp in the regulatory base of widows' pensions. Other spending measures are the reinstatement of unemployment benefits for persons over 52 years old, more funds for dependent persons and the extension of paternity leave to eight weeks.

The Draft Budget exhaustively details the other spending measures and priorities, which I shall not repeat here for the sake of brevity. In all, in 2019 State expenditure will, in accordance with this Draft Budget and in budgetary accounting terms, grow by 6.7% with respect to the budget outturn projection provided for 2018 (see Chart 8). By component,

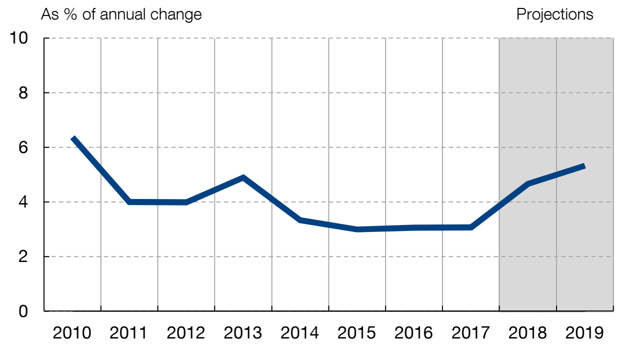
PUBLIC SPENDING IN THE DRAFT STATE BUDGET

CHART 8

PRIMARY EXPENDITURE (a)



PENSION EXPENDITURE (a)



SOURCES: IGAE, Plan Presupuestario 2019, State Budget 2019 and Banco de España.

a Cash-basis outturn data, 2018 Budget outturn projection and initial 2019 Budget, except general government spending, which is National-Accounts-based.

among the payments subject to greater discretionality, purchases of goods and services will grow by 2.7%; capital expenditure by 7.9%; and expenditure on staff by 4.8%. Among the expenditure items influenced by the behaviour of the financial, macroeconomic or demographic fundamentals, interest payments in cash terms will grow by 4.6% in 2019, while, in the social security budget, spending on contributory pensions will increase by 5.3% and that on unemployment benefits by 1.2%.

The targets for the less discretionary items taken as a whole are in line with the estimates of the models used by the Banco de España. This is particularly so for pension expenditure (the behaviour of which is determined by the increases agreed for 2019 and population ageing), unemployment benefits (which depend mainly on the behaviour of unemployment) and interest in National Accounts terms (which reflects the behaviour of government debt and of interest rates).

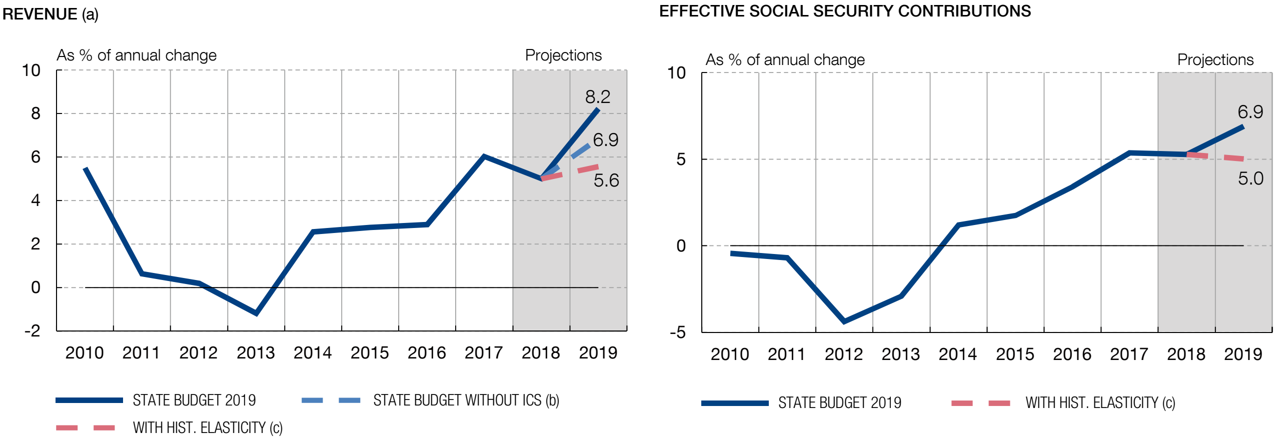
2.2 Projected revenue in the Draft Budget

On the revenue side, a broad set of legislative changes is proposed, including notably an increase in personal income tax and in wealth tax at higher income levels, the establishment of a minimum rate of 15% of taxable income for large corporations, the limitation of double taxation exemptions, and an increase in hydrocarbons tax, focused on diesel. On official estimates, these changes would raise government revenue by some €2.8 billion in 2019. Also, the Draft Budget includes the new taxes on financial transactions and certain digital services, with an officially estimated impact on revenue of some €2 billion in 2019.

The Draft Budget revenue projections are also affected by the introduction in July 2017 of the system known as “immediate supply of VAT information” (SII by its Spanish initials). Among the changes entailed by the new system in 2017 was the delay in the filing of VAT self-assessments (from the 20th to the 30th day of the month following the accrual), which, for accounting purposes, meant that the revenues for a month that would previously have been included in 2017 were actually included in 2018. Under the Draft Budget, with the new system firmly established, in 2019 the filing of VAT self-assessment will be put back to the 20th day of the month, so that there will be an opposite effect to the one in 2017.

REVENUE FORECAST IN THE DRAFT BUDGET

CHART 9



SOURCES: Agencia Tributaria, State Budget 2019 and Banco de España.

a Sum of shared taxes (personal income tax, corporate income tax, VAT and excise duties) plus effective Social Security contributions.
b Immediate supply of VAT information. In 2019, the submission date for VAT self-assessments shall be brought forward from the 30th to the 20th each month. This will mean that, for that year, revenue takings will cover 13 months, instead of 12.
c Historical elasticities estimated by the European Commission.

Overall, the Draft Budget assumes growth in tax revenues and social contributions of 8.2%, in budgetary terms, as a result of the entry into force of the measures announced, the effect of the above-mentioned SII and the growth in the tax bases, which basically depend on the macroeconomic situation (see Chart 9).

These government revenue estimates are subject to significant downside risks, in National Accounts terms, arising from various considerations.

First, the higher revenues under the new VAT SII system are not passed through to National Accounts items. Under European law – specifically, Article 2 of Regulation (EC) No 2516/2000 – the impact on the general government deficit of taxes and social contributions must follow the accrual principle. This means that taxes should affect the deficit of the period in which the taxable events giving rise to the tax payments take place. Applying this regulation, the VAT accrued in 2017 and collected in 2018 was recorded in 2017 and, in a similar manner, the increases in revenue included in the Draft Budget due to the effect of the SII would not affect the general government deficit in National Accounts terms.

Second, although there is always some uncertainty regarding the response of government revenues to tax bases (elasticity of taxation), the Draft Budget projections seem to be based on higher elasticities than have been recorded on average in the past. This consideration is based on the Banco de España's estimation of a set of standard models for the main items of government revenue (personal income tax, VAT, corporate income tax, social contributions and excise duties). These items are made to depend on the growth in the macroeconomic bases of the Draft Budget for 2019, with an impact proportional to the tax elasticities estimated by the European Commission and the Organisation for Economic Co-operation and Development (OECD), to which should be added the effect of the measures I have already described, taking the impact on the Draft Budget estimated ex ante. According to these calculations, the aggregate collection of shared taxes and social contributions would increase by 5.6% in 2019, as compared with the increase projected in the Draft Budget of 6.9%, correcting for the effect of the SII in both cases (see left-hand panel of Chart 9). The main source of this discrepancy is the difference in the projected social contributions (see right-hand panel of Chart 9).

The third source of risk for projected revenues that I wish to highlight relates to the fact that the estimation of the revenue impact of the new taxes is subject to a high degree of uncertainty, given the absence of any data on how they have functioned in the past.

Finally, caution should be exercised in relation to the potential delay in the entry into force of the measures accompanying the Draft Budget, which adds a further risk for expected revenues in 2019.

2.3 The government deficit target and the fiscal policy stance in 2019

Having discussed the spending policies and revenues of the Draft Budget separately I will now consider them together, in order to assess the uncertainty surrounding achievement of the deficit target of 1.3%. For this purpose, economists at the Banco de España have conducted a preliminary updating of the December projections, which I have already considered in detail. In particular, the impact on these projections of the revenue and spending measures that have been included in the Draft Budget since then is estimated, resulting in a general government deficit of around 2% of GDP in 2019, as compared with the Banco de España's December projection of 2.4%. Moreover, the economic growth forecast would be revised down slightly, mainly as a result of incorporation of the impact of the tax measures.

This tentative estimate suggests that achievement of the official deficit target of 1.3% in 2019 is subject to far-from-negligible risks.

A smaller revenue impact of the new taxes than officially estimated, a delay in the entry into force of the tax measures included in the Draft Budget or potential materialisation of the downside risks to the economic growth outlook that I have already discussed would raise the projected deficit. On the other hand, a more dynamic response by tax revenues to macroeconomic conditions than historically estimated or a containment of discretionary spending would have the opposite effect.

In any event, the Banco de España will publish a complete estimate at the end of March, including an update of the macroeconomic projections with all the information that has become available since the last projection exercise was conducted in December.

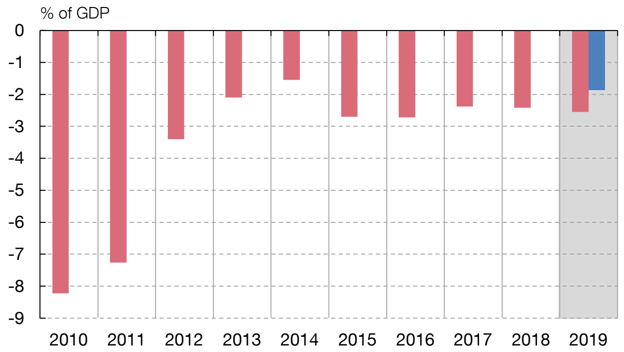
As regards the fiscal policy stance in 2019, derived from these preliminary estimates and measured by the change in the general government structural balance, it would be roughly neutral. The level of the structural deficit would stand at around 2.5% of GDP, according to the Banco de España's estimates, similar to its value over the last five years and higher than in 2013-14, which implies that practically the entire reduction observed in the government deficit since 2013 has been due to the effect of the business cycle (see Chart 10).

Although the general government "structural deficit" is not directly observable and, therefore, its calculation is based on assumptions subject to a high degree of uncertainty, it is a useful indicator of the underlying state of public finances. This indicator will, moreover, play a more important role in the new phase of fiscal policy due to begin, in the event that the EU Council eventually rules that Spanish general government is no longer in an excessive deficit situation. As I have already mentioned, the latest data point in this direction.

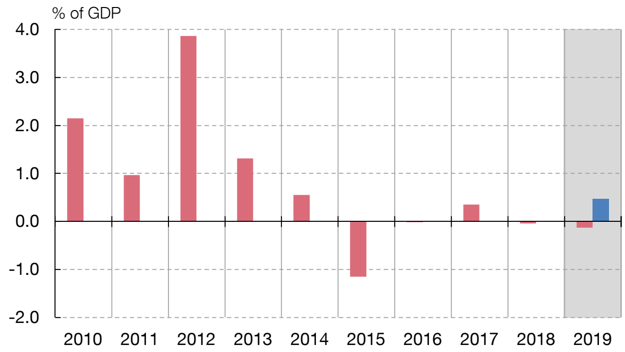
In fact, exiting the "corrective arm" of the EU's Stability and Growth Pact would involve Spain automatically entering the "preventive arm". Countries in this situation remain

THE BUDGET DEFICIT TARGET AND THE FISCAL POLICY STANCE IN 2019 CHART 10

GENERAL GOVERNMENT STRUCTURAL BALANCE



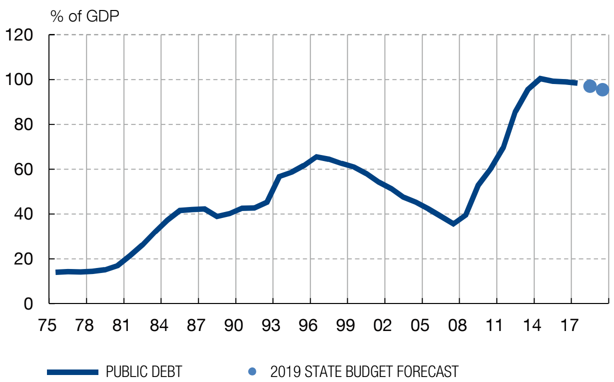
STRUCTURAL BALANCE CHANGE



SOURCES: European Commission, IGAE, 2019 State Budget and Banco de España.

GENERAL GOVERNMENT DEBT IN THE DRAFT BUDGET CHART 11

PUBLIC DEBT



BREAKDOWN OF GENERAL GOVERNMENT DEBT

	2017	2018	2019
Debt as a % of PIB	98.3	96.9	95.4
Debt change (as GDP pp)	-0.7	-1.4	-1.5
Due to:			
Balance	3.1	2.7	1.3
GDP nominal rate of change	-4.2	-3.6	-3.7
Flow-stock adjustment	0.5	-0.6	0.9

SOURCES: Banco de España and 2019 State Budget.

subject to a set of rules restricting fiscal policy which, in Spain's case, would mean that: first, the structural government deficit would have to be reduced each year by 0.5 pp of GDP, under normal conditions, until the medium-term objective (MTO) of structural balance were achieved; second, the annual growth of general government spending would have to be less than or equal to the economy's potential medium-term growth; and, finally, the government debt-to-GDP ratio would have to be reduced each year by one twentieth of the difference between its level and the target of 60%. Given that the debt ratio stood at 98.3% of GDP in 2017, the latest year for which data are available, this rule would require an average annual reduction of 1.5 pp of GDP over the next decade.

2.4 Government debt in the Draft Budget

According to the Draft Budget, the general government debt ratio will fall by 1.5 pp as a percentage of GDP, from 96.9% estimated in the Draft Budget for 2018 to 95.4% in 2019, continuing along the path of gradual decline observed since 2014 (see Chart 11). This is a result of the expected favourable development of nominal economic growth. However, if the upside risks to the government deficit referred to earlier were to materialise, the reduction in the debt ratio would be more moderate.

3 FISCAL POLICY CHALLENGES

The accounts presented should also be assessed from a more general standpoint. Accordingly, before ending, I will now refer to some of the challenges facing Spanish public finances.

First, it is essential that we move towards lower public debt levels (see Chart 12). The empirical evidence shows that maintaining a very high level of public debt over a prolonged period may have negative effects on economic growth. These adverse effects arise because public debt absorbs funds that could be put to more productive use and alters the overall financing conditions of the economy, distorting private investment decisions. Moreover, in adverse situations, high indebtedness detracts from the stabilising capacity of fiscal policy. In addition, sustaining high public debt requires maintaining primary surpluses over a prolonged period, which may call for higher levels of taxation or lower levels of productive expenditure. Lastly, one of the key possible adverse effects of high debt is the greater vulnerability of public finances to changes in investor or market sentiment.

According to simulations performed in studies published by the Banco de España, under credible assumptions, the process of reduction of Spanish government debt will be very gradual; indeed, several decades may elapse before the debt-to-GDP ratio reaches 60%, which is the benchmark set in the current European fiscal rules framework.

In consequence, it is crucial that advantage be taken of the current favourable economic setting to complete the fiscal consolidation process and create budgetary headroom in order to be in a position to address future downturns. The work remaining should take the form of a medium-term programme setting out the measures required to meet the budgetary objectives, together with prudent macroeconomic and public revenue forecasts.

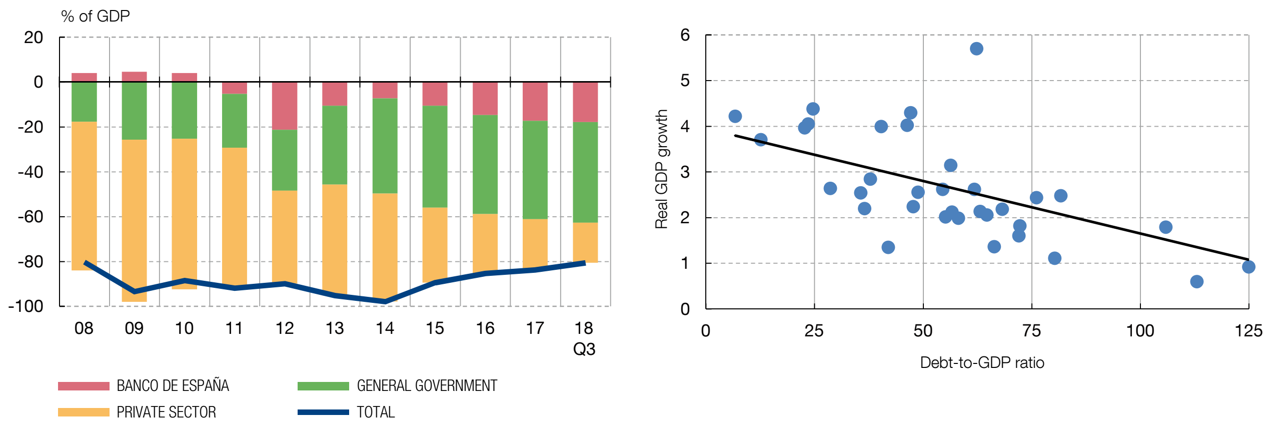
Reducing the vulnerability of Spanish public finances is even more important considering the medium and long-term challenge posed by population ageing (see Chart 13). The latest estimates point to a significant increase in public expenditure on pensions, healthcare and long-term care deriving from the surge in the dependency ratio, which even in the most optimistic demographic projections is set to rise from 25% at present to over 50% by 2050.

In the case of the pensions system, the 2011 and 2013 reforms included some adjustments that managed to significantly offset the effect of the expected increase in the dependency ratio in the long term. However, the 2018 Budget and the Budget for 2019 being discussed here today, mark an easing of the entry into force of those mechanisms, as they delay the application of the sustainability factor until 2023 and, in particular, they entail a return to the system of annual revaluation of pensions in accordance with the CPI. According to Banco de España calculations, the permanent reinstatement of this indexation system would entail an additional increase in expenditure of more than 3 pp of GDP in 2050. In consequence, in order to ensure the financial sustainability of the public pensions system, additional measures will be required on the revenue or the expenditure side, or on both sides, to offset that extra burden.

In short, I must stress that it is, in this respect, essential to define, in accordance with social preferences, the replacement rates that the pensions system should seek to ensure, so as to subsequently adjust the level of revenue accordingly and thus ensure the

HIGH PUBLIC DEBT

CHART 12

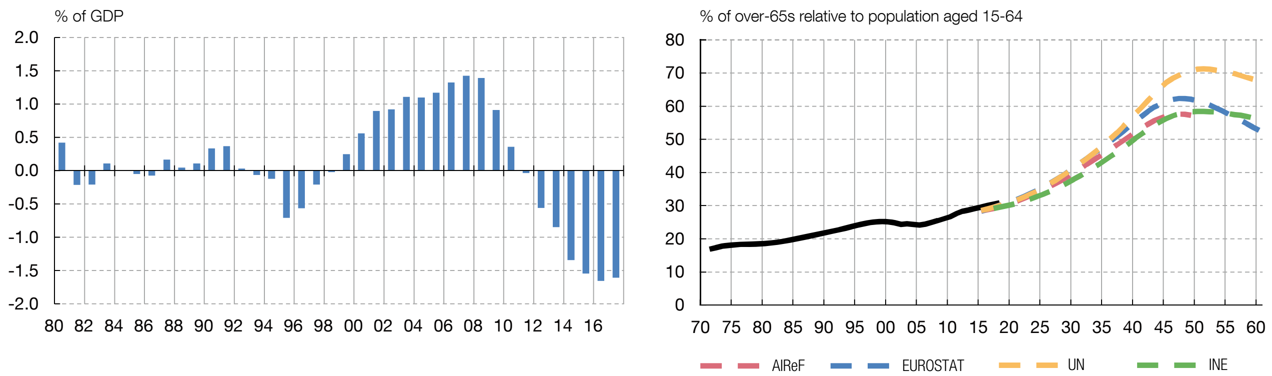


SOURCES: Eurostat, OECD and Banco de España.

a Regression with average values for the EU and OECD countries in the 1995-2015 period.

THE CHALLENGE OF POPULATION AGEING

CHART 13



$$\frac{\text{pension spending}}{\text{GDP}} = \underbrace{\frac{\text{n pensions}}{\text{population}}}_{\text{Dependency ratio}} * \underbrace{\frac{\text{population}}{\text{n employees}}}_{\text{Inverse of employment rate}} * \underbrace{\frac{\text{average pension}}{\text{average wage}}}_{\text{Replacement rate}} * \underbrace{\frac{\text{total gross wages}}{\text{GDP}}}_{\alpha}$$

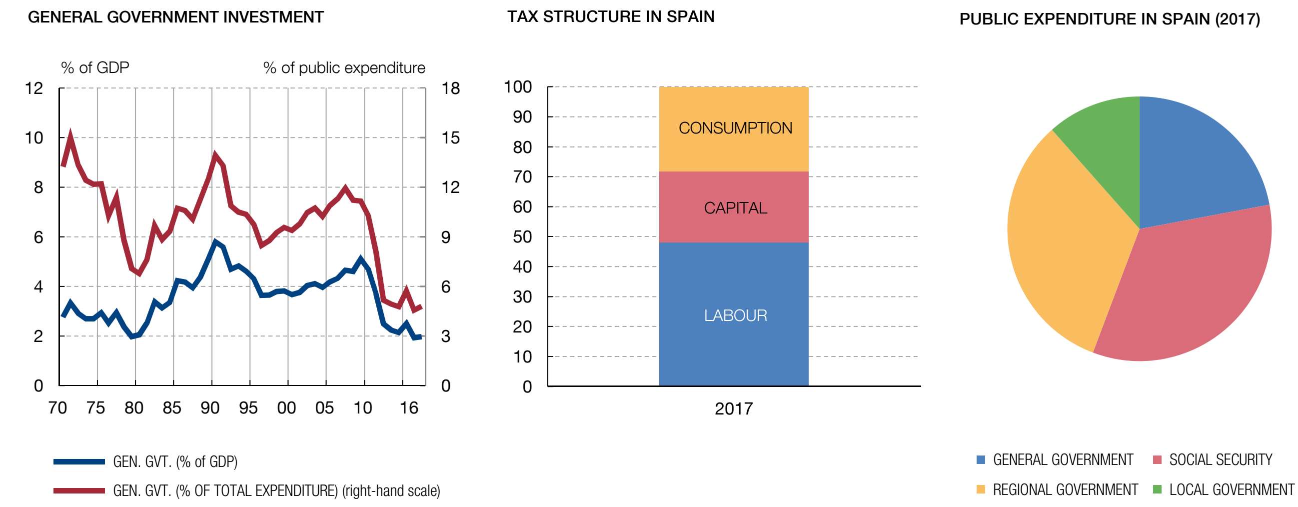
SOURCES: Social Security and National Accounts, AIReF, Eurostat, United Nations and INE.

sustainability of the system. I believe this is a structural issue that requires broader debate, not confined to the habitual annual budget discussions. Indeed, population ageing also has an adverse impact on the participation rate, productivity and potential economic growth, so a broad approach is needed to address this issue, both as to the time period considered and the set of economic policy instruments to be used.

In view of the medium-term challenges posed by the high debt-to-GDP ratio and the impact of population ageing on public expenditure, the process of redressing fiscal imbalances must be compatible with an increase in the quality of public finances. In this respect, the composition of the income/expenditure adjustment in the necessary medium-term programme is of utmost importance in order to achieve the objectives set without

THE QUALITY OF PUBLIC FINANCES

CHART 14



SOURCES: IGAE, INE and Banco de España.

hampering economic growth. Accordingly, prudent and in-depth analysis of the structure of general government income and expenditure is essential in order to progress in this respect (see the illustrations in Chart 14). On the expenditure side, there appears to be room for continued progress in raising its efficiency and reorienting its composition towards those items that have a greater impact on the accumulation of physical, technological and human capital. In this respect, the outcome of the ongoing public expenditure review may be key to further progress in this direction. On the revenue side, there is room to consider a review and definition of the tax basket, moving towards structures more favourable to potential growth.

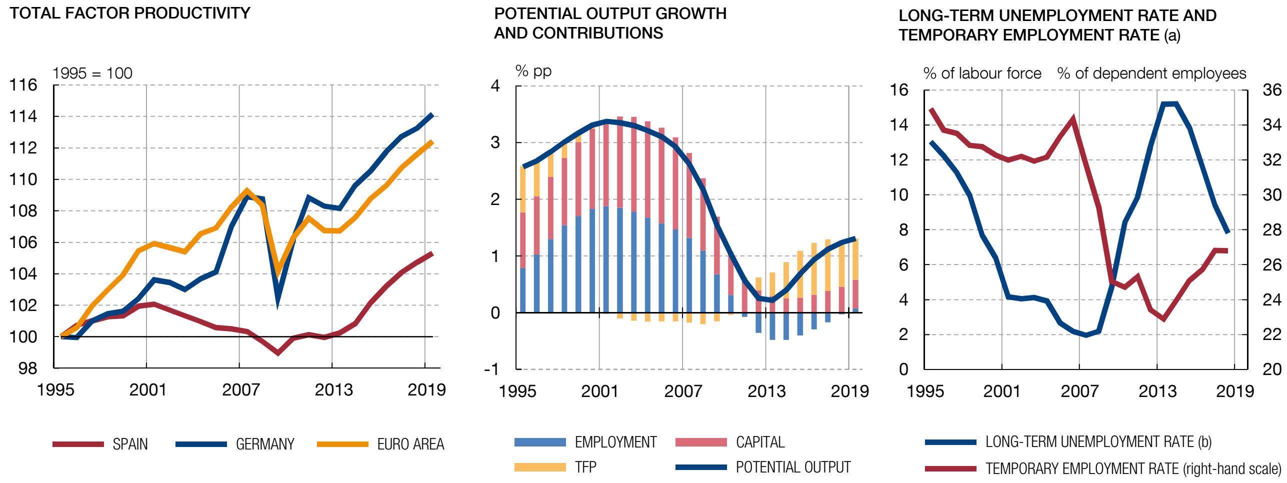
In addition, in such a highly decentralised government system as the Spanish one, the regional authorities play an essential role. In this respect there is a general consensus on the need for reform of the system of regional government financing, tailoring the resources at their disposal to their requirements, based on a previous objective estimate of those requirements, in order to ensure a transparent distribution of funds and increase the degree of fiscal co-responsibility.

Lastly, let me add that this process of fiscal consolidation needs to be accompanied by an ambitious structural reform agenda to boost potential economic growth. In the Banco de España's latest Annual Report, published in May 2018, we outlined a broad range of areas where such initiatives could be set in process. Here I would like to highlight two of those areas (see Chart 15). First, greater labour market efficiency, through lower temporary employment and improved employability, especially in the case of less skilled workers, could boost economic growth potential. Second, productivity gains thanks to investment in human capital, greater innovation and the elimination of inappropriate barriers to competition would also have beneficial effects on economic progress in the medium term.

Before I close I would like to mention, among the structural challenges facing the Spanish economy, those facing the banking sector. Spanish banks do indeed still face challenges, such as reducing their volume of non-productive assets, improving their capital structure and profitability, strengthening their reputation and making optimum use of technological developments.

OTHER STRUCTURAL CHALLENGES

CHART 15



SOURCES: Eurostat, INE and Banco de España.

a Annual data for Q2.
b Unemployed seeking work for more than one year.

4 CONCLUSIONS

I wish to conclude simply by emphasising that although the Spanish economy is now entering its sixth consecutive year of real GDP growth, and that this growth pattern is expected to continue, albeit at a progressively slower pace, the risks to the prolongation of the expansionary phase have increased somewhat, especially in the international sphere. Thus protectionist measures, Brexit and the persistence of certain focal points of political and economic uncertainty within the euro area partially explain the slowdown in the global economy in 2018, but further adverse effects cannot be ruled out in coming quarters. In any event, the world economy is now at an advanced stage of the cycle, and the Spanish economy is not immune to developments in the international arena, in particular in the euro area, especially in view of the continuing high level of both external and public debt in Spain.

For this reason, efforts to continue to improve the budgetary position of the different tiers of Spanish general government and to bring in reforms to shore up confidence in the various economic agents and boost growth potential should not be delayed. These two conditions are essential to redress the existing imbalances and ensure continued economic growth and job creation.

Thank you for your attention.