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29.11.2022

Testimony before the Senate Budget Committee in relation to the Draft State Budget for 2023*

Senate

Pablo Hernández de Cos
Governor

* English translation from the original in Spanish

Ladies and gentlemen,

I appear before this Senate Committee for the parliamentary presentation and discussion of the State and Social Security Budget (hereafter, the Budget) for 2023.

In this address I will provide an update of my previous assessment of the Budget before the Parliamentary Budget Committee on 17 October. Specifically, I will address the following matters. First, I will review the outlook for the Spanish economy against an extraordinarily uncertain international background. Second, I will analyse the role that economic policy should play in such a setting. Third, I will offer my views on the main aspects of the Budget for 2023, as well as the Budgetary Plan for 2023 published on 15 October. For this purpose, I will begin by offering an analysis of the various channels through which the current inflationary episode is affecting the public finances. Lastly, I shall conclude with some thoughts on the medium-term fiscal policy challenges facing our country.

1 Recent developments in, and the outlook for, the Spanish economy

1.1 The global and European context

Global economic activity has been losing steam appreciably in recent months. This adverse development is the result of various interacting factors, the most prominent possibly being global inflation soaring to levels not seen in several decades. These inflationary pressures have elicited a forceful response from the main central banks, which is causing global financial conditions to tighten significantly.

HIGH INFLATION RATES PERSIST GLOBALLY

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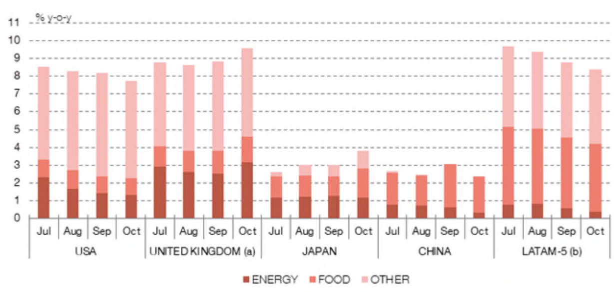
RECENT CHANGES IN INFLATION AND CONTRIBUTIONS



Sources: National statistics and Refinitiv.
(a) The CPIH index.
(b) The LATAM-5 aggregate comprises Brazil, Chile, Colombia, Mexico and Peru.

The increase in consumer prices is largely being driven by the higher cost of numerous commodity imports, which is reducing the purchasing power of households and firms.

Commodity prices were rising before the war in Ukraine, but the latter has served to exacerbate the increases. The war has also fuelled uncertainty regarding the security of

Europe’s energy supply and even made a major escalation in global geopolitical tensions a more likely prospect.

WIDESPREAD NORMALISATION OF MONETARY POLICIES IN RESPONSE TO HIGH AND PERSISTENT INFLATION

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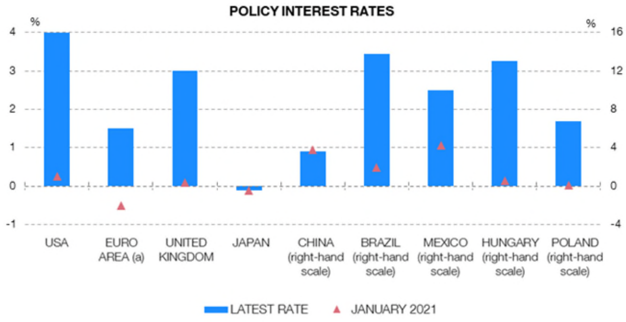

Source: National central banks.
(a) Deposit facility rate.

All these factors combined have already contributed to the considerable slowdown in activity in the two main world economies (the United States and China), which has translated into significant downward revisions to their projected GDP growth for this year.

WEAKNESS IN THE MANUFACTURING AND SERVICES PMIs IN THE UNITED STATES AND THE EURO AREA

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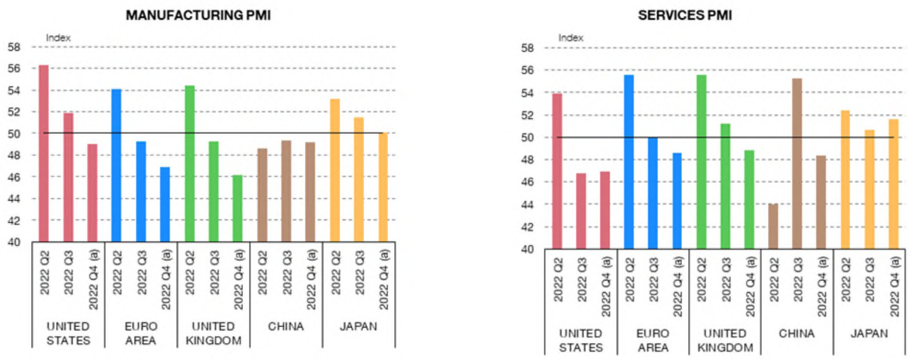

Source: S&P Global.
(a) Average of October and November 2022, except for China, which only includes October.

And the signs of slowing activity are now widespread among geographical areas. For example, the Manufacturing and Services Purchasing Managers' Indices (PMIs) have decreased appreciably in the main world economies since the summer and in many cases already stand in contractionary territory. International trade has also moderated as a result of slowing activity.

These developments have led economic analysts to systematically and significantly revise down their economic growth forecasts for 2022 and 2023. In tandem, the financial markets consider that the likelihood of a global recession has risen significantly.

CLEAR SIGNS OF A GLOBAL ECONOMIC SLOWDOWN ARE VISIBLE AND THE GROWTH OUTLOOK HAS BEEN REVISED DOWNWARDS AND THE INFLATION OUTLOOK UPWARDS

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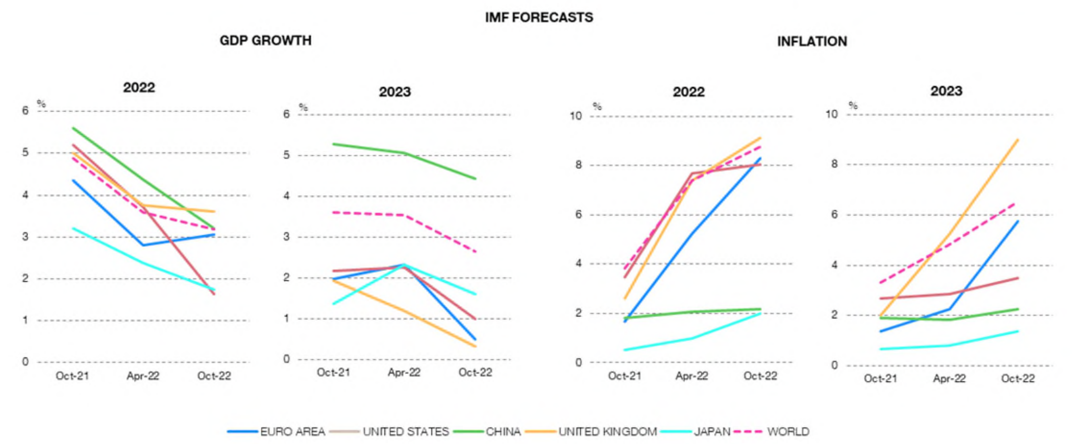

Source: IMF.

For example, the latest International Monetary Fund (IMF) forecasts published in October expect global economic growth to moderate from 6% in 2021 to 3.2% in 2022 and 2.6% in 2023. The growth rate forecast for 2022 is down 0.4 pp from the IMF's April projections, while the 2023 rate is down 1 pp.

Meanwhile, the stronger, broader-based inflationary surge has prompted successive upward revisions to inflation forecasts. For example, according to the new IMF projections, global inflation will stand at 8.7% in 2022 and 6.3% in 2023, 1.3 pp and 1.5 pp, respectively, above the April projections.

The upside to waning activity is the reduction, since mid-2022, in the prices of most commodities and the easing of the global supply and production chain bottlenecks. This is lowering, to some extent, the risks of a severe global recession accompanied by particularly elevated and persistent inflation.

Europe is particularly exposed to developments linked to the war in Ukraine on account of its geographical proximity and, in particular, its reliance on commodity imports from Russia, especially imports of gas, which is used as a primary source of energy by households and firms and also in electricity production.

GAS INVENTORIES HAVE RISEN CONSIDERABLY IN RECENT MONTHS

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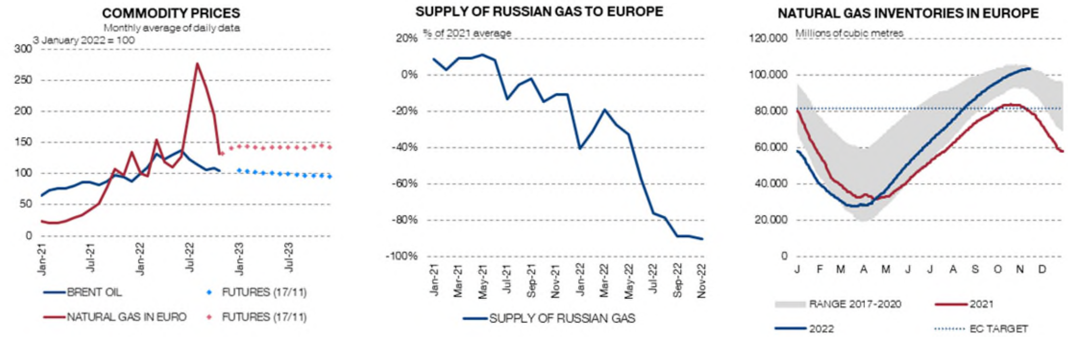


Sources: Refinitiv, ENTSO-G and Gas Infrastructure Europe. Latest observation: 17 November (left-hand and central panels), 14 November (right-hand panel).

The war has triggered increasing disruptions to the supply of gas, which Europe is addressing through a number of complementary channels, including the geographical diversification of its gas imports and reducing consumption. Lower demand for gas is attributable to its high price, warm temperatures, energy-saving measures, such as limits on air-conditioning and heating temperatures, and the replacement of gas with other energy sources. Indeed, Europe is approaching this coming winter with historically high gas storage levels that exceed the targets set by the European Union.

However, the measures implemented thus far do not fully guarantee the availability of supply in winters beyond this one – especially in some central European countries. If Europe experiences severe weather conditions, the shortage of gas could prompt fresh price rises and scarcity in some countries, with particularly severe adverse effects on activity. This is why it remains key to act early to reduce consumption and extend the solidarity and interconnection-development mechanisms.

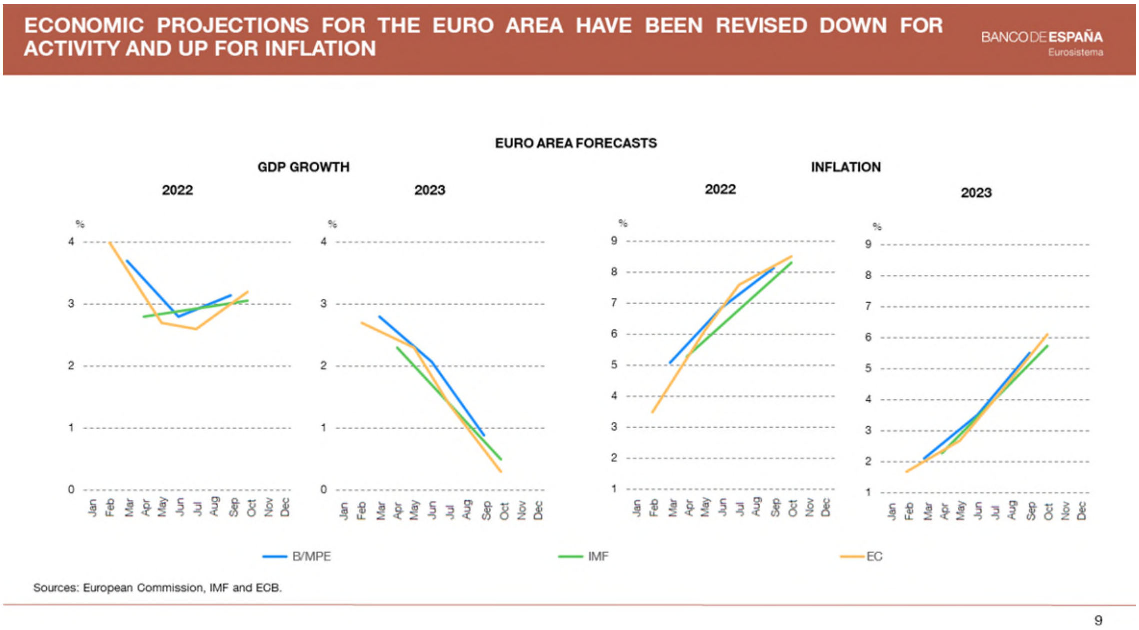
Inflationary pressures in the euro area have intensified and are proving more persistent than expected a few months ago. Thus, euro area inflation reached 10.6% in October. Just over 40% of inflation is directly attributable to the energy component. But rising energy prices have also had an indirect impact on the price of other consumption basket items. According to existing estimates, energy's "indirect effects" are behind almost 30% of underlying inflation, or, in other words, around 10% of headline inflation.

Further, around one-quarter of the rise in inflation is due to food. The surge in food prices is related to strong global demand for food commodities, adverse weather conditions and the higher costs of international shipping and some key inputs, such as fuel and fertilizers.

Aside from the changes in energy and food prices, we have also seen inflationary pressures spreading to other goods and services, leading to underlying inflation of 5% in October, against a background in which certain supply constraints still persist in some sectors and where there has been a strong reorientation of demand towards more contact-intensive services.[1] Indeed, more than half of the underlying inflation items have inflation rates above 4%.

Turning to activity, euro area GDP growth surprised on the upside in 2022 H1 (with quarter-on-quarter growth of 0.6% and 0.8% in the first two quarters of the year), largely as a result of the pandemic-related restrictions being rolled back. By contrast, it eased considerably in Q3 (with GDP growing by 0.2% quarter-on-quarter) and, based on the latest indicators, will likely slow further still in Q4.

This slowdown in activity is mainly a consequence of the energy crisis (which has eroded euro area household purchasing power and driven up the costs of the most energy-intensive sectors), the weakening of global demand, the tightening of financial conditions resulting from monetary policy normalisation, and economic and geopolitical uncertainty.



The latest economic projections envisage a very sharp decline in activity in 2023. Specifically, according to the European Commission's Autumn 2022 Economic Forecast, published on 11 November, euro area GDP growth will fall from 3.2% in 2022 to 0.3% in 2023. This is 0.2 pp lower than the rate projected in the latest IMF and OECD publications (dated 11 October and 22 November, respectively) and 0.4 pp lower than the ECB projection published on 8 September.

Analysts' consensus has been revising up the inflation forecasts significantly for both 2022 and 2023. For example, the Commission's latest forecasts envisage euro area inflation of 8.5% on average in 2022 and of 6.1% in 2023. These rates are 1 pp and 2.1 pp, respectively, higher than its July forecasts and 0.4 pp and 0.6 pp, respectively, higher than the ECB's September projections.

[1] See M. Pacce, A. del Río and I. Sánchez (2022). "The recent performance of underlying inflation in the euro area and in Spain", Analytical Articles, *Economic Bulletin* 3/2022, Banco de España.

In any event, I wish to highlight that these economic projections are currently subject to extraordinary uncertainty. This uncertainty is reflected, for instance, in the dispersion among analysts in the one-year economic outlook for the euro area. This dispersion is very high in the case of GDP – close to the levels observed in the 2008 financial crisis – and stands at an all-time high in the case of the inflation outlook.

Specifically, this outlook is highly dependent on how the war in Ukraine unfolds, given that this will largely determine matters as important as the behaviour of energy commodity prices (mainly gas and electricity prices), the possibility of energy supply interruptions and production cuts in some economies (especially if the coming winter proves to be very cold), the severity of production and supply chain bottlenecks, and future developments in economic agents' confidence.

Overall, in light of these war-related uncertainties, the risks to the baseline projection scenario are tilted to the downside in the case of growth and to the upside in that of inflation. For example, the September ECB projections included a downside scenario under which euro area GDP could contract by 0.9% and average inflation could rise to 6.9% in 2023.

1.2 Recent developments in the Spanish economy

The developments I have just described are weighing down GDP growth and driving up inflationary pressures in Spain as well. High geopolitical uncertainty in the wake of the outbreak of the war and the energy crisis in Europe have affected Spanish private agents' spending decisions, as they have dented their confidence and compounded the loss of real income they were already experiencing before the war. In addition, the ECB's monetary policy tightening as a result of persistent high inflation has meant that financing conditions for general government, households and firms in Spain are less accommodative.

IN SPAIN, GDP SLOWED DOWN SHARPLY IN Q3, IN LINE WITH THE BANCO DE ESPAÑA PROJECTION

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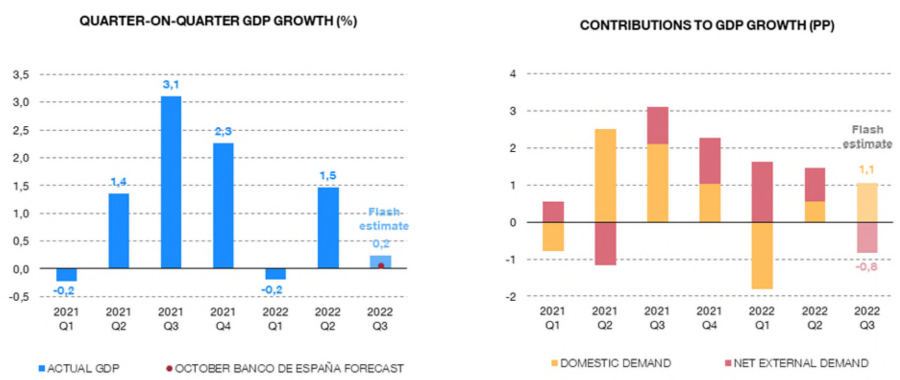

Sources: Banco de España and INE.

Consequently, quarter-on-quarter GDP growth fell sharply in Q3, decelerating from 1.5% in Q2 to 0.2%, according to the National Statistics Institute (INE) flash estimate. This figure is in line with the estimate in the October Banco de España projections, which envisaged growth of 0.1%.

Output growth stemmed from the positive contribution of domestic demand, the result of higher private and government consumption and investment excluding construction. Conversely, net external demand made a negative contribution, as imports outpaced exports.

On the supply side, as in Q2, the highest growth rates were in the market services sectors that were hardest hit by the pandemic, particularly the recreation and hospitality-linked sectors, whereas the primary, industrial and construction sectors recorded weaker growth, probably on account of being more affected by supply difficulties and higher energy prices. Like activity, employment also lost steam in Q3.

UNLIKE IN THE EURO AREA, THE RECOVERY IN ACTIVITY IN SPAIN IS STILL INCOMPLETE AND UNEVEN ACROSS SECTORS

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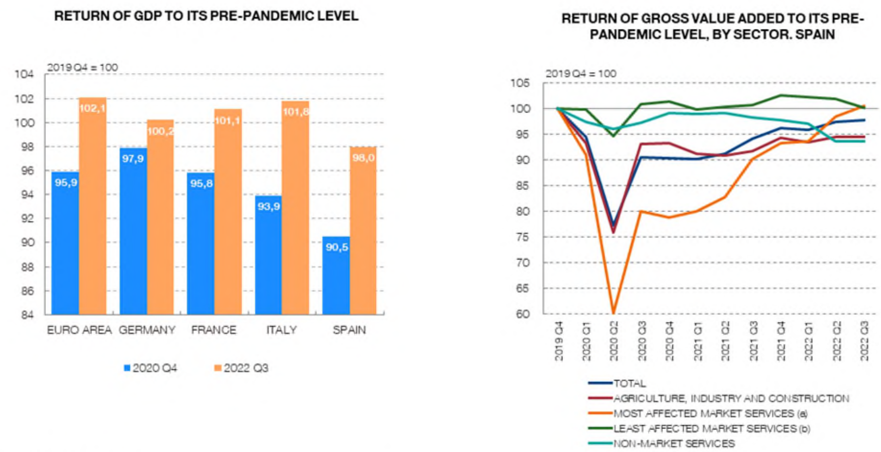

Sources: Banco de España, Eurostat and INE.
(a) Most affected market services: trade, transportation and hospitality, professional, scientific and administrative activities and arts and recreation services.
(b) Least affected market services: information and communication, financial and insurance activities and real estate activities.

Based on the flash estimate for Q3, Spanish GDP is still 2 pp below its end-2019 level. In the case of the labour market, in terms of total hours worked the gap vis-à-vis the pre-crisis level also remains negative, although it is narrower than in the case of output (-0.9 pp). However, the number of persons employed is already 0.6% higher than at end-2019.

y contrast, in the euro area as a whole, these gaps are already positive. In Q3, output and persons employed were 2.1 pp and 1.9 pp, respectively, higher than their pre-crisis level. In the case of hours worked, in Q2 (the latest available figure) the positive gap amounted to 0.4 pp.

ACCORDING TO THE LATEST INDICATORS AVAILABLE, THE SPANISH ECONOMY WILL CONTINUE TO BE SLUGGISH IN 2022 Q4

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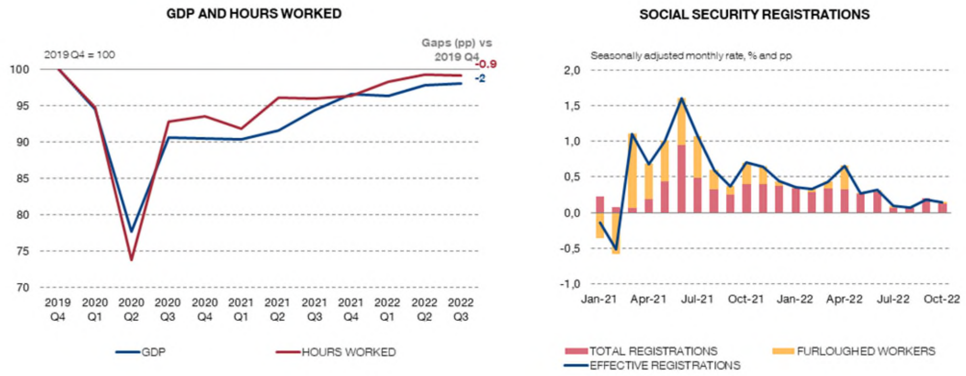

Sources: Banco de España, INE and Ministerio de Inclusión, Seguridad Social y Migraciones.

The indicators for Q4 suggest that output will remain weak, potentially growing slightly like in Q3. Specifically, the qualitative indicators have tended to reveal a further slight weakening in the current quarter. The composite PMI fell to 48 points in October, standing, therefore, in contractionary territory, i.e. below 50, the level which, a priori, marks the frontier between output rising and falling. In turn, the economic sentiment indicator also remains at relatively low levels; by component, the poor relative performance of the consumer confidence index stood out.

CONFIDENCE INDICATORS REMAIN AT VERY LOW LEVELS OR CONTINUE TO DECLINE

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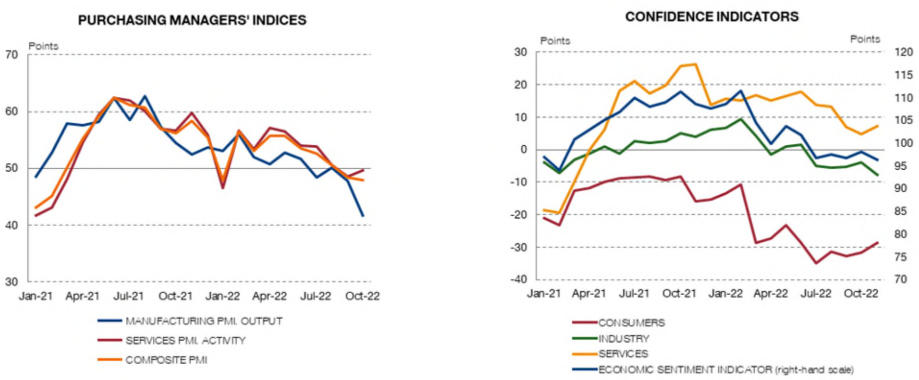

Sources: S&P Global and European Commission. Latest observation: October (PMIs) and November (confidence indicators).

However, employment has been more buoyant. In October, growth in social security registrations did not differ much from the increases observed over Q3 (month-on-month growth of 0.1% in seasonally adjusted terms). The latest information for the first fortnight of November shows that employment has even performed slightly more vigorously in that period, suggesting that gross social security registrations for the month as a whole could be similar to the October figure. This contrasts with the declines usually recorded in this month (-0.2% on average between 2016 and 2019).

INFLATIONARY PRESSURES IN SPAIN REMAIN VERY HIGH AND AFFECT A BROAD RANGE OF COMPONENTS IN THE CONSUMPTION BASKET

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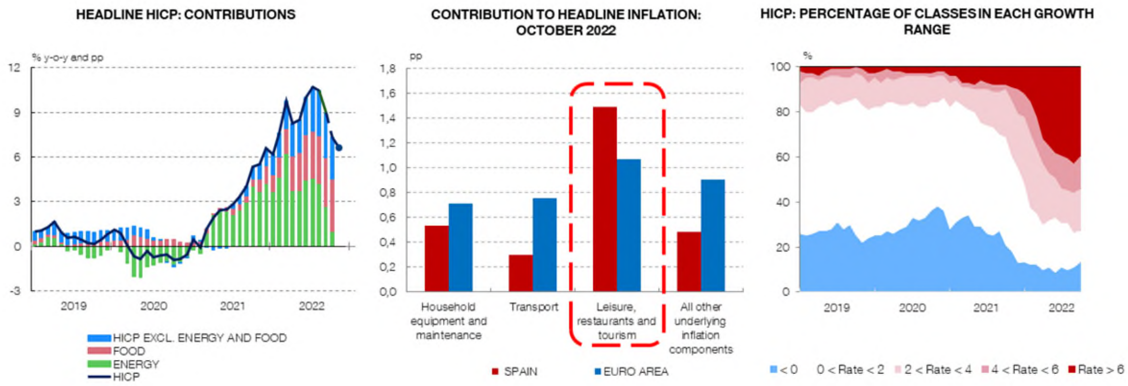

Source: INE.

Meanwhile, consumer prices have been gradually easing in recent months. Specifically, according to the flash estimate, the harmonised index of consumer prices (HICP) grew year-on-year by 6.6% in November. If confirmed, this would represent a decline of 4.1 pp from the July peak. That said, it is important to underscore that this fall owes exclusively to the energy component, which, for the reasons I have already described, is currently subject to huge fluctuations, while, by contrast, the other components have continued to accelerate considerably.

In particular, the lower contribution of the energy component is attributable, above all, to the decline in electricity prices for household consumers, given the pricing system in force in Spain for households on the regulated market, which means that changes in wholesale market prices are passed through to consumers immediately. This is an important difference with regard to most European countries, where the pass-through of wholesale electricity prices to retail ones takes much longer and, as a result, the energy component has not decelerated like in Spain.

In addition, over the course of the year energy price growth in Spain has been contained by the effects of different measures adopted by the authorities. According to Banco de España estimates, these measures have helped lower headline inflation by just over 2 pp in October, the last month for which disaggregated information is available; the vehicle fuel discount and the cap on the increase in the cost of the commodity in the regulated rate for small natural gas consumers are the two measures with the strongest mitigating impact (almost 1.5 pp). By contrast, the measures affecting electricity prices had little impact in October. This is due, first, to the limited effect of the “Iberian exception” on account of the drop in the gas price,[2] and, second, to the cut in the excise duty on electricity and the lower energy policy charges in the electricity bill no longer having a mitigating impact on inflation, as these cuts began to be applied in mid-September 2021.[3]

Conversely, food prices are soaring, recording year-on-year growth of 14% in October.[4]

Underlying inflation has reached very high levels (4.4% in October), indicating just how much inflationary pressures have spread. In October, 52% of HICP items recorded year-on-year growth of over 4%, which contrasts with the January 2022 figure (less than 25% of the items). These dynamics have been driven by the persistence and magnitude of the past surges in energy and other commodity prices, which have been gradually passed through to the prices of other consumer goods and services more intensely than before the pandemic.[5]

In the immediate future, the continuation of the recent trends in gas and, therefore, electricity prices should help contain headline inflation over the winter. However, it is possible that the pass-through of the past increases in energy prices to the prices of other goods and services is not yet complete. This will very likely contribute to underlying inflation remaining high in the coming months.

From the standpoint of price formation for goods and services produced in Spain, for the time being no significant second-round effects on inflation via wages are being detected, while profit margins remain relatively contained in aggregate terms.

On the data to October, the average wage settlement under collective bargaining agreements in force in 2022 is somewhat above 2.6%.[6] However, the percentage of workers covered by indexation clauses has risen to almost 24% (from 16.1% in 2021),[7] which increases the risks of future second-round effects on inflation being stronger than those observed to date.

As regards profit margins, net operating income for the median firm in the Banco de España's Central Balance Sheet Data Office Quarterly Survey held relatively stable in 2022 H1, at around pre-pandemic levels.[8] Based on the information in the Quarterly Non-Financial Accounts for the Institutional Sectors, the ratio of gross operating surplus (GOS) to gross value added (GVA) for non-financial corporations (NFCs), which fell as a result of the pandemic, is returning to pre-pandemic levels. In any event, it is important to highlight that

[2] In particular, there were nine days in October where the cap on the gas price was not operational because it was below €40/MWh.

[3] Specifically, the excise duty on electricity was cut from 5.11% to 0.5%, while energy policy charges were lowered by 96% vis-à-vis August 2021 (energy policy charges are currently 56% lower than in that month).

[4] As a result, this component's contribution to the headline index amounted to approximately 50% in October.

[5] See J. M. González Mínguez, S. Hurtado, D. Leiva-León and A. Urtasun (2022). "De la energía al resto de componentes: la generalización del fenómeno inflacionista", Artículos Analíticos, *Boletín Económico*, Banco de España, forthcoming.

[6] This settlement mostly reflects the increase negotiated in agreements signed in previous years. The wage increases negotiated in newly signed collective agreements, to October 2022, have also remained relatively contained, at 2.9%.

[7] This percentage would rise to 45% on the basis of the partial information available for 2023.

[8] See A. Menéndez and M. Mulino (2022), "Results of non-financial corporations to 2022 Q2", Analytical Articles, *Economic Bulletin* 3/2022, Banco de España.

these overall developments conceal considerable heterogeneity across sectors and firms.[9] Thus, for example, the sectoral information in the Quarterly National Accounts points to profit margins performing more dynamically in manufacturing, mining and quarrying, energy and water, in contrast to the more sluggish performance of profit margins in construction.

1.3 Macroeconomic projections for the Spanish economy

SUMMARY OF THE OCTOBER BANCO DE ESPAÑA GROWTH FORECAST FOR 2022-2024

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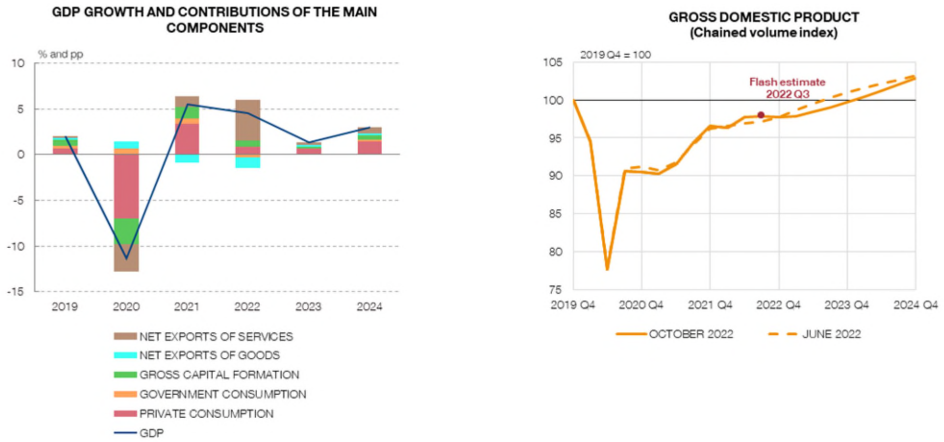

Sources: Banco de España and INE.

The Banco de España published its latest macroeconomic projections on 5 October.[10] Amid continued extraordinary macro-financial and geopolitical uncertainty, developments since then have not prompted any particularly significant changes to that assessment. Therefore, the outlook depicted in the next Banco de España projections is unlikely to differ from that published in October.[11]

Specifically, in the October projections Spanish GDP was forecast to grow by 4.5%, 1.4% and 2.9% in 2022, 2023 and 2024, respectively. This represented a 0.4 pp upward revision to the GDP growth for 2022 forecast in the June projections. By contrast, the growth projected for 2023 was revised down by 1.5 pp.

In sum, the current phase of weak economic activity, hampered by the pressure that high inflation is exerting on household income, is likely to continue over the winter months. In addition, the recent momentum of inbound tourism flows, practically recovering pre-health

[9] For further details on the heterogeneity of profit margins at firm level, see A. Fernández-Cerezo, J. M. Montero and E. Prades (2022), "Mark-ups in Spain: recent developments", Box 3, "Quarterly report on the Spanish economy", *Economic Bulletin* 2/2022, Banco de España.

[10] See "Macroeconomic projections for the Spanish economy (2022-2024)", Box 1, "Quarterly Report on the Spanish Economy", *Economic Bulletin* 3/2022, Banco de España.

[11] Banco de España staff are currently preparing the next projections as part of the joint Eurosystem exercise and they will be published in December.

crisis levels, may flag in the short term due to the effects of soaring inflation on potential tourists' real income.

Activity is expected to regain increasing momentum from spring, fuelled by a combination of factors. These include a gradual easing of energy market tensions – bringing with it a progressive recovery in agents' real income, greater confidence and a strengthening of external demand –, the gradual abatement of the persisting global supply chain disruptions and a comparatively larger deployment of Next Generation EU (NGEU) funds.[12] The gradual strengthening of activity will not foreseeably be vigorous enough to enable the recovery of the pre-pandemic GDP level before early 2024.

Turning to inflation, the October projections revised up average inflation for 2022 to 8.7%, which will gradually ease to 5.6% in 2023 and 1.9% in 2024, largely due to the expected reduction in the pace of growth in the energy and food components, in line with the price trajectories of oil, gas and food commodities on the futures markets.

However, underlying inflation is not expected to decline from its current elevated levels until next spring, since, over the coming months, firms will finish off passing through the recent cost increases to their selling prices. The completion of this pass-through, coupled with the firming of the recent indications that the persistent global supply chain disruptions are fading away, should lead to a progressive moderation of underlying inflation.

SUMMARY OF THE OCTOBER BANCO DE ESPAÑA INFLATION FORECAST FOR 2022-2024

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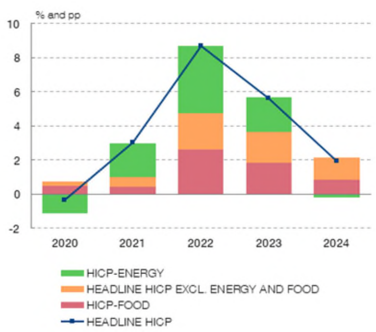
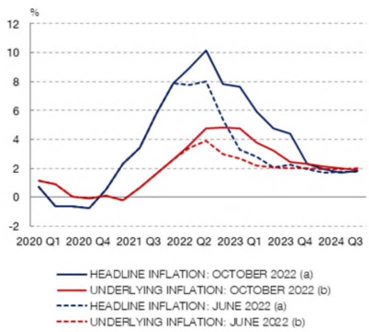
CONTRIBUTIONS TO HICP GROWTH BY COMPONENT



HEADLINE AND UNDERLYING INFLATION



Sources: Banco de España and INE.
(a) Measured by the harmonised index of consumer prices (HICP).
(b) Measured by the HICP excluding energy and food.

It should be underscored that the October projections rest on two key assumptions.

First, the available evidence indicates that the prices of non-energy goods and services have responded to the current energy price shocks more swiftly in the current inflationary episode than they have, on average, in the past. The projections therefore assume that the feed-through of higher energy costs to final selling prices is already at a relatively advanced stage. Specifically, profit margins are projected to grow moderately in 2023, less than the 2022

[12] Implementation of projects under the NGEU's Recovery and Resilience Facility (RRF) is lagging somewhat behind. This translates into a lower contribution to economic growth in the near term and a higher one towards the end of the projection horizon.

forecast, and, in any event, at an insufficient level to offset the fall in 2020, as margins would remain slightly below their 2019 levels.

Second, the wage response to the upturn in inflation has, thus far, been moderate. Looking ahead, this response is expected to remain relatively contained, so that a price-wage spiral (typically referred to as second-round effects) will be avoided. However, as I mentioned earlier, the higher prevalence of indexation clauses in collective agreements (over 40% of covered workers in 2023)[13] poses a risk.

1.4 Uncertainties surrounding the projections

THE INTERNATIONAL GEOPOLITICAL AND MACRO-FINANCIAL SITUATION REMAINS SUBJECT TO HIGH UNCERTAINTY

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- Energy market developments (prices and/or volumes)
- Scale and timeframe of the indirect effects associated with the increase already observed in commodity prices, and the strength of second-round effects on inflation
- Household and business resilience to the loss of real income and the rise in interest rates
- Implementation and impact of the NGEU programme
- Behaviour of economic activity and international financial markets, particularly in Europe
- Economic policy response and interactions

The economic outlook is subject to a high degree of uncertainty.

The main uncertainty is linked to energy market developments. The risks to economic activity on this front derive from both the uncertainty surrounding energy price developments and the doubts over the sufficiency of gas supply in Europe to meet demand.

Another source of uncertainty is associated with the extent to which the rise in prices and costs is passed through to other prices in the economy and to wages. In this respect, the forcefulness of the pass-through of higher production costs to final prices in recent months, alongside the greater prevalence of indexation clauses in collective agreements, has increased the likelihood of significant second-round effects and, therefore, of a further exacerbation of the inflationary process, with adverse ramifications for external competitiveness and for activity and employment.

Further, the persistence of the current episode of high price growth increases the risks of a deanchoring of medium-term inflation expectations. A potential deanchoring of such

[13] On partial information on collective agreements in force in 2023 (see "Recent Indexation Clauses: An Analysis", Box 6, "Quarterly report on the Spanish economy", *Economic Bulletin* 3/2022, Banco de España).

expectations would affect firms' and workers' decisions in current price and wage-formation processes, which would further exacerbate the existing inflationary pressures.

These uncertainties surrounding the persistence of the inflationary episode, associated with both the duration of the shocks that have triggered it (such as the high commodity prices) and the aforementioned transmission mechanisms, also introduce uncertainties over the duration and forcefulness of the monetary policy normalisation process. More persistent inflation would require a sharper tightening of the monetary policy stance, which would increase the vulnerability of those agents in a less sound economic and financial position. This could have a stronger impact on their spending levels than that envisaged in the October projections. Specifically, interest rate rises would above all increase the financial pressure borne by the firms with higher debt levels and with a higher proportion of liabilities whose cost is revised in the short term, while, in the case of households, financial pressure would rise more sharply for lower income indebted ones.

In addition, in the current setting of high uncertainty, a potential rise in precautionary saving – weighing down household spending and aggregate consumption – cannot be ruled out.

Second, an additional source of uncertainty is the pace at which the investment projects associated with the NGEU programme are rolled out and their impact on the economy. The successive downward revisions to the estimated macroeconomic effects of using these funds in the latest Banco de España projection exercises are a good example of this uncertainty. Thus, for 2021, the Banco de España initially estimated in March of that year that the use of the funds would have an impact of approximately 1 pp on GDP growth. On the latest available data, that impact has shrunk to around 0.2 pp. Similarly, for 2022, the impact is reduced from 1.4 pp estimated at the start of the year to 1 pp according to the latest projections published in October. For 2023, an impact of 0.6 pp on GDP growth is estimated. Depending on whether the effective roll-out of the NGEU projects is faster or slower than anticipated, it could have potentially significant effects on growth projections and inflation.

Lastly, other relevant sources of uncertainty are related to the behaviour of economic activity and international financial markets – especially developments in Europe – and the different economic policy responses and how they interact with one another.

2 The role of economic policies in the present situation

In the second part of my testimony, I would like to share with you some thoughts on what I believe the economic policy response to the complex situation we find ourselves in should be.

First, I should like to point out that the current situation differs significantly from that prevailing at the time of the outbreak of the COVID-19 pandemic in the spring of 2020. We then faced an exogenous, temporary, but highly adverse shock, in a setting free of inflationary pressures, but, on the contrary, with major risks of deflation. That environment warranted a firm monetary policy response, in order to create conditions that were conducive to extraordinary fiscal expansion measures which would guarantee the income of households and firms and thus minimise the crisis-induced structural damage to employment, productive capacity and growth.

The current circumstances are different. Once again, we are facing a crisis which could adversely affect economic activity and agents' income. However, this time, some loss of income is inevitable, insofar as it is caused by the rise in the prices of goods that we do not produce. Specifically, the loss of income associated with the deterioration in the real terms of trade with the rest of the world is estimated at around 3 pp of GDP for 2022 as a whole. Attempting to avoid the adjustment that is needed will only trigger a more persistent and protracted inflationary process, with very negative consequences for competitiveness and economic stability in Spain. The monetary policy response therefore has to be different.

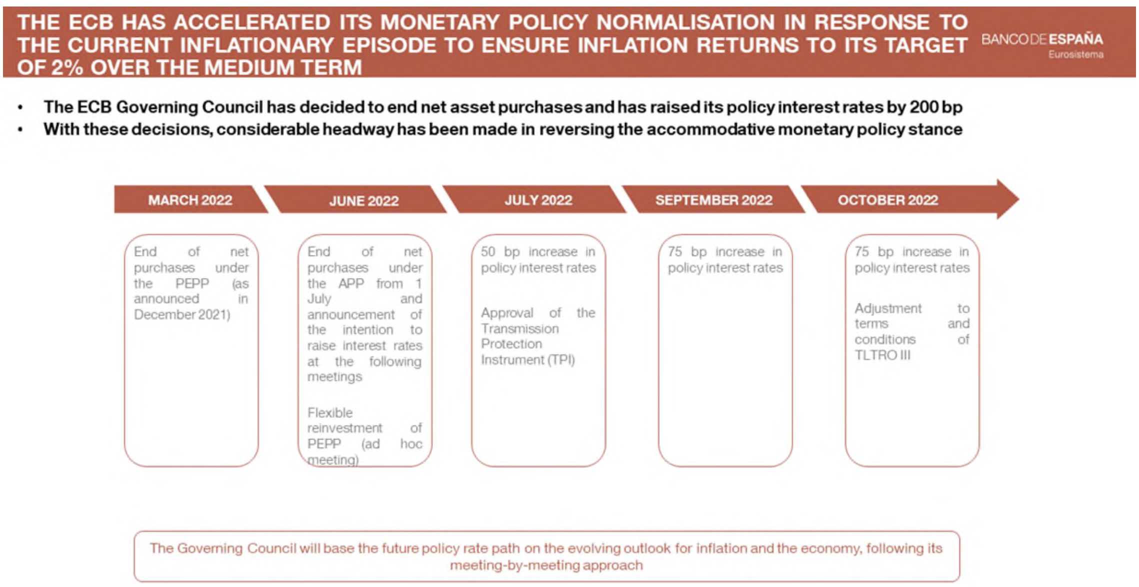
2.1 ECB monetary policy

I shall begin by examining the role that monetary policy must play in the current setting.

The ECB is responsible for maintaining price stability in the euro area. This is how monetary policy can best contribute to ensuring sustainable economic growth in the medium term, given the huge distortions to economic activity caused by inflation, which the lower-income population groups bear the brunt of.

In the aforementioned scenario of soaring inflation and high persistence of the episode of high price growth, at the ECB Governing Council we decided to embark on a process of gradual monetary policy normalisation in late 2021.

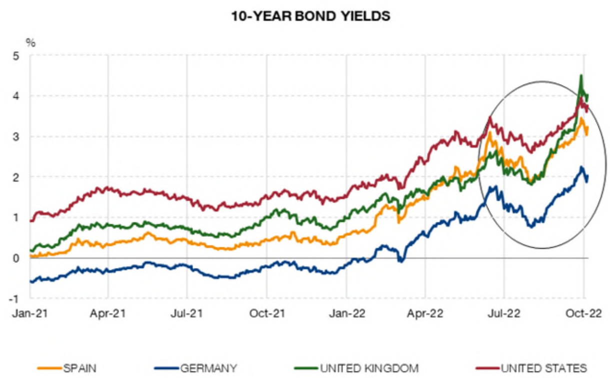
The first step was to withdraw the extraordinary monetary stimulus that we implemented at the start of the pandemic. To do so, we brought an end to net purchases under the pandemic emergency purchase programme (PEPP). Subsequently, on 1 July, once the conditions set out in our forward guidance had been met, we decided to discontinue net purchases under the asset purchase programme (APP). We raised interest rates by 50 basis points (bp) in late July, with the deposit facility exiting negative territory for the first time since 2014. In September and again in October, we increased those interest rates by 75 bp, bringing the deposit facility rate to 1.5%.



During this process, the decisions adopted by the ECB to ensure the smooth transmission of its monetary policy stance to all euro area countries also played an important role. Thus, at the ad hoc meeting held in June, we decided to activate the flexibility in reinvesting redemptions coming due in the PEPP portfolio, as a first line of defence to counter the risks to the transmission mechanism that we were seeing.

In addition, in July we approved a new instrument, the Transmission Protection Instrument (TPI). Its creation stems from our firm belief that the singleness of our monetary policy is a precondition for the ECB to be able to deliver on its price stability mandate. The TPI has thus become part of our toolkit and, subject to fulfilling the criteria established, can be activated to counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the euro area.

CONSEQUENTLY, SOVEREIGN YIELDS HAVE RISEN NOTABLY IN 2022 BANCO DE ESPAÑA Eurosistema



Source: Refinitiv Datastream. Latest observation: 25/11/2022.

Specifically, under the TPI, we will be able to make secondary market purchases of securities issued in countries experiencing a deterioration in financing conditions not warranted by economic fundamentals, in order to counter risks to the monetary policy transmission mechanism to the extent necessary. In any event, purchases under the TPI would be conducted such that they cause no persistent impact on the overall Eurosystem balance sheet and hence on the monetary policy stance.

The criteria for activating the TPI will include a number of elements to assess whether countries apply sound and sustainable fiscal and macroeconomic policies. They include: (1) compliance with the EU fiscal framework; (2) absence of severe macroeconomic imbalances; (3) a favourable assessment of public debt sustainability; (4) fulfilment of the commitments laid down in the recovery and resilience plans and of the European Commission's country-specific recommendations in the fiscal sphere as part of the European Semester.

The monetary policy normalisation process has also affected the conditions applied to the third series of targeted longer-term refinancing operations (TLTRO III), which proved essential for supporting bank lending to households and businesses during the pandemic and thus counter the downside risks to price stability. However, in light of the extraordinary spike in inflation, we decided in October to recalibrate the conditions of these operations with a view to strengthening the transmission of policy rate increases to bank lending conditions.

This monetary policy normalisation process has already translated into a significant increase in market interest rates, although this trend has moderated in recent weeks. Thus, since early 2022 the 12-month EURIBOR has climbed by more than 335 bp, while the 10-year overnight index swap (OIS) rate (typically used as the benchmark risk-free interest rate at that maturity) has risen by 234 bp.

These increases have passed through swiftly and fully to the cost of public-sector borrowing on financial markets. In Spain, 10-year government bond yields have risen by 2.4 pp this year and the spread against the German Bund has widened by approximately 21 bp, although it has remained fairly stable since the TPI was approved, even narrowing slightly in the last month. These increases have also begun to pass through, albeit partially, to the cost of bank borrowing by businesses and households, which will help to contain inflationary pressures.

The ECB's actions over this period must be understood in the context of the new monetary policy strategy approved in 2021, which establishes a symmetric medium-term inflation target of 2%. The ECB's aim is therefore not to stabilise current, observed inflation, but to stabilise inflation over the medium run, which means that our decisions are not based on the latest inflation figure, or even on the inflation expected over the coming quarters, but on our projections over a two or three-year horizon. This does not mean that we should ignore short-run inflation developments, but rather that the latest inflation data matter insofar as they contain information regarding medium-term inflationary pressures. Maintaining a medium-term horizon is justified because our actions affect inflation in a very gradual way, reaching their maximum impact after about two years, and is particularly appropriate in the face of certain kinds of shocks – such as adverse supply-side shocks, which push inflation and activity in opposite directions in the short term.

By its very nature, the medium-term orientation requires projecting the future path of inflation. Surveys and financial market instruments provide us with useful tools in this respect, as they give us evidence of how different agents (experts, households, businesses and financial market participants) see inflation evolving in the future. In addition, central banks rely on their staff's forecasts for inflation and economic activity –which typically draw on a huge amount of economic and monetary analysis– as a key input in their decision-making process.

According to this strategy, ECB interest rates will have to reach a level that allows us to ensure that inflation gradually returns to our medium-term target of 2%,

which the ECB Governing Council currently believes will require additional interest rate increases. Accordingly, the ECB's latest inflation projections (September) place euro area inflation at 2.3% in 2024, that is, above the 2% target. Moreover, these projections were based, among other factors, on a future path of interest rates – implicit in the financial market data available when the projections were prepared –,[14] which not only included the expectations for ECB interest rate increases but also a risk premium component. Thus, on the information then available, it could be inferred from these projections that the interest rate hikes expected by the market at the time would not be sufficient to reach the 2% inflation target. It should be borne in mind that the ECB subsequently raised interest rates on two occasions, to the current 1.5%, still below the level then expected by the market in the medium term.

However, given the enormous uncertainty, we cannot anticipate to what extent interest rates should be raised to secure our medium-term inflation target. Our decisions on the future path of policy interest rates will be determined by different factors.

First, the medium-term inflation outlook will depend on economic developments. The extent of the economic downturn, including the higher probability of a recession that we are currently observing, and its effects on wages and profit margins, will be key determinants of the medium-term inflation expectations and, therefore, of our monetary policy decisions.

Second, we will take into account the measures already adopted and the lags in the transmission of monetary policy to the economy and to inflation. We should bear in mind that the three consecutive policy rate hikes since July (totalling 200 bp) represent considerable headway in reversing the accommodative monetary policy stance and reflect the fastest rate hike since the launch of the euro.

Third, we will examine the changes in the medium and long-term inflation expectations and their potential deanchoring above the 2% level, which would affect the price and wage-related decisions of firms and workers. This would lead to even higher and more persistent inflation, requiring the adoption of even more forceful monetary policy measures that would be detrimental to activity and employment.

The information available to date shows no indications of expectations becoming deanchored, although there are some early signs that need to be watched. The most recent surveys of professional forecasters put inflation in 2024 at, or just above, 2%. The latest data from inflation-linked derivatives markets (adjusting for risk premia) suggest likewise. However, the latest round of the ECB's monthly Consumer Expectations Survey (CES) puts the median inflation expectations three years ahead at 3%, up from just over 2% at the start of the year. We will be extremely vigilant of these indicators in the coming months. Indeed, the need to guard against this risk is one of the reasons for the faster monetary normalisation that our latest decisions entail.

Fourth, another risk factor relates to possible second-round effects, i.e. when high inflation is passed through to wage increases and these, in turn, push up consumer prices as firms seek to maintain (or widen) their margins. This scenario would make inflation far more persistent and, thus, increase the likelihood of the feared deanchoring of inflation expectations.

On the information available, there is no evidence of such effects occurring at present, at least on a widespread basis. Wage settlements in the euro area have gathered pace since

[14] For instance, the September ECB projections were prepared on the information available at 22 August 2022, and envisaged short-term interest rates of 0.2% in 2022, 2.0% in 2023 and 2.1% in 2024. Likewise, at that time the average nominal yield on euro area 10-year sovereign bonds was 1.6% for 2022, rising gradually to 2.2% in 2024.

the end of last year and, while they are expected to accelerate further in 2023, the increases currently projected would be compatible with the 2% inflation target once trend productivity growth is taken into account. Broadly speaking, profit margins have also remained moderate, although unevenly across sectors. However, the longer the current high inflation persists, the greater the probability of these second-round effects occurring.

Lastly, interest rate decisions must take into account our decisions regarding the reduction of the balance of our securities portfolio, since this also crucially affects financial conditions in the euro area. This reduction is known as quantitative tightening. As announced by President Lagarde last month, we will decide on the key principles for this process at the ECB Governing Council's December meeting.

The process of shrinking our securities portfolio needs to be very gradual and predictable, for a number of reasons. First, the effects of quantitative tightening are highly uncertain, since we lack sufficient historical evidence about them. Second, the fiscal landscape has deteriorated in recent years, and this will tend to magnify the impact of quantitative tightening on the term premium.[15] Third, the abundant liquidity provided by the TLTRO programme is already dwindling, and this decline will continue in the coming months and may amplify the effects of quantitative tightening. Lastly, just as quantitative easing reduces financial fragmentation within the euro area, quantitative tightening could exacerbate it.

2.2 An incomes agreement

Aside from monetary policy, in an adverse scenario such as the present one, other economic policies also have a central role to play. In particular, as I have just pointed out, the outlook for the Spanish economy is heavily influenced by the risk of a price-cost feedback loop, which, were it to materialise, would have highly adverse effects on external competitiveness, resulting in further losses in terms of jobs and growth.

To avoid this, it is essential that economic agents (essentially firms and households, but also general government) assume the loss of income caused by the rise in the cost of imported commodities.

As I mentioned earlier, the pass-through of inflationary pressures to wage settlements has so far been very contained, and profit margins have remained relatively stable. However, the use of indexation clauses and the pass-through of higher costs to final prices by firms have increased. Consequently, the signing of an incomes agreement, under the framework of social dialogue, would be desirable, so that the burden is shared between firms and workers, with all agents assuming a loss of real income.

Such an agreement should take into account the fact that the current shocks are having an uneven impact across different groups of workers, firms and sectors. For this reason, the agreement should avoid overly sweeping measures that might prove unsuitable for different groups of agents. Moreover, it would also be desirable to avoid arrangements that automatically link wages to past inflation or indexation clauses, to reduce the risk of triggering a wage-price feedback loop. In addition, any potential incomes agreement cannot be limited to the current year but should envisage multi-year commitments regarding wage

[15] The greater the amount of debt that private markets must absorb, the lower the liquidity in sovereign debt markets and the higher the yields that markets will demand.

increases and profit margins. This would offer households and firms some certainty in their spending and investment decisions. As regards government spending, the widespread use of automatic indexation clauses should be avoided, against a background, moreover, in which fiscal space is highly constrained by burgeoning public debt.

THE NEED FOR AN INCOMES AGREEMENT TO PREVENT AN INFLATIONARY SPIRAL

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- Under such an agreement, firms and workers would share the inevitable loss of income in the national economy that higher commodity import prices entail.

What form should this agreement take?

MINDFUL OF THE UNEVEN IMPACT	The uneven impact of the current shocks among workers, firms and sectors must be taken into account, by avoiding overly sweeping measures that may prove excessively rigid for some groups of agents
WAGES	Arrangements that automatically link wages to past inflation or indexation clauses are also to be avoided
MULTI-YEAR	The agreement should envisage multi-year commitments concerning wage settlements – where the nominal benchmarks for wage bargaining should be based on the projected course of underlying inflation – and job protection
PROFIT MARGINS	Explicit commitments to moderate profit margins

2.3 Fiscal policy

FISCAL POLICY IN RESPONSE TO THE CURRENT INFLATIONARY EPISODE

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Amid high inflationary pressures, and given the impulse expected from NGEU-funded spending, other fiscal policy measures should adopt a slightly contractionary stance in 2023

This should be compatible with some very targeted support measures for lower income households and the firms most vulnerable to the current shock; these measures should, in any event, be temporary so as not to further increase the structural budget deficit

The use of automatic indexation clauses in public expenditure should also be avoided, to support the incomes agreement in the private sector

Any measures approved should also avoid significantly skewing price signals

The fiscal consolidation process should be launched, as part of a multi-year programme enabling the structural budget deficit and public debt to be gradually reduced

In the current setting, the role of fiscal policy should be different from that played during the COVID-19 crisis.

In particular, fiscal policy should not give any significant impetus to demand, as this could jeopardise the monetary authority's goals of controlling inflation. Likewise, fiscal policy support measures should counter the inevitable loss of income that the higher energy prices have entailed for Spain and, in particular, they must be compatible with the much-needed incomes agreement I have just referred to. Moreover, we must bear in mind that fiscal space has been squeezed by events since the pandemic broke out, in particular, the rise in Spanish general government debt (by close to 20 pp of GDP) and the persistently high structural budget deficit.

First, any potential targeted support measures should be focused on lower-income households, which bear the brunt of higher inflation, and on the firms most vulnerable to the recent price surge in many commodities (both energy and non-energy) and to the ongoing disruptions in some global supply chains.

Second, fiscal measures should be designed to avoid any significant skewing of price signals or of economic agents' incentives.

With respect to these two aspects, it should be noted that around 70% of the measures adopted this year (in terms of cost for general government) are blanket (non-targeted) measures,[16] and do not take into account the degree of vulnerability of their recipients. In addition, some of these measures would discourage saving on energy consumption, by reducing the marginal cost for consumers. Cases in point are the widespread tax cuts and the fuel price subsidies.

Third, any measures should be temporary so as not to further increase the structural budget deficit.

Fourth, bearing in mind that the roll-out of the investment projects under the NGEU programme already represents an appreciable fiscal stimulus, even if implementation is experiencing some delays, other fiscal policy in Spain should maintain a slightly restrictive stance to contain the expansionary impulse. Given that the use of the European funds does not directly affect the budget deficit, this combination of the large-scale use of the funds and a slightly restrictive stance of other fiscal policy would allow for the necessary process of reducing the structural budget deficit of public finances in Spain to start as early as 2023, and to be accompanied by positive net effects on economic growth.

Thus, for instance, in a recent press release forming part of the Article IV consultation, the IMF recommended an adjustment to Spain's structural budget deficit of up to 0.5 pp of GDP in 2023. Assuming a budget deficit multiplier of 0.5 (in line with the available economic literature) for economic activity, the effect of this structural adjustment on GDP growth would be -0.25 pp in 2023, while the impact of the NGEU funds that year, estimated by the Banco de España, would stand at around 0.6 pp of GDP. The overall net effect on economic growth would therefore be positive.

Fifth, given the current high level of uncertainty, the fiscal policy stance should ideally be adjusted relatively swiftly based on the materialisation of the risks to which I have referred earlier. For instance, stronger inflationary pressures might call for a more contractionary budgetary policy stance. Indeed, at the ECB we are implementing just such a flexible, data-dependent approach, and in recent months have been adjusting the pace of monetary policy normalisation in response to changes in the inflation outlook.

[16] In the case of households, targeted measures are dependent on household income. In that of firms, targeted measures are intended for industrial sectors that have been particularly hard hit by the energy crisis. In a similar analysis, the European Commission concluded that approximately 70% of the measures associated with the rise in energy prices were not targeted.

Lastly, I would again like to stress before this Senate committee that a credible and ongoing process to strengthen the sustainability of Spain's public finances requires the definition of a multi-year fiscal consolidation plan. Such a plan should be backed by broad political consensus and be accompanied by a comprehensive efficiency review of public spending and the tax system, including all tiers of general government. In addition to the medium and long-term benefits of such a strategy, defining the plan early on would generate greater certainty and trust in public policies, which is particularly important against the backdrop of monetary policy normalisation that I have described.

I would like to stress this last point. The high degree of uncertainty surrounding the growth and inflation outlook makes it particularly difficult to determine the specific level that interest rates will have to reach to meet the inflation target set by the ECB. If this level is higher than that currently expected by the financial markets, it could lead to further tightening of the financing conditions of general government. I therefore believe that, following a prudent approach, it is essential that Spain embarks on fiscal consolidation as soon as possible through a medium-term programme.

2.4 Supply-side policies and NGEU

STRUCTURAL REFORMS ARE THE BEST ECONOMIC POLICY IN RESPONSE TO THE CURRENT SUPPLY SHOCK

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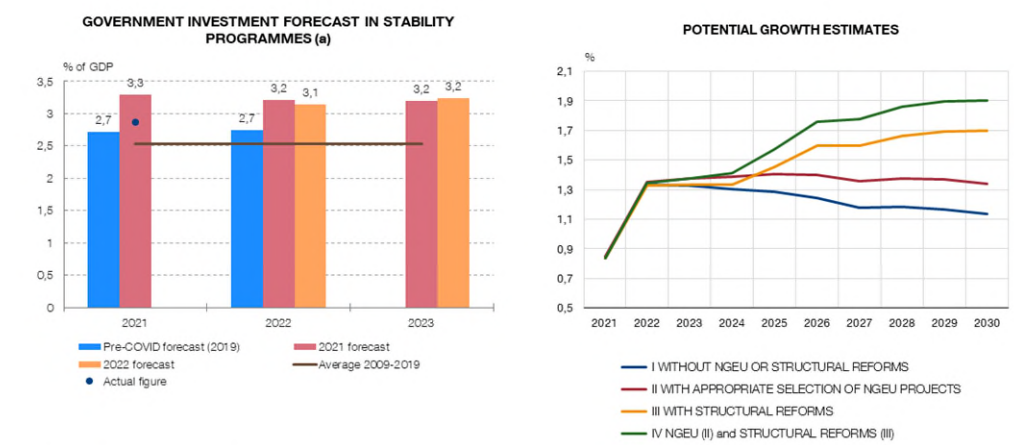

Sources: Banco de España and National Stability Programmes.
(a) Euro area-19 (except Greece). Forecasts made in spring of each year (date of publication of the Stability Programmes) for that year and subsequent years.

Offsetting the adverse effects of the current supply-side shock also calls for ambitious policies to boost productivity growth and the economy's potential GDP. In other words, the optimal economic policy response to an adverse supply shock, such as the present one, includes structural reforms (among them, naturally, energy market reforms) to ease the supply-side tensions.

The common European instrument to realise this ambition is the NGEU programme. Harnessing its full potential and maximising its potential positive effects represents a huge challenge in itself, one that we must not underestimate. In this regard, I wish to highlight four aspects that I deem priorities.

First, if the aim is to boost the transformative capacity of the NGEU funds, the programme must be implemented alongside a broad set of ambitious structural reforms, as envisaged in the Spanish Recovery, Transformation and Resilience Plan (RTRP). These reforms should, inter alia, remove the impediments in our institutional framework to the reallocation of resources between firms and sectors. A recent paper by the Banco de España[17] shows that if projects with a high degree of synergy between public and private investment are selected within the framework of the NGEU programme, and if structural reforms that reduce the rigidities in the product and labour markets are implemented, the Spanish economy's potential growth rate could stand at around 2% by the end of the decade, compared with 1% in the absence of those effects.

Second, with regard to funding under the NGEU programme, the project selection process should be geared towards implementing those with the greatest potential to transform the economy. To this end, a high degree of synergy between public and private initiatives is particularly important. The different initiatives should be assessed in real time, so that any possible deviations from the goals established can be corrected swiftly. A robust framework should also be established for ex post evaluations by the research community and independent bodies.

Third, given the importance of carefully selecting the projects to be funded by the NGEU programme and the administrative difficulties that this entails, and in light of the programme's structural approach, it would be desirable to consider longer time horizons for its implementation.[18] Not only would this increase the chances of the NGEU programme having a considerable transformative impact on the economy, but it would also avoid an excessive fiscal impulse over the coming quarters against a background of already marked inflationary pressures.

Fourth, the NGEU programme should be the germ of a permanent macroeconomic stabilisation mechanism in Europe. A successful deployment of the programme would serve to strengthen the perception in Europe that such a permanent mechanism is warranted and necessary, and that further progress should be made in the common European project. This brings me to the role that I believe European policies should play in the present circumstances.

2.5 Policies at European level

The Russian invasion of Ukraine has laid bare the EU's vulnerabilities in key sectors such as energy, as well as the marked disparity between the Member States in their exposure to such vulnerabilities. A challenge of this magnitude underlines the importance of a joint response to common risks. As with the COVID-19 pandemic, the response to the war in Ukraine must, once again, be more Europe.

[17] For further details, see Cuadrado et al. (2022), "The potential growth of the Spanish economy after the pandemic", *Occasional Paper* No 2208, Banco de España.

[18] According to European Regulation 2021/241 and the agreements reached between the European Commission and the Spanish Government, 60% of the funds of the Recovery and Resilience Facility should be committed by December 2022, and the remaining funds by December 2023. The application deadline for the final instalment of disbursements passes in 2026 Q3, subject to fulfilment of the established milestones and targets.

Such a resolute common response must apply both to short-term measures, to address potential energy supply problems in the coming quarters (in line with the recent European Commission proposals), and to more structural, medium and long-term initiatives.

The war in Ukraine has shown us that structural policies that foster the integration and interconnection of European markets – in particular energy markets – and that strengthen the single market will not only generate greater resilience to shocks, but will also drive competitiveness.

Likewise, joint funding arrangements should be established to safeguard this common effort and avoid any excessive or highly unequal impact on national public finances, and any disruptions in the single market. Common funding arrangements would enable financing for large-scale programmes based on shared quality standards and provide for a uniform approach to assessing programme execution.

Unquestionably, headway in this direction must come in unison with the establishment of a European fiscal framework that ensures the sustainability of national public finances, which is indispensable for the smooth functioning of the euro area. I will discuss this in greater depth in the final part of my testimony.

Progress must also be made in the expansion of the public and private risk-sharing arrangements in the EU. In particular, the euro area needs a permanent macroeconomic stabilisation mechanism – with revenue-raising and borrowing capacity – to complement the single monetary policy. It is also imperative that the banking union be completed, with the establishment of a European deposit guarantee scheme, and that progress be made in developing the capital markets union.

THE NEED TO MAINTAIN AND STRENGTHEN A JOINT EUROPEAN RESPONSE

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- This episode has shown us that **structural policies** that foster the integration and interconnection of European markets – in particular energy markets – and strengthen the single market will not only increase resilience to negative supply shocks, but will also drive competitiveness
- It is also necessary to **establish joint funding arrangements** to safeguard this common effort without putting an excessive or highly unequal burden on national public finances, as well as risk-sharing arrangements in the EU and a European fiscal framework that ensures the sustainability of national public finances
- The euro area needs a **permanent macroeconomic stabilisation mechanism** – with revenue-raising and borrowing capacity – to complement the **single monetary policy**
- Moreover, **it is imperative** that the banking union be completed with the establishment of a European deposit guarantee scheme and that **headway be made in constructing the capital markets union**

3 Draft State and Social Security Budget

In this third part of my testimony I shall offer an assessment of the macroeconomic forecast incorporated into the Draft Budget, its attendant government receipts and spending, the resulting fiscal policy stance and public debt dynamics.

Before I begin, I wish to note three very important aspects when analysing the Draft Budget.

First, it is in general easier to offer an assessment of the Draft Budget with the published Draft Budgetary Plan, which includes the Government's expectations of how general government as a whole and in National Accounts terms will perform in 2023.

However, one notable new development in this year's Draft Budgetary Plan is that it contains two alternative scenarios. Only scenario 1 would be compatible with the Draft Budget. That said, as well as forecasting lower revenue than that suggested by the recent tax revenue data (which I shall come to later), this scenario omits some measures that are unrelated to the Draft Budget but which have already been approved or are currently before Parliament.[19] Therefore, neither scenario 1 nor, by extension, the Draft Budget provide a complete account of the role of fiscal policy in 2023.

Moreover, there are also obstacles to taking scenario 2 as an accurate representation of the fiscal programme for the coming year because, while it provides a more realistic forecast of government receipts and factors in the measures I have mentioned, it also includes other possible measures that have not been approved or announced or which are insufficiently detailed in this document. Therefore, the assessment I shall offer of the 2023 Draft Budgetary Plan in the rest of my testimony is influenced by the comparability problems I have just mentioned.

Second, the Draft Budget has been drawn up in a setting in which the escape clause, which permits the temporary suspension of European fiscal rules, remains in force for 2023, as it was in 2021 and 2022. This eases, among other aspects, the requirements regarding budget deficit correction with a view to facilitating fiscal policy support for activity at this complex juncture. However, we should be mindful that the European Council, in the context of the European semester, issued a recommendation on controlling current expenditure, which was designed to serve as fiscal guidance for 2023 while the escape clause of the Stability and Growth Pact remains active.

Third, as I indicated earlier, one of the defining characteristics of the present situation is the high inflationary pressures. Therefore, any diligent assessment of the Draft Budget for 2023 must include detailed analysis of the different channels whereby inflation has a very significant bearing on public finances. Allow me first to delve deeper into these various channels, before assessing the macroeconomic forecasts included in the Draft Budget and its other key aspects.

3.1 The impact of inflation on public finances

The pronounced inflationary pressures observed in recent quarters affect public finances through various channels, with impacts that are highly heterogeneous in terms of their nature, time horizon and scale across the main budget items. For instance, some items are affected by inflation contemporaneously, while for others the impact essentially comes at a lag. Moreover, in some headings of government expenditure and receipts the increase in inflation has a relatively mechanistic or automatic effect, whereas in others the scale of the impact depends largely on the discretionary decisions made by the authorities.

[19] For example, the additional 1.5% increase in public sector wages in 2022, the State's assumption of the deficit from the regulated rate for small natural gas consumers and the introduction of a new wealth tax.

Also, not all price increases are equally significant for the different budget items. For instance, the key measure of inflation when assessing the performance of VAT revenue – or future pension expenditure – is price developments in consumer goods and services. However, in the case of personal and corporate income tax, movements in household wage income and firms' gross operating surplus are more relevant.

This consideration is all the more important in the current context, in which a very significant share of the inflationary pressures stem from products that the Spanish economy does not produce, but rather imports from abroad. In this case, the import deflator grows faster than the export deflator – giving rise to a deterioration in real terms of trade –, and consumer inflation – which includes imported consumer goods – exceeds the growth in the GDP deflator – which refers to price developments in consumer goods and services produced in Spain and approximates to nominal household income growth.

Indeed, on QNA figures, in the first three quarters of 2022, the import deflator increased by 25.6% with respect to the same period in 2021, compared to the rise of 15.5% in the export deflator. During the same period, the consumption and investment deflators and CPI grew by 7.1%, 4.6% and 9.0%, respectively, while the GDP deflator was up 3.5%.

3.1.1 Impact on government receipts

Both in 2021 and in 2022 to date, tax revenue in Spain has systematically and significantly surprised on the upside. For instance, in the first eight months of 2022, VAT revenue was up by 21.5%, while revenue from personal income tax and social security contributions grew by 23.9% and 5.2%, respectively, compared with the same period in 2021. This robust buoyancy contrasts with the growth rates observed for these items prior to the pandemic. In particular, in the period 2017-2019, revenue from both VAT and personal income tax grew at an average annual rate of around 4%.

A very significant share (around 70% on Banco de España estimates)[20] of the sharp cumulative growth in Spain's tax revenue in 2021 and 2022 is linked to the broadening of tax bases. Leaving aside the fiscal measures, which have negatively impacted tax revenue, the broadening of tax bases would owe to the increase in real activity, against a backdrop of notable growth in consumption, GDP and employment since early 2021. On the other hand, a substantial portion of the increase in tax bases – around two-thirds, excluding the effect of the fiscal measures – would owe to price inflation. This is particularly evident in the case of VAT where, for a given level of consumption, inflation causes a near automatic and contemporaneous increase in the tax base and revenue.

In this setting, it is important to note that the estimated price impact factors in the non-indexation of certain parameters of the tax system, leading to tax revenue growth in excess of the rate of price growth that feeds through to each tax. A textbook case is that of personal income tax brackets defined in nominal terms and the exemption thresholds for this tax. Because personal income tax is a progressive tax, higher inflation that feeds through to the

[20] These estimates, which include the effect of the tax measures on tax bases, are subject to considerable uncertainty and rest on different assumptions in terms of approximating the various tax bases and tax elasticities considered.

tax bases will cause tax revenue growth beyond that attributable to the increase in the tax bases, due to inflation pushing household nominal income towards higher tax brackets.

In any event, it should be noted that another part – around 30%, according to Banco de España estimates – of the buoyancy of tax revenue in Spain in recent quarters does not appear to stem from changes in nominal tax bases (which are estimated on the basis of National Accounts information). In particular, high positive tax residuals are detected, which are defined as the component of government receipts that cannot be explained either by the tax measures adopted or by changes in nominal tax bases, taking into account the estimated elasticities of the response of receipts to changes in the tax bases.[21] These tax residuals exist in most taxes and are particularly high in revenue from VAT, social security contributions and corporate income tax.

THE NATURE OF THE CURRENT INFLATIONARY SHOCK HAS SIGNIFICANT IMPLICATIONS FOR PUBLIC FINANCES. AS A RESULT, NOT ALL OF THE RECENT GOVERNMENT REVENUE DYNAMICS SHOULD BE VIEWED AS PERMANENT

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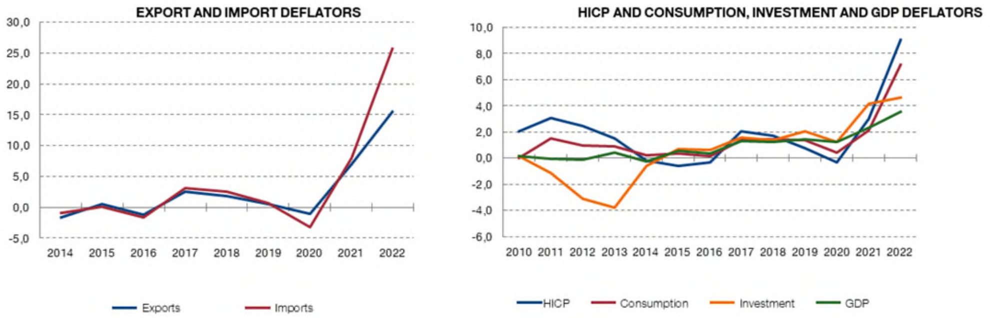

Source: Banco de España.

The origin of these positive residuals may lie in a variety of factors, including the potential surfacing of parts of the underground economy.[22] Analysing their origin is essential in order to determine whether they will be permanent or temporary. However, assessing this issue in real time is not easy.

In any event, historical evidence shows that these positive residuals are sometimes partially or fully reversed in subsequent years.[23] A prudent approach to budgetary programming

[21] The Quarterly Macroeconometric Model of the Banco de España considers elasticities of 1.5 for direct taxes on households, 0.9 for social security contributions, 1.2 for direct taxes on enterprises and 1 for indirect taxes. These figures are in line with those estimated by Price, Dang and Botev (2015), "Adjusting fiscal balances for the business cycle: New tax and expenditure elasticity estimates for OECD countries".

[22] Indeed, the Draft Budgetary Plan suggests that this factor may have been behind the sound revenue performance. It should also be noted that in this analysis tax bases are calculated on the basis of disaggregated National Accounts data, which only allows for an approximation of the actual tax base. Therefore, part of the residual may also be due to this discrepancy between the actual effective tax base for tax purposes and its approximation drawing on the National Accounts.

[23] For instance, high government receipt residuals arose in Spain during the last real estate boom, only to largely disappear during the global financial crisis. They were also at the root of much of the budget deficit increase during that period.

should not treat government receipts associated with these residuals as permanent until their origin is clearly ascertained; therefore, it is not advisable to link permanent expenditure items to the presumed continuation of these revenue dynamics.

3.1.2 Impact on government spending

On the expenditure side, the rise in inflation appears to have affected several important budget items, albeit very unevenly.

First, public pensions are at present automatically indexed to the CPI with a lag of about one year. Thus, while the Banco de España projections foresee an average increase in the CPI of 8.7% for 2022, pension expenditure (which, when adjusted for the extra payment, grew by 4.7% in the first eight months of 2022 due to inflation developments in 2021, but also to the rise in the number of pensioners and in the average pension) has not yet been affected by this price increase, the impact of which will materialise in 2023. Indeed, according to Banco de España estimates, each percentage point of CPI-based pension revaluation increases aggregate spending on this item by approximately €1.8 billion.

Second, personnel costs associated with the public sector wage bill are only affected by inflation insofar as general government agencies themselves adopt discretionary measures to mitigate (often partially and after the fact) the impact of price growth on these workers' purchasing power. On Banco de España estimates, for each percentage point of public sector wage bill revaluation, personnel costs rise by approximately €1.4 billion.[24]

Third, inflation affects procurement and transfers in kind through changes in the prices of the products purchased or transferred, while it affects government investment through the cost of materials and labour. The relatively immediate impact of inflation on these items could nevertheless be limited by certain nominal caps on general government spending and by the restrictions on the updating of prices bid as part of a tender procedure. In this case, and insofar as these nominal caps are binding and remain unchanged, rises in inflation may ultimately not be passed through to spending in full.[25]

Fourth, public debt interest spending is also sensitive to higher inflation through several channels. First of all, insofar as part of the stock of public debt is held in inflation-linked bonds, price inflation would have an automatic impact on the cost of these instruments. In particular, at end-2021 inflation-linked bonds accounted for an estimated 5% of the outstanding amount of debt securities issued by general government. Under the current inflation forecast, this would represent an increase of around €4 billion in interest expenses over the course of 2022.

The rise in inflation would also have a relatively delayed indirect effect on debt interest spending, insofar as the monetary policy response to contain the inflationary pressures leads to market interest rate rises. The average term to maturity of Spanish public debt is

[24] In the first eight months of 2022, the growth in personnel costs with respect to the same period a year earlier stood at 2.9%, down from 4.9% in 2021.

[25] Royal Decree-Law 2/2022 of 2 March 2022 provides for exceptional circumstances in the field of public work procurement in which the increase in the price of certain commodities and materials has had a significant impact. Specifically, the contract can be revised where the cost increase has had an impact in 2021 of more than 5% of the amount billed in that year, up to a maximum of 20%.

currently more than eight years, increasing the lag of this channel. The sharp interest rate reductions observed in recent years are similarly subject to a lag. In any event, the Spanish public sector's annual financing needs are close to 20% of GDP. Thus, every additional 100 bp increase in the expected path of short, medium and long-term interest rates would raise the increase in the debt burden for 2024 by a further 0.4 pp.

In fact, due to how these two channels work, they have already caused debt interest payments to grow by 17.1% year-on-year in the first eight months of 2022, in contrast to the more moderate growth in 2021 (3.7%) and the negative rates observed in 2020 and 2019 (-11.4% and -3.2%, respectively).

In the same vein, the Banco de España's balance sheet and income statement will also be affected by the process of monetary policy normalisation.[26] Specifically, our analyses show that, like the vast majority of Eurosystem central banks, the Banco de España will likely post negative results, before the use of provisions for risks, in 2023 and for some years to come. This is a direct consequence of the cost of our liabilities adjusting immediately to the higher interest rates, whereas the return on our asset portfolios does not rise as quickly, as they mainly comprise held-to-maturity investments. How long this period lasts will depend on the speed and intensity of the monetary normalisation process.

Nevertheless, as the financial risks stemming from its balance sheet growth have increased, in recent years the Banco de España has made the corresponding provisions to cover risks such as the one materialising now. The volume of provisions currently stands at €31,380 million, which will provide coverage from the negative impacts on profits that may arise from monetary policy normalisation over the coming years, thereby balancing out the income statement and avoiding a net loss.

In any event, the Banco de España will not be able to keep making revenue contributions to the public finances over the coming years, as it has been doing in recent years.[27]

In short, it may be concluded that, in contrast to the evidence presented for government receipts, general government spending has not yet been significantly affected by the price increase, mainly because of the time lag with which spending on pensions, public sector wages and debt interest responds to current inflation. However, the impact of inflation on government spending is expected to become significant from 2023 onwards as, alongside higher input prices, pensions are revalued in line with 2022 inflation and the expected discretionary increase in public sector wages materialises, among other effects.

3.1.3 Impact on the general government balance and the stock of debt as a percentage of GDP

In order to estimate the impact that higher prices have on the general government balance as a percentage of GDP and on the ratio of public debt to GDP, it is essential to assess their effect on the denominator of these ratios (i.e. on nominal GDP). In particular, ceteris paribus, a rise in nominal GDP prompted by an increase in its deflator would automatically entail a

[26] https://www.ecb.europa.eu/ecb/educational/explainers/tell-me-more/html/ecb_profits.en.html.

[27] For instance, we expect the Banco de España's contribution to the Treasury out of 2022 results, which is made in several instalments from December 2022 until the approval of this year's accounts in 2023, to add up to around €1.5 billion, although naturally there is some uncertainty about this figure, given that it will depend on the speed and intensity of the monetary normalisation process.

reduction in the general government balance as a percentage of GDP and in the public debt-to-GDP ratio. Thus, for instance, for Spain's level of public debt at end-2021 (118.3% of GDP), a 5% increase in the GDP deflator would automatically reduce the debt-to-GDP ratio by 5.6 pp.

Moreover, bearing in mind the various automatic and discretionary effects on the different budget items I mentioned earlier and the different paces at which they materialise, as well as the “denominator effect” I have just described, an initially positive effect of inflation on public finances is to be expected, which could turn negative over time.

In particular, in 2022 the rise in inflation appears to be having a positive effect on the general government balance, thanks to the buoyant tax bases – in line with their deflators – and the relatively subdued government spending, which would not yet reflect the price upturn in full. However, although persistent inflation will foreseeably continue to drive up tax revenue in 2023, this channel would be weaker than in 2022, while the increase in government spending would be relatively stronger as a result of the revaluation of pensions in line with the CPI for 2022.

In any event, over a longer time horizon the so-called general equilibrium effects gain importance. These are effects that operate through changes in agents’ behaviour in response to movements in the prices of goods and services in the economy. Accurately quantifying these effects requires models which simultaneously determine the performance of inflation, real activity and the general government balance, among other variables. Such models take into account not only the changes in agents’ behaviour in response to price variations (estimated on the basis of observed historical relationships between the different variables), but also the type of shock driving the higher inflation.

Using the Quarterly Macroeconometric Model of the Banco de España, an imported energy price shock that pushes inflation up by 1% would lead to a deterioration of 0.2 pp and 1 pp of GDP in the general government balance and the public debt ratio, respectively, three years later.[28] In other words, the effect of such a shock on public finances over a medium-term horizon would be negative.

3.2 The macroeconomic forecast of the Draft Budget

I shall now go on to detail the salient aspects of the Draft Budget and the Budgetary Plan for 2023.

The Draft Budget for next year and the two Budgetary Plan scenarios are both set against the same macroeconomic forecast, which has GDP growth standing at 4.4% in 2022 and at 2.1% in 2023.

[28] For more details, see Hernández de Cos et al. (2016). “Public finances and inflation: the case of Spain”, *Occasional Paper* No 1606, Banco de España (the simulations in this paper are based on shocks of the opposite sign).

The real GDP growth rate for 2022 envisaged in the Draft Budget macroeconomic forecast (4.5%) is very similar to that of the Banco de España's projections report published on 5 October (4.4%), and does not deviate significantly from other analysts' forecasts.[29]

However, the differences in real GDP growth for 2023 are bigger. In particular, the 2.1% growth projected in the Budget is higher than the Banco de España forecast (1.4%), the AIReF forecast (1.5%) and analysts' consensus forecast (0.8%).

PROJECTED REAL GDP GROWTH IN 2023 IN THE MACROECONOMIC FORECAST IS HIGHER THAN THE ANALYSTS' CONSENSUS AND IN LINE WITH THE CONSENSUS FOR NOMINAL GROWTH

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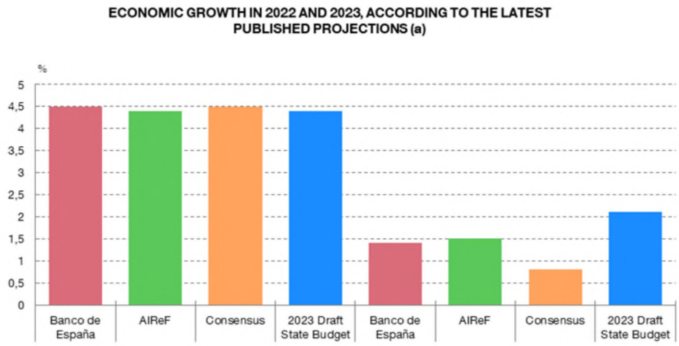


Sources: Banco de España, AIReF, Consensus Economics and Draft State Budget for 2023.
(a) Latest dates available: October for the Banco de España and AIReF and November for Consensus (07/11/2022).

The differences are less significant in nominal terms. Specifically, nominal GDP growth incorporated in the Draft Budget is 8.4% for 2022 and 5.9% for 2023, compared with 8.1% and 5.9%, respectively, in the Banco de España's projections, and 8.2% and 5.9% in the AIReF forecast. This means that our projections envisage lower real growth and a larger increase in the GDP deflator than those included in the Draft Budget.

In terms of the composition of projected growth for 2023, the scenario in the Draft Budget envisages a contribution from domestic demand of 2.4 pp, compared with 0.9 pp in the Banco de España projections. The Draft Budget macroeconomic forecast for gross fixed capital formation is particularly buoyant, with a growth rate of 7.9% in 2023 compared with 0.9% in the Banco de España projection.

These differences should be interpreted with due caution. That said, the different composition of growth for 2023 and the greater real GDP growth in the macroeconomic projections accompanying the Draft Budget might be explained, albeit only partially, by the different assumptions about the pace and macroeconomic impact of the roll-out of NGEU funds.

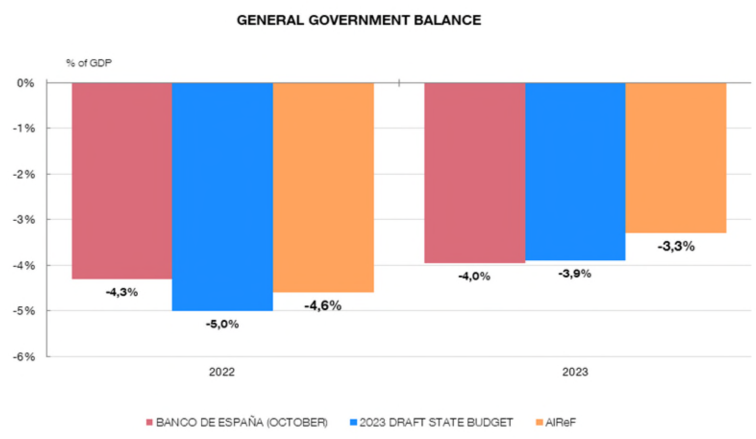
In particular, the Draft Budget estimates that NGEU funds through the Recovery, Transformation and Resilience Plan (RTRP) will have an impact on GDP of 1.9% in 2022 and

[29] For example, in the Consensus Economics Forecasts panel published this month, the analyst consensus pointed to real GDP growth of 4.5% this year. Meanwhile, the Independent Authority for Fiscal Responsibility (AIReF) forecasts 4.4% growth.

2.8% in 2023. The effect of these impacts on the growth rate for 2023 would amount to around 0.9 pp, compared with a contribution of approximately 0.6 pp in the case of the Banco de España projections.

3.3 Public finances position at end-2022

THE FAVOURABLE GOVERNMENT REVENUE DEVELOPMENTS IN 2022 SUGGEST THAT THE BUDGET DEFICIT IN 2022 WILL BE LOWER THAN THAT INCLUDED IN THE DRAFT BUDGET



Sources: Draft State Budget for 2023, Banco de España and AIReF.

The Draft Budget and the two Budgetary Plan scenarios for 2023 envisage an estimated budget deficit for 2022 of 5.0%. The same figure was anticipated when the 2022 Draft Budget was presented over a year ago.

However, government receipts have since proven surprisingly buoyant, leading most of the institutions that analyse Spain's public finances to revise their projections upwards. In particular, according to Consensus Economics data, the general government balance projections for 2022 rose, on average, 0.9 pp between September 2021 and the present moment. In other words, even incorporating the various fiscal measures rolled out in the wake of the energy crisis, the general government balance projections have improved significantly over the course of the year. Meanwhile, the Banco de España's latest projections from October envisaged a budget deficit of 4.3% in 2022, 0.7 pp below the official estimate.[30] The budget outturn figures published since then have tended to bear out this prediction.

On the revenue side, the Draft Budget anticipates an improvement in 2022 with respect to the budget, with shared tax collection, on a settlement basis, up 9.4% on the figure recorded in 2021. This represents a 5.6 pp increase on the amount initially budgeted for this year.

Nonetheless, in view of the figures up to September, the increase will all likelihood be even higher by the year-end. Indeed, the Banco de España's October projections envisaged a 11.6% rise in shared tax collection in 2022, up 2.2 pp on the Draft Budget forecast. On the

[30] The latest AIReF forecast is 4.6%, also below the Government benchmark.

most recent data, that figure should even be revised slightly upwards. Conversely, in the case of social security contributions, the Banco de España's growth estimate (6.0%) is slightly below the 6.6% increase envisaged in the Draft Budget. Overall, the available data suggest that the Draft Budget may underestimate the 2022 government receipts.

The same conclusion can be drawn from an analysis of the two scenarios contemplated in the Budgetary Plan. Thus, the total general government receipts in National Accounts terms projected by the Banco de España in October stood at 43.0% of GDP in 2022, not including the effects of the European funds.[31] This figure tallies with the AIReF's forecast in its assessment of the Budgetary Plan and is very similar to the 42.9% envisaged in scenario 2 of the Budgetary Plan. Nonetheless, in scenario 2 (the scenario compatible with the Draft Budget), such receipts are 0.9 pp lower (42.1%).[32]

3.4 Projected government receipts for 2023

The Draft Budget forecasts a 7.5% increase in tax and social security receipts in 2023 compared with the 2022 outturn projection. This increase rests essentially on the projected buoyancy of tax bases – which will remain heavily influenced by the increase in prices – and on the impact of the tax collection measures announced prior to the publication of the Draft Budget, such as the increase in social security contributions due to the implementation of the intergenerational equity mechanism and the temporary taxes on energy firms and banks.

THE GOVERNMENT REVENUE FORECAST FOR 2023 IS PLAUSIBLE, BUT THE COMPOSITION WILL PROBABLY DIFFER

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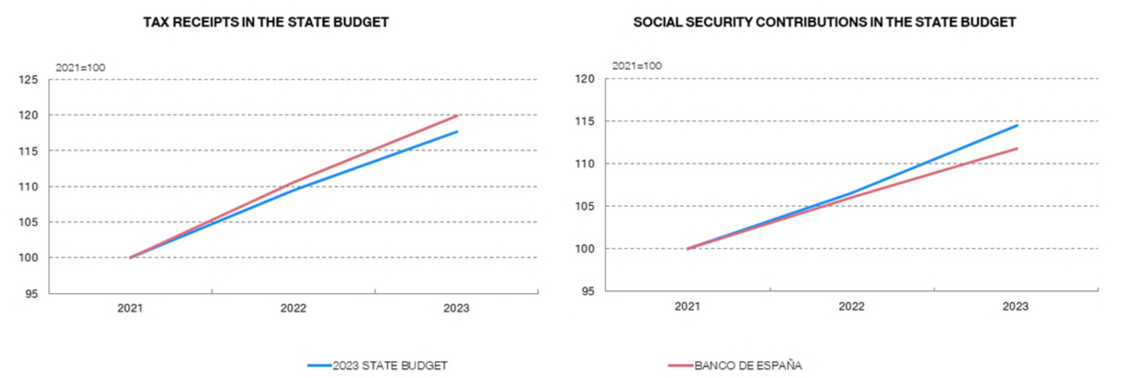

Sources: Draft State Budget for 2023 and Banco de España.

In the following, I will structure my comments on this revenue forecast around two elements: the new measures announced and the risks to the projected receipts.

[31] Unless otherwise indicated, the figures referring to general government receipts and expenditure are always presented without including the Recovery, Transformation and Resilience Plan funds, which is how they are reported in the Budgetary Plan.

[32] It is worth noting that, despite this, the budget deficit estimated for 2022 under scenario 2 remains unchanged at 5.0% since, according to the Budgetary Plan, this scenario envisages costs associated with various measures that are not included in the Draft Budget.

First, the measures announced in the Draft Budget are expected to have a low net impact on revenue in 2023. This is because the negative impact on revenue of some of the measures – mainly the increase in the labour income tax credit, which represents an estimated revenue loss of some €1.55 billion – would be partially offset by others that have a positive impact, primarily the increase in the maximum social security contribution bases, with an estimated impact of €900 million on revenue.

In addition, it is estimated that the temporary taxes on certain credit institutions and firms in the energy sector, announced before the Draft Budget, could bring in around €2.5 billion overall between 2023 and 2024.[33] In relation to the tax on certain credit institutions, the ECB Governing Council has issued an opinion noting, among other considerations, that it should be preceded by an exhaustive analysis of the consequences for the banking sector, to ensure that it does not pose any risks to financial stability, to the resilience of the sector or to lending, which could adversely impact economic growth. In this regard, while policy interest rate hikes tend to improve institutions' net interest income, the materialisation of downside risks to growth in the current setting could lead to lower lending volumes, investment portfolio losses and higher credit portfolio impairment allowances. Moreover, given that the tax is levied on income as opposed to profit, the opinion stresses that making credit institutions liable for the temporary tax while posting net losses would significantly distort and further harm the resilience of loss-making banks.[34] The temporary tax on energy firms is also levied on income, without factoring in costs, and should therefore be designed so as to tax the windfalls for which it was created.

Meanwhile, the Draft Budget to one side, a new temporary tax on high net worth individuals has been announced, which could raise around €1.5 billion in 2023 and 2024.

Lastly, mention should be made of the possible extension into 2023 of the tax measures approved this year, with a view to mitigating the effect of higher energy prices (specifically, the suspension of the tax on electricity generation, the reduced rate of VAT on electricity and gas, and the reduced rate of the excise duty on electricity), in line with the assumptions under scenario 2 of the Budgetary Plan. As I mentioned earlier, a broad-based reduction in taxes on energy products has a high cost in terms of revenue and discourages agents from changing their behaviour to seek greater energy efficiency. In the current climate of fiscal uncertainty, a more targeted approach should be designed to support the most vulnerable households and firms, without incurring a high cost or adversely affecting the goal of making headway with the environmental goals assumed by Spain.

In 2024, the set of measures announced together with the Budget would increase revenue by 0.2 pp of GDP, primarily owing to the effect of the cap on loss relief introduced in corporate income tax.

In any event, it is important to note that a good many of these tax increases are expected to disappear in 2025, as most of the measures adopted are strictly temporary.

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[33] This figure is lower than the €3.5 billion initially estimated by the Spanish Government, due to an amendment incorporated by Parliament exempting regulated market activities from the tax on energy utilities. We estimate that this could reduce the related tax revenue by half, from €2 billion to €1 billion per year.

[34] Opinion of the European Central Bank of 2 November 2022 on the imposition of temporary levies on certain credit institutions.

Second, as regards estimated revenue for 2023, the Budget envisages a 7.6% increase in tax revenue, slightly below the estimate contained in the Banco de España's projections. By contrast, the estimated rate of increase in revenue from social security contributions (7.4%) is somewhat higher than that projected by the Banco de España (5.4%).

Overall, given the underestimation of government receipts envisaged in the Draft Budget for 2022 that I referred to earlier, the government receipts estimate included in the 2023 budget appears feasible.

Meanwhile, the Banco de España's projected total 2023 government receipts would again be more in line with scenario 2 under the Budgetary Plan than with scenario 1. According to scenario 2, government receipts would stand at 43.0% of GDP in 2023. This represents an increase of almost four percentage points with respect to pre-pandemic levels. Again I insist on the need to consider that not all this increase is permanent until we know the reason for the decoupling I referred to earlier, observed since 2020, between tax revenue and macroeconomic tax bases. Slightly more than half of the increase in revenues observed up until 2022 can be attributed to this decoupling. It should also be borne in mind that tax receipts due to temporary measures that represent 0.3 pp of GDP are forecast for 2023.

3.5 Budgeted expenditure for 2023

On the expenditure side, the Draft Budget includes an increase in State expenditure in 2023 of 6.5% compared with the 2022 outturn projection. Nonetheless, this is largely due to the significant rise in interest payments (17.4%) and capital expenditure (21.7%). Conversely, the State's current primary spending is expected to increase by only 1.7%. Current social security spending is expected to rise more, influenced by developments in contributory pensions, which are expected to increase by 9.7% in 2023 according to the Draft Budget.

Based on the figures in the Budgetary Plan, general government expenditure would grow by around 4.0% in 2023, in both scenario 1 and scenario 2, albeit starting from a 2022 level 0.8 pp of GDP higher in the latter case. A more notable increase in interest payments and gross capital formation can also be seen.

In National Accounts terms, interest payments are expected to increase by 11.9%, albeit still falling below the 19.7% contemplated in the Banco de España's projections. Strong interest payment growth is consistent with the effects expected when interest rates are rising. According to the Banco de España's projections, the interest burden will be 2.5% of GDP in 2023, slightly above the 2.4% estimated in the Budgetary Plan.

Moreover, despite the 12% increase in public investment expenditure, the share of capital expenditure in GDP terms is expected to fall slightly, by around 0.1 pp, to stand at 3.3%, as a result of the decline in investment grants and other capital transfers in National Accounts terms.

Worth noting among other expenditure items is, first, the increase in public sector wages, which entails a cumulative wage increase of 9.5% over the period 2022-2024. This increase breaks down as follows. For this year, a retrospective 1.5% wage rise is proposed, on top of the 2% increase already approved. For 2023, the wage rise is set at 2.5%, plus a possible further 0.5% if the sum of 2022 HICP and the early HICP estimate for September 2023 is more than 6%, something which, as I mentioned in my remarks on the macroeconomic scenario, seems highly likely. A further increase of 0.5% in public sector wages would be applied if nominal GDP were to equal or exceed the figure estimated in the macroeconomic forecast that accompanies this Draft Budget. In total, this amounts to an upward revision of €2.3 billion in the general government wage bill, compared with the Banco de España's latest projections. Also included is a preliminary agreement for a wage rise of 2% for 2024, which could reach 2.5% depending on the change in the harmonised CPI.

In terms of employment, the forecast underpinning these increases in the Budgetary Plan is compatible with general government employment growth of around 0.7% in 2022 and 1.2% in 2023, significantly below the growth observed in 2021, albeit relatively in line with the Banco de España's projections.

THERE ARE UPSIDE RISKS IN SOME EXPENDITURE ITEMS IN 2023 COMPARED WITH THE BUDGET

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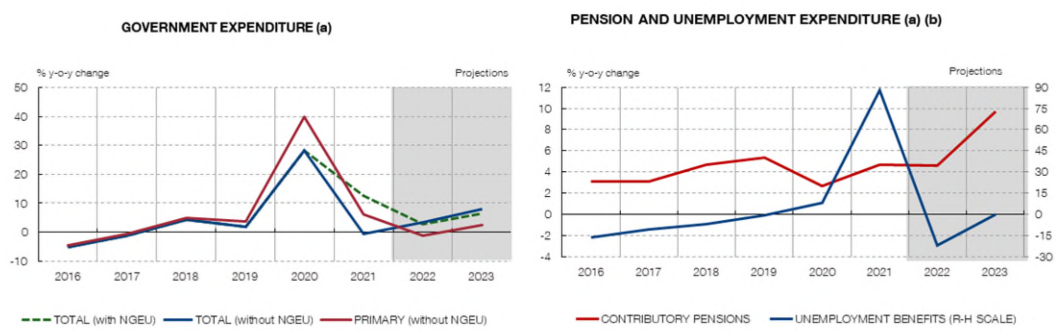

Sources: IGAE, Draft State Budget for 2023 and Banco de España.
(a) Cash-basis outturn data, 2022 Budget outturn projection and initial 2023 Budget.
(b) 2022 unemployment benefits, as estimated by the Banco de España.

For its part, as already noted, social security expenditure is expected to grow more sharply, with contributory pensions in particular increasing by 9.7%. There are also some upside risks in this budgetary item. First, the estimated 8.5% increase is approximately in line with the Banco de España's CPI growth forecast. Second, the increase in pension numbers estimated in the Budget for 2023 (0.7%) is 0.2 pp below both the increase expected in 2022 and the average of the last five years. Lastly, for 2023, the average pension is estimated in the Budget to grow by 0.5% more than the increase agreed, significantly less than both the figure expected for 2022 (1.2%) and the average of the last five years (1.6%). This is mainly because new pensioners are receiving higher average pensions than those who are dying.

Meanwhile, unemployment expenditure is expected to decline more than projected by the Banco de España. This is consistent with the fact that the fall in the unemployment rate (0.6

pp in 2023, to 12.2%) envisaged in the macroeconomic forecast that accompanies the Draft Budget is higher than that considered in the Banco de España's projections.[35]

The European Commission (EC) has recently published its assessment of Spain's Budgetary Plan, stating that it meets the European Union's recommendations for our country.

Specifically, the EU has recommended that public investment (including European funds) be used to address the needs of the digital, climate and energy transition. It has also recommended that increases in current primary expenditure financed at the national level be below a specific threshold, defined in accordance with medium-term nominal potential output growth, once the impact of any temporary support measures for the most vulnerable households and firms in response to the surge in energy prices and those destined for refugees from the war in Ukraine has been factored in.[36] In spirit, this recommendation aims to protect the productive expenditure needed to achieve the climate goals, while suggesting that rising inflation should not lead to a widespread increase in current expenditure amounting to an overall stimulus that will contribute to inflationary pressures.

In this regard, in its assessment report the EC notes that Spain's Budgetary Plan would comply both with the need to maintain an expansionary fiscal policy stance in 2023 deriving from growth in investment, whether financed domestically or using EU funds, and the need to apply a prudent fiscal policy stance to current expenditure.

With respect to this second aspect, the EC has set an adjusted 5.0% threshold for growth in current expenditure in 2023, based on its projections of growth in the GDP deflator and in the potential output of our economy. Thus, such compliance stems from the European Commission's forecast whereby growth in current primary expenditure financed domestically will fall below this threshold in 2023.

It is important to note that, when making that calculation, the discretionary revenue measures are subtracted from the growth in expenditure. In 2023, the EC estimates increased revenues of 0.7 pp of GDP for this reason. Applying this same calculation to our own estimates, the Banco de España would also expect the European recommendation to be met in 2023, albeit with a narrower margin than that estimated by the EC and always on the understanding that the temporary measures introduced in 2022 are not renewed. Against this background, it is particularly important to take great care when designing any new relief from energy market tensions.

It is also important to note that, in principle, a significant portion of 2023's higher revenues (0.5 pp, on the Banco de España's estimates) are either temporary in nature or are earmarked for covering future deficits in the Spanish pension system. Indeed, the Banco de España estimates that current primary expenditure, excluding temporary measures, could rise by around 7%[37] in 2023.

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[35] The Banco de España's projections envisage a slight increase in the unemployment rate, to 12.9%, which would raise unemployment expenditure by around 6.5% in 2023.

[36] See Council Recommendation to Spain, of 23 May 2022.

[37] This includes growth of more than 10% in pension expenditure, as per our estimates, and of around 5% in the public sector wage bill and other current expenditure, which is under pressure from the higher costs deriving from the energy shock.

3.6 The general government deficit target and the fiscal policy stance

Overall, the Draft Budget estimates that the budget deficit will narrow in 2023 by 1.1 pp of GDP, to 3.9%. This target seems achievable given that the general government deficit is likely to end 2022 below the official estimate (by around 0.7 pp, according to the Banco de España's latest projections). This better figure in 2022 could counter the possible deviations in the event that growth proves to be lower than expected (as anticipated in the Banco de España's latest projections).[38]

I will now share a few considerations on the cyclical stance of fiscal policy. First of all, may I remind you of the difficulties involved in assessing the cyclical position of the economy, as this assessment is based on non-observable measures whose estimation entails a high degree of uncertainty, especially at a cyclical juncture such as the present one, marked by severe supply-side shocks.

Beyond these difficulties, and on the information contained in the Budgetary Plan, the fiscal policy stance, measured by the change in the structural balance, would go from being slightly expansionary in 2022 (-0.5 pp) to slightly restrictive in 2023 (+0.3 pp). This cyclical stance of fiscal policy is consistent with the temporary nature of the measures approved since the start of this year in response to the surge in energy prices and the consequences of the war in Ukraine.

Nevertheless, this assessment is influenced by the deficit forecast for 2022 which, as I have said, could possibly not implicitly include the good public revenue performance observed in recent months. Indeed, on the Banco de España's estimates, which envisage a lower budget deficit in 2022, the change in the structural balance points to an almost neutral fiscal policy stance in 2023 (+0.0 pp)[39] and a slightly restrictive one (+0.1 pp) according to the European Commission. In other words, if the lower deficit in 2022 is confirmed and the budget targets for 2023 are maintained, there would be no improvement in the structural deficit, and the fiscal consolidation process could not be said to have commenced.

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[38] Including the new measures announced after the Banco de España's macroeconomic projections were published on 5 October would not have a significant impact on the deficit forecast for 2023.

[39] Although this estimate is based on the Banco de España's projections published on 5 October, before the Draft Budget and the Budgetary Plan were known, including the new measures announced after that date would make no major difference.

THE CYCLICAL STANCE OF FISCAL POLICY IS EXPECTED TO BE ROUGHLY NEUTRAL IN 2023, BUT EXPANSIONARY IF THE IMPULSE FROM THE NGEU FUNDS IS CONSIDERED. THE STRUCTURAL BUDGET DEFICIT IS OVER 3%

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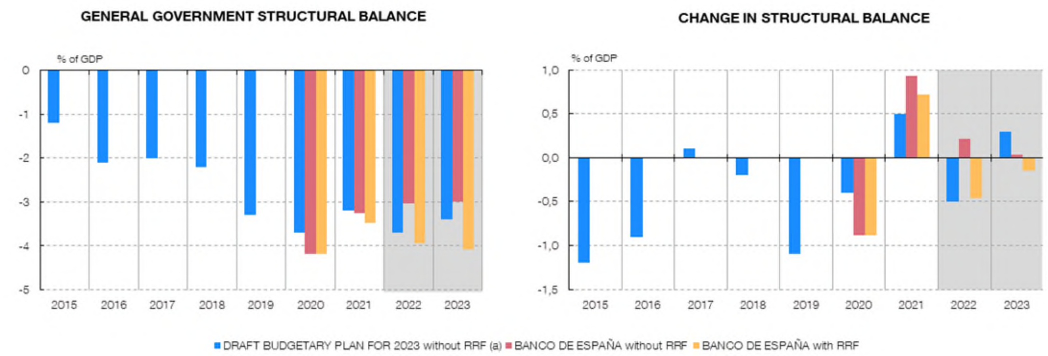

Sources: European Commission, Draft Budgetary Plan for 2023 and Banco de España.
(a) The structural balance under the Budgetary Plan for the period 2015-2020, drawing on European Commission forecasts.

In any event, when assessing the fiscal policy stance, the effect of the European funds channelled through the RRF must also be considered, as these do not affect the deficit level in National Accounts terms, since they entail a significant increase in expenditure but are not the result of revenue raised from resident agents, given the way in which they are financed. Accordingly, considering the timing of the spending of the European funds envisaged in the Banco de España's projections, the fiscal policy stance is expected to be expansionary both in 2022 and, albeit to a lesser extent, in 2023.

Beyond the fiscal policy stance inferred from the changes in the structural balance, it is clear, given the negative level of the structural balance expected for both 2022 and 2023, that fiscal policy will continue to generate a significant stimulus.[40]

Lastly, I feel it is important to note that, based on the information in the Budgetary Plan, a high structural budget deficit of -3.4% is forecast for 2023. This level is similar to that estimated in 2019, and includes the strong public revenue momentum in recent years. Thus, maintaining the level of the structural government balance is tantamount to assuming that these higher revenues (including the positive residuals referred to earlier) will be offset by an equivalent rise in structural government expenditure.[41] In this regard, if it were to emerge that part of the recent strong revenues has a transitory component, the structural deficit would in reality rise somewhat during this period.

3.7 Public debt

Both the Budget and the Budgetary Plan expect the public debt-to-GDP ratio to decline gradually, from the peak of 120.4% in 2020 to the 112.4% forecast for 2023 (2.8 pp below the level expected for 2022 and 5.8 pp in cumulative terms between 2022 in 2023).

[40] In its report, the European Fiscal Board advocates defining the fiscal policy stance in terms of the level of the structural primary balance. It thus recommends referring to the change in the structural balance as a "fiscal impulse" and to the level of the structural balance as the "fiscal stance" or "budgetary position".

[41] This interpretation is similar to the one set out in the European Commission's Autumn Forecast, since its estimate for the 2023 structural deficit (-3.6%) is very similar to the one recorded in 2019 (-3.8%).

THE PUBLIC DEBT-TO-GDP RATIO IS EXPECTED TO CONTINUE TO FALL, OWING TO THE DENOMINATOR EFFECT, BUT IT WILL REMAIN HIGH

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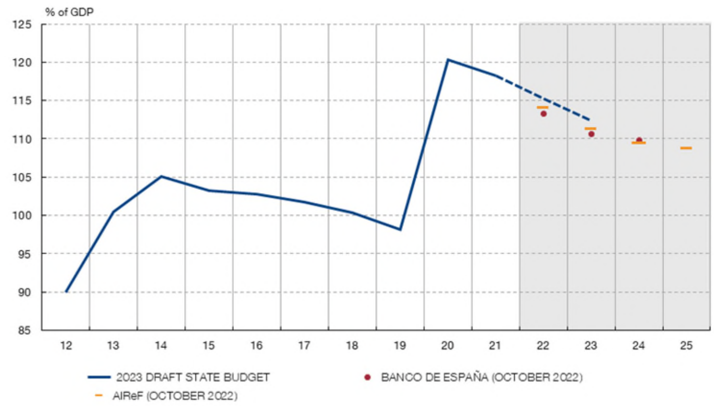
GENERAL GOVERNMENT DEBT



Sources: Banco de España, AIReF and Draft State Budget for 2023.

This decline is exclusively due to nominal output growth, which more than offsets the increases resulting from the budget deficit and interest payments.[42] The reduction in the debt-to-GDP ratio is somewhat smaller than that envisaged in the Banco de España's latest projections. Specifically, the Banco de España expects there to be a cumulative improvement in the public debt-to-GDP ratio of 7.6 pp between 2022 and 2023, resulting from a contribution of more than 15 pp from the denominator effect (nominal GDP growth), which more than counters the cumulative contributions of interest payments and the structural primary balance which are expected to raise the ratio by 4.8 pp and 3.5 pp, respectively, between 2022 and 2023.

3.8 European funds

The Draft Budget also provides information on the budget appropriations to be financed out of the European funds from the Recovery and Resilience Facility (RRF), under the framework of the Recovery, Transformation and Resilience Plan (RTRP). Regarding the outturn of budget appropriations in 2022, at 30 September obligations for a total of €12,945 million had been recognised (45.5% of the total).[43] For 2023, the Draft Budget envisages a slightly lower amount of new appropriations to be financed out of European funds (non-financial expenditure of €23,839 million, compared with €25,622 million in 2022).

However, neither the Draft Budget nor the Budgetary Plan offer any information on expenditure linked to the European funds in National Accounts terms for consolidated

[42] Stock-flow adjustments, which will also make a slight upward contribution according to the Budgetary Plan, reflect the set of transactions and flows that do not affect the deficit but do affect public debt (and vice versa). Thus, for instance, NGEU grants received have no impact on the budget deficit, but they can affect public debt if the volume of these grants does not match, in a specific year, the amount of the expenditure outturn.

[43] The initial budget for RRF expenditure in the Budget for 2022 amounted to €26.9 billion (€25,622 million for non-financial expenditure and €1,278 million for financial expenditure). After various changes to the budget appropriations, including the addition of carryovers from 2021, the total amounted to €28,448 million.

general government expenditure, which is the most useful metric for assessing the execution of the projects linked to the RTRP with an impact on the real economy.[44, 45]

In any event, the Draft Budget includes an estimate of the RTRP's impacts on economic growth: standing at 1.9% of GDP in 2022 and 2.8% of GDP in 2023. As mentioned earlier, these figures are higher than those included in the Banco de España's projections. The Draft Budget breaks down these impacts into an expectations channel, a direct investment-based channel, and the structural reform channel. The latter accounts for a growing portion of the macroeconomic impact, with the increase in GDP eventually reaching 3% in 2031.

4 The medium and long-term challenges for fiscal policy

In the final part of my testimony I will address what I think are the main challenges for Spanish fiscal policy in the medium and long term.

4.1 The design of a medium-term consolidation plan

As noted earlier, the Spanish general government's debt and budget deficit ratios are expected to remain high in 2022, with a significant structural component in the case of the latter, estimated at 3.7% in the Draft Budgetary Plan.

The state of Spain's public finances is a considerable source of vulnerability for the country's economy and leaves less fiscal space in the event of possible future adverse macro-financial shocks.

REDUCING PUBLIC DEBT CALLS FOR THE DESIGN AND IMPLEMENTATION OF AN AMBITIOUS FISCAL ADJUSTMENT PLAN

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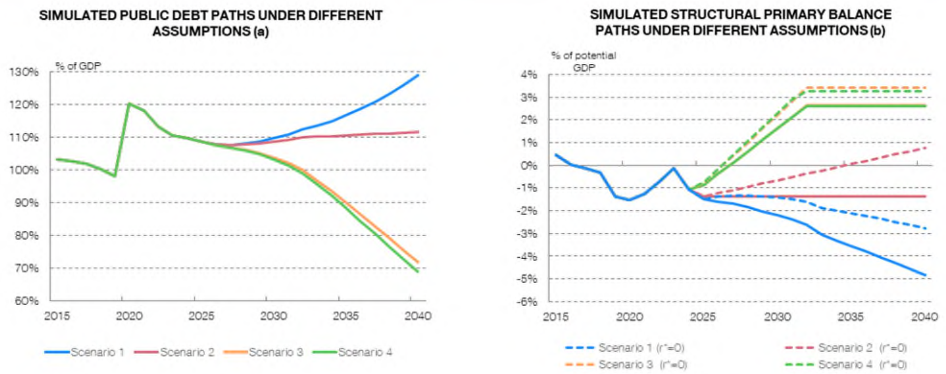

Source: Banco de España.
(a) All the scenarios include a deterioration in the structural primary balance up to 2040 owing to ageing costs (pensions, health care and long-term care). Scenario 1 assumes a fiscal policy that does not correct that deterioration. Scenario 2 envisages a fiscal policy that makes a consolidation effort consistent with maintaining the structural primary balance at pre-pandemic levels. Alternatively, scenario 3 assumes a fiscal policy that makes a further adjustment to the structural primary balance of 0.3 pp of potential GDP each year, until total structural balance equilibrium is reached. Scenario 4 modifies scenario 3 with long-term potential GDP growth of 1.9% (instead of 1.3% as assumed in all the other scenarios).
(b) For each simulation, the unbroken lines denote the structural primary balance associated with the public debt paths in the left-hand panel, under a baseline scenario determined by a future interest rate trajectory consistent with monetary policy analysts' consensus forecasts (SMA). The broken lines denote the structural primary effort needed to achieve the same public debt paths under an alternative scenario where interest rates rise by almost 1.5 pp in the long term with respect to the baseline scenario to which they refer (unbroken lines).

[44] The Budgetary Plan for 2022 carries expenditure according to the economic classification of the Budget through to National Accounts headings. However, as they continue to refer to the State level, these figures do not provide information on total expenditure by all tiers of general government under the framework of the RTRP.

[45] For instance, a significant portion of the obligations recognised up to September 2022 was recognised vis-à-vis other tiers of general government, but there is no information available on the effective execution of specific projects financed out of the obligations recognised.

In the current setting, such shocks could come, for example, from a significant deterioration in the economic growth outlook as a result of a potential escalation of the war in Ukraine, or from the possible emergence of financial market tension against a backdrop in which monetary policy is immersed in a process of tightening financing conditions. In particular, given the economic uncertainty at present, this monetary policy tightening may entail interest rates being raised higher than current market expectations, so as to meet the European monetary authorities' inflation target. Partly as a result of this process, recent months have already seen a notable rise in most European long-term sovereign bond yields. In the case of Spain, on 25 November the 10-year sovereign bond yield stood at 3%, compared with 0.6% at the turn of the year.

Starting the fiscal consolidation process in 2023, and that it be part of a medium-term programme enabling those imbalances to be gradually reduced, is therefore necessary.

In this regard, according to the simulations conducted by the Banco de España, under various assumptions regarding future economic growth and interest rate developments, a failure to make any fiscal adjustments in Spain in the coming years, together with the pressures on public expenditure entailed by an ageing population, would lead to a gradual rise in the public debt-to-GDP ratio. Conversely, in an alternative scenario in which consolidation efforts are made, for instance to improve the structural primary balance by 0.5 pp of potential GDP per year, to reach total structural balance equilibrium, public debt could fall to close to 70% of GDP by 2040. Moreover, if the adjustment described in this last scenario is accompanied by an ambitious package of structural reforms that enhance the Spanish economy's growth capacity, the debt-to-GDP ratio would fall yet further.

As well as making public finances more sustainable, the design of this plan, which must involve all tiers of government, would also boost confidence in Spain's economic policies. This is particularly important in the current context of monetary policy normalisation and high uncertainty.

I will now set out a few observations on public expenditure and revenue that could, in my opinion, serve as a guide for the design of this consolidation strategy. In general, it should be stressed that, alongside the multi-year fiscal consolidation plan the Spanish economy needs to make its public finances more sustainable, it is essential to seek a balance of public revenue and public expenditure that paves the way for the structural transformation the economy will have to undergo in the coming years (for instance, in the digital and environmental arenas) and boosts Spain's potential growth capacity. In other words, the quality of Spain's public finances must be improved.

4.2 Public expenditure

General government expenditure policies must be subject to an exhaustive review, with two essential aims: to increase the efficiency of each budget item and to optimise the distribution of public expenditure across items in order to promote more robust and equitable economic growth.

First, given the relatively limited fiscal space available, it is imperative to identify the budget items where expenditure efficiency can be enhanced. In this regard, the Spending Reviews conducted by the Independent Authority for Fiscal Responsibility (AIReF) in recent years suggest there is significant scope for enhancing the efficiency of public spending in some key items, such as active labour market policies, subsidies, tax benefits, hospital spending and hiring incentives. In March 2022 the Government published its first report following up on the recommendations made by the AIReF in its Spending Reviews, setting out such recommendations and detailing the legislative changes and other measures adopted in response.

Second, it would be desirable to consider how public expenditure could be best distributed to drive Spanish economic growth in the medium term, without overlooking various key equity considerations. In this respect, in the coming years the Spanish economy should undertake large-scale investment to adapt to the green and digital transition, among other structural challenges, in a setting in which population ageing will also exert significant upward pressure on public expenditure.

When assessing how best to distribute public expenditure, it may prove useful to compare the structure of general government spending in Spain with expenditure in our neighbouring economies, while also taking on board the findings set out in different empirical studies in the academic literature.

In international terms, education and public investment expenditure account for a lower share of general government finances in Spain than in the EU overall. On average, in the period 2015-2019, before the onset of the pandemic, which has notably skewed some key macroeconomic aggregates, public expenditure on education and public investment in Spain accounted for 4% and 2.9% of GDP, respectively, 0.9 pp and 1.5 pp below the EU figures.[46]

EDUCATION AND PUBLIC INVESTMENT EXPENDITURE ACCOUNT FOR A LOWER SHARE OF GENERAL GOVERNMENT SPENDING IN SPAIN THAN IN THE EU OVERALL

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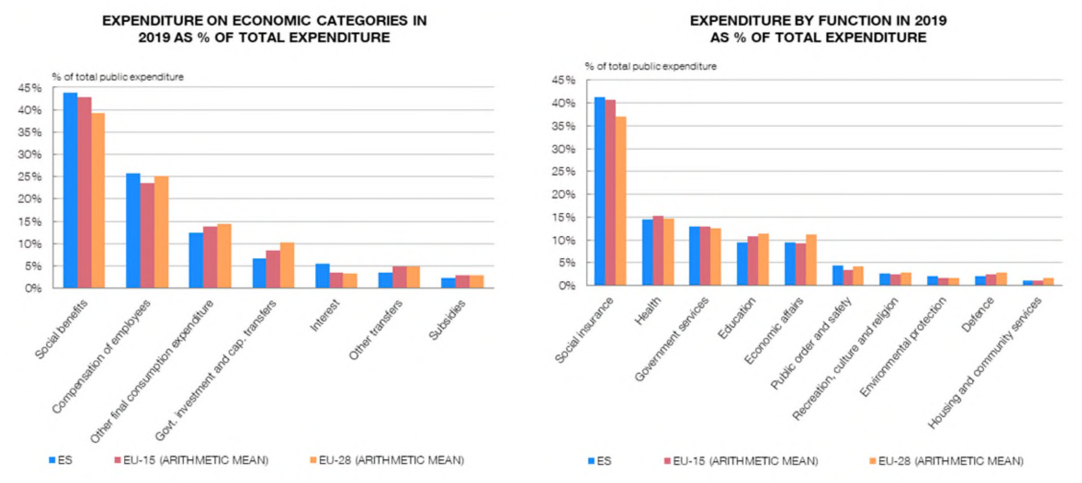

Sources: Eurostat and Banco de España.

In the academic literature there is broad consensus regarding the importance of these two items to drive economic growth and mitigate inequality. First, academic literature has

[46] For more details on these comparisons, see Alloza et al. (2022), "El gasto público en España desde una perspectiva Europea", *Documento Ocasional* 2217, Banco de España.

demonstrated the positive impact that expenditure on education and public investment has on the accumulation both of physical and human capital and, by extension, on economic growth.[47] Second, the available evidence also suggests that the explanation for the lower degree of inequality in Europe compared with the United States lies, above all, in the role played by pre-distribution policies such as public education.[48] Thus, the fact that public policies facilitate widespread access to quality education encourages a more equal distribution of income before taxes and transfers. This evidence suggests that pre-distribution policies, such as education, could be as or more effective in reducing inequality than other post-market redistribution policies, such as welfare benefits designed to prevent social exclusion.

4.2.1 The pension system

Given that the demographic trends expected in Spain in the coming years will exert huge pressure on pension-related public expenditure, a specific analysis of the main features and reform of the pension system is essential when assessing the future sustainability of Spain's public finances.

As you are fully aware, the two key elements for containing pension expenditure included in the 2013 pension system reform were recently removed. Specifically, in late 2021, as part of the first phase of a new reform of the pension system,[49] pensions were indexed to inflation and the sustainability factor was eliminated, among other measures. According to the AIReF projections and the European Commission's Ageing Report, the two measures mean that pension expenditure as a percentage of GDP will grow by between 3.2 pp and 3.5 pp between 2019 and 2050.[50]

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[47] See, for example, Ramey (2020), Deleidi (2022) and Barro (2001).

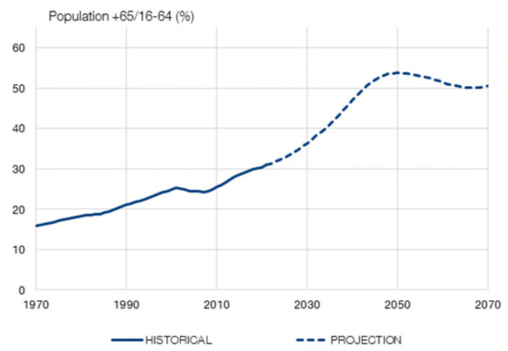
[48] See Blanchet et al. (2022), "Why Is Europe More Equal than the United States?", *American Economic Journal: Applied Economics*, Vol. 14(4), pp. 480-518.

[49] See Law 21/2021 of 28 December 2021 guaranteeing the purchasing power of pensions and establishing other measures to strengthen the financial and social sustainability of the public pension system.

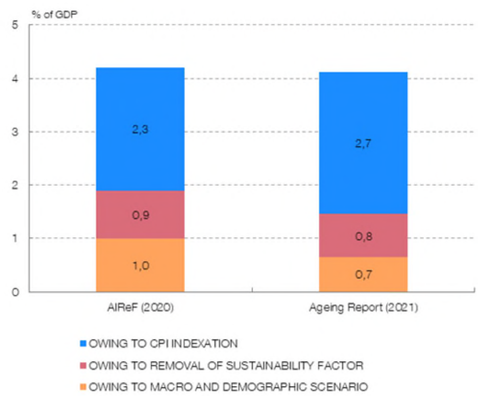
[50] In 2023, budgeted pension expenditure, including former government employee pensions, minimum pension top-ups and non-contributory pensions, stands at 13.7% of GDP, around 0.4 pp higher than in the CPI-indexed pension scenario annexed to the Ageing Report. Meanwhile, budgeted contributory pension expenditure, including minimum pension top-ups, stands at 12% of GDP in 2023, 0.2 pp more than the AIReF forecast for the same year.

THE DEMOGRAPHIC TRENDS EXPECTED IN SPAIN IN THE COMING YEARS WILL EXERT CONSIDERABLE UPWARD PRESSURE ON PENSION EXPENDITURE

DEPENDENCY RATIO: CHANGES AND PROJECTION



PROJECTED INCREASE IN PENSION EXPENDITURE, 2019-2050



Sources: INE, AIReF and European Commission.

Nevertheless, various steps have been taken in recent months to offset the expected future rise in pension spending. Furthermore, a substantial increase in transfers from the State to Social Security has also been approved, to meet the latter's so-called extraneous expenses. This considerably enhances the social security budget balance, albeit with zero impact in terms of the aggregate general government budget balance.

First, an "intergenerational equity mechanism" has been set in place, whereby a specific-purpose 0.6 pp increase in social security contributions is envisaged for ten years, starting in 2023. It has been estimated that this increase could bolster the Social Security Reserve Fund by up to around 2.5% of GDP by 2032. Thereafter, if withdrawals from the Fund are made up to the maximum legal limit (0.2 pp of GDP per year), the capital accumulated would be depleted in little more than ten years. New revenue and expenditure measures would then have to be approved in line with the conditions established by the above mechanism. Approval of these measures is subject to future negotiations with the social partners. Moreover, the adjustment entailed by the intergenerational equity mechanism is limited to the estimated impact associated with the now defunct sustainability factor (0.8 pp of GDP by 2050).

Second, new incentives for delaying retirement have also been approved. On official estimates, these could yield savings for the pension system in the order of 0.6 pp to 1.6 pp of GDP by 2050. However, these estimates are subject to considerable uncertainty.[51]

Third, a new contribution system under the Special Regime for the Self-Employed has also recently been approved, with a view to more closely aligning the contribution bases for the self-employed with their net income. The preliminary estimates suggest that over the first

[51] See the *Memoria del Análisis de Impacto Normativo del Anteproyecto de Ley de Garantía del Poder Adquisitivo de las Pensiones y de Otras Medidas de Refuerzo de la Sostenibilidad Financiera y Social del Sistema Público de Pensiones* (p. 44). Specifically, they rest on the assumption that retirement is delayed by an average of three years for between 20% and 60% of new retirees.

three years of the transitional period, which runs to 2031 at the latest, the new system's impact on tax revenue will be small.[52]

Overall, although long-term projections are, by their very nature, highly uncertain, an analysis of the pension-related measures adopted in recent months suggests that the higher spending commitments associated with the elimination of the key elements of the 2013 reform have not yet been fully offset by the new measures recently introduced, the expected impact of which is also subject to a significant degree of uncertainty.

Thus, official estimates place the savings associated with the intergenerational equity mechanism and the incentives for delayed retirement at between 1.4 pp and 2.4 pp of GDP by 2050,[53] while indexing pensions to the CPI and the removal of the sustainability factor are expected to increase pension expenditure by between 3.2 pp and 3.5 pp of GDP by the same year, according to the AIReF and the Ageing Report, respectively. It is also worth noting that, even in the scenario projected after the 2013 reform, pension expenditure as a percentage of GDP was expected to increase by between 0.7 pp and 1 pp of GDP between 2019 and 2050, given the macroeconomic and demographic scenario envisaged.

In any event, other measures are being discussed as part of the second phase of the pension reform that may affect the parameters determining the calculation of pension benefits and the system's revenue. These measures notably include amending the regulatory base calculation period and changes in maximum social security contribution bases and maximum pensions. It is still too early to determine how much these new measures will bolster the financial position of the pension system, since concrete details on the form they will take are as yet unavailable.

In sum, it seems likely that further future action will be needed on either the revenue or the expenditure side, or on both, to cater for the growth in pension expenditure stemming from population ageing. In this respect, in recent years the Banco de España has been pointing to the need to strengthen the link between contributions made and benefits received, while ensuring a sufficient level for the most vulnerable households. Moreover, the redistribution and intergenerational equity-related consequences of any future reforms proposed must be analysed. The system should also be made more transparent and easier to plan for, to offer greater certainty to the population and facilitate decision-making as regards saving, work and retirement. In this respect, automatic adjustment mechanisms could possibly be introduced, to adapt certain pension system parameters to changes in demographic and economic dynamics.

[52] At the end of the transitional period, if the contribution bases are linked to net income much as they are under the General Regime, the new system could yield a notable rise in social security contributions by the self-employed, leading to higher benefits on retirement.

[53] This range is obtained by adding the impact of the intergenerational equity mechanism (0.8 pp of GDP) to the savings estimated by the authorities as a result of the incentives for delayed retirement (ranging between 0.6 pp and 1.6 pp of GDP).

4.3 Public revenue

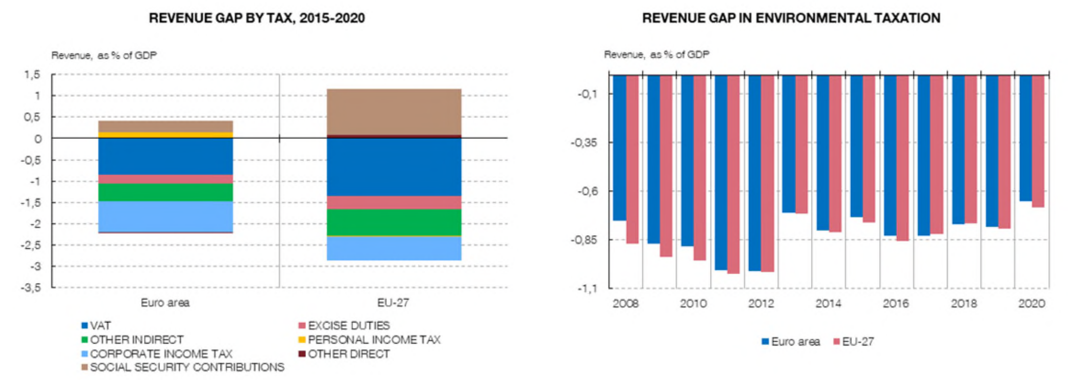
On the revenue side, improving Spain's public finances would call, among other actions, for a comprehensive review of the Spanish tax system to assess whether, overall, the different taxes meet their goals in the most efficient and most effective manner possible.[54]

A useful starting point for this analysis is to compare Spain's tax structure with that of its European neighbours.[55] The comparison with the EU-27 average over the period 2015-2020 shows that revenue from indirect taxes and effective tax on consumption is lower in Spain. In the case of direct taxation, corporate income tax revenue is also lower in Spain, while personal income tax revenue is in line with the EU-27 average. Moreover, the Spanish tax system obtains a larger proportion of revenue from tax on non-corporate capital, and higher public revenue from social contributions.

If the Spanish tax structure is compared, not with the European Union but with the average of the euro area economies, in the period 2015-2020 Spain also has a negative revenue gap in terms of indirect and corporate taxation, while it obtains a higher proportion of revenue from the other direct taxes and social security contributions.

INDIRECT TAX REVENUE AND EFFECTIVE TAX ON CONSUMPTION ARE LOWER IN SPAIN THAN IN THE EU AS A WHOLE

BANCO DE ESPAÑA Eurosistema



Source: Eurostat.

The academic literature suggests that shifting the burden of taxation to consumption yields potential efficiency and equity gains,[56] and the additional revenue associated with the

[54] To this end, it may be worth taking into consideration the diagnosis of the Spanish tax system and the measures proposed for a potential reform in the *Libro Blanco sobre la Reforma Tributaria* presented in March by a committee of experts appointed by the Government with the aim of preparing a document that lays the groundwork for a future tax reform.

[55] For a more detailed descriptive analysis of the structure of the Spanish tax system, comparing it with that of the other EU-27 economies, see López-Rodríguez and García Ciria (2018), "Spain's tax structure in the context of the European Union", *Occasional Paper* No 1810, Banco de España.

[56] The role played by consumption taxes in terms of redistribution and social insurance, and their positive effects on welfare, are examined in Correia (2010), "Consumption Taxes and Redistribution", *American Economic Review*, Vol. 100(4). The potential expansionary impact that shifting the burden of taxation from income to consumption could have on economic activity is examined, for example, in Nguyen et al. (2021), "The Macroeconomic Effects of Income and Consumption Tax Changes", *American Economic Journal: Economic Policy*, Vol. 13(2), pp. 439-466.

efficiency gains obtained from such a shift could be used to neutralise its potential regressive effects. These compensatory measures could be introduced through adjustments in personal income tax or transfers to lower income households;[57] the amount and scope of these measures should be established according to society's distributive preferences.

Any reorganisation of the Spanish tax structure should also include a review of the tax cost associated with the consumption tax relief measures. On the information available, this cost is the main component of tax relief in Spain.[58] Following the AIReF's initial review, all tax benefits currently available must generally continue to be rigorously and independently analysed to determine whether they effectively and efficiently meet their initial goals, and otherwise to eliminate them.

There is broad consensus that fiscal policy, in general, and green taxation, in particular, have to play a central role in reducing the negative effects associated with climate change and incentivising the energy transition. Accordingly, and to facilitate fulfilment of the ambitious medium and long-term climate goals Spain has assumed, it would be desirable for environmental taxation in Spain to rise gradually over the coming years, once the current energy commodity price shock is over, and draw closer to that of our European peers. This policy would foreseeably have an important distributive effect on less well-off households and adversely affect activity in those industries with a higher environmental impact. However, these effects could be mitigated by compensatory packages seeking to neutralise the regressive impact of the measures on the most vulnerable groups.

Moreover, the growing digitalisation and globalisation of economic activity require greater international coordination and harmonisation of the tax system. In this setting, the recent international taxation agreements reached under the aegis of the OECD-G20 are to be welcomed, as are the various EU initiatives to advance in the coordination and integration of corporate taxation and taxation of digital activities. The Spanish tax system needs to adapt to this new reality, since furthering the processes of international coordination and tax harmonisation driven by the EU is the surest means of preventing any erosion of tax bases and Spain's economic competitiveness.

4.4 The role of structural reforms

The possible adjustments to public spending and revenue I have just described would be geared towards improving the quality of public finances and, therefore, making them more sustainable. In any event, the Banco de España has been stressing that, to make headway towards the goal of making public finances more sustainable, one complementary approach would be to design and implement a broad package of ambitious structural reforms. As I have already mentioned, these reforms would have the capacity to boost our growth

[57] Both the AIReF's Spending Review and the *Libro Blanco sobre la Reforma Tributaria* point to the inefficiency and high cost of a redistributive policy based on the widespread use of reduced and super-reduced rates of VAT. In this respect, a flat rate of VAT, combined with transfers or negative personal income taxes for lower income households, would enable the same distributive goals to be achieved more efficiently.

[58] According to the *Memoria de Beneficios Fiscales* accompanying the Draft Budget, the central government forgoes an estimated €45.2 billion of tax revenues in connection with these benefits.

potential in the medium and long term and therefore amplify the positive effects for public finances of gradually implementing a multi-year fiscal consolidation plan.

Allow me at this point to briefly refer to the Spanish Recovery, Transformation and Resilience Plan (RTRP), which is linked to the roll-out of the NGEU programme in Spain. This plan envisages a total of 102 possible reforms, addressing a wide range of aspects that significantly affect the institutional framework in which the Spanish economy operates. In particular, these reforms are broadly inspired by a relatively comprehensive diagnosis of some of the main shortcomings consistently shown by the Spanish economy in recent decades. The main challenge of the plan is ensuring a proper design and swift roll-out of these reforms. Pressing ahead with the reform strategy is particularly important in the present setting, which, as I mentioned earlier, is marked by a very significant adverse supply shock stemming from the war in Ukraine and its effects on energy prices.

4.5 Reform of the European fiscal rules framework

Fiscal rules are a key component of a monetary union's institutional architecture. Specifically, for a monetary union to function smoothly, the fiscal rules must provide the right incentives to encourage the national fiscal authorities to behave virtuously and must ensure a certain level of implicit budgetary policy coordination between the different countries.

The European Commission is currently reviewing the European fiscal rules framework.[59] The objectives of this review include simplifying the framework, improving compliance, boosting the countercyclical behaviour of fiscal policy and accommodating the new investment needs of the digital and green transitions.

In this context, on 9 November the Commission presented a proposal for a reformed framework, in order to guide the ensuing discussions at all EU institutional levels.

Its proposal maintains the budget deficit rule (under which it should remain below 3% of GDP). This rule has proved effective at anchoring Member States' public finances in the medium term.[60]

The Commission also proposed reforming the other rules, compliance with which has clearly fallen short.[61] The cornerstone of the new system would be the expenditure rule, under which a short and medium-term trajectory for public expenditure compatible with the long-term sustainability of public debt would be set. The Commission would be responsible for proposing such trajectory, which would be negotiated individually with the Member States in order to define a medium-term budgetary and structural reform plan. A specific aspect that would be taken into account would be any investments and reforms that enhance debt

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[59] For a more detailed discussion on the reform of the Stability and Growth Pact, see Alloza et al. (2021), "The reform of the European Union's fiscal governance framework in a new macroeconomic environment", *Occasional Paper* No 2121, Banco de España.

[60] See F. Caselli and P. Wingender (2021), "Heterogeneous effects of fiscal rules: The Maastricht fiscal criterion and the counterfactual distribution of government deficits", *European Economic Review*, Vol. 136, 103748.

[61] See M. Larch and S. Santacroce (2020), "Numerical Compliance With EU Fiscal Rules: The Compliance Database of the Secretariat of the European Fiscal Board", Working Paper.

sustainability and are linked to the EU's common objectives, something largely inspired by the current NGEU governance framework.

This proposal is an interesting starting point for a debate that will have to pave the way for the approval, in the first quarter of 2023, of a better fiscal rules and governance framework than the one currently in force. Against this backdrop, I would like to set out some thoughts on the Commission's proposal, with a view to contributing constructively to this debate.

In my opinion, which does not differ fundamentally from the views of various economic policymakers and analysts, the new framework should reflect a series of principles that I will now detail.

First, the new framework should take into account the economic transformations (the decline in the natural rate of interest and in potential output, among others) that have arisen over recent decades, which have been marked by a sharp rise in public debt. However, following the recent severe shocks, there is some uncertainty over whether these transformations will persist in the future. At the same time, the rules should allow for a greater degree of cross-country heterogeneity. While some details are unknown, it should be mentioned that the European Commission's proposal includes, in this respect, the establishment of country-specific spending targets that would reflect each country's individual features.

Second, the fiscal rules framework should be capable of preventing the traditional procyclical behaviour of public finances. The framework in force in the pre-pandemic period was clearly incapable of doing so. In other words, insufficient savings were built up during upswings to cushion the necessary growth in spending in downturns. This has contributed to the undesired growth in public debt in recent decades. Consequently, the discussions regarding the Commission's proposal should seek to clarify whether it incorporates a set of clear incentives to accelerate fiscal consolidation efforts during economic upturns that would provide fiscal space for economic crises.

Another desirable facet of the new fiscal framework would be greater automaticity in the application of the rules. While the Commission's proposal outlines some improvements in this respect, how this will actually work, which has been the main issue in prior formulations of these mechanisms, remains to be seen.

Another key element stems from the confirmation that an overly complex and opaque rules framework does not contribute towards its effectiveness: an effective framework should be at once straightforward and realistic. In this regard, the Commission's proposal clearly simplifies the framework, establishing a rule on expenditure that is compatible with the long-term sustainability of public finances. However, defining the latter concept is far from easy. How do we define and determine operationally the medium and long-term sustainability of public finances? Although there are some tools at our disposal that allow us to organise our thoughts on this subject (specifically, the Debt Sustainability Frameworks) and we have experience of using such tools (e.g. as part of the IMF programmes), their practical use to inform economic policy decisions remains complex. Therefore, with this proposal, the system's complexity is being shifted from the rules framework to the discussion on the definition and application of the tools for analysing the sustainability of public finances.

Lastly, the reform of the fiscal rules cannot be considered without taking into account the need to make headway in other key aspects of the European project. For example, the new European governance framework for national fiscal policies should be completed with a number of elements to expand the risk-sharing channels in the EU. This would entail, for instance, establishing a European unemployment insurance system and a central fiscal capacity. It should be noted that, under the current fiscal rules framework, it is not possible to ensure, at any given moment, that the aggregate stance of the national fiscal policies is appropriate for the EU as a whole, which makes it hard to achieve a balanced fiscal and monetary policy mix.

New tools must also be developed to enable the risk of financial fragmentation to be reduced and new common investment needs to be financed. In this respect, some of the initiatives approved during the pandemic should be expanded, such as the temporary Support to mitigate Unemployment Risks in an Emergency (SURE), launched in April 2020, which has demonstrated how access to EU loans generates significant interest savings for most Member States and also protects them from situations of financial market stress.[62] It would also be desirable to review the timeframe for the NGEU programme to reduce the risk that some of the investment necessary to boost digitalisation, the fight against climate change and EU strategic autonomy may not be completed. For example, the length of the application period for loans under this programme, which expires in mid-2023, could be reconsidered.

5 Conclusions

In conclusion, I would like to reiterate that the scenario facing the Spanish economy is marked by high inflation and by the tensions sparked by the war in Ukraine, which has prompted a downward revision to the economic growth projections for 2023 and a significant increase in the inflation outlook. Nevertheless, the economic projections are surrounded by an extraordinarily high level of uncertainty, with the risks on the upside for inflation and on the downside for growth.

In this setting, I would like to convey the following main economic policy recommendations.

First, the ECB's monetary policy will continue on the path of normalisation until it ensures that inflation returns to the 2% target over the medium term. Second, other monetary policies should play a key role in tackling the current situation through an incomes agreement, resolute supply-side policies and a reinforcement of the European project.

Strictly from a budgetary perspective, I believe that any stimulus measures adopted need to be temporary and target solely the most vulnerable agents, avoiding an across-the-board fiscal impulse and further increases in the structural budget deficit that would fuel the inflationary episode and undermine the sustainability of public finances.

In parallel, a fiscal consolidation strategy that reduces the vulnerability of the public finances and allows the fiscal space to be rebuilt should be designed for launch in 2023. If this strategy is rigorously designed, promptly announced and backed by a broad consensus, its effectiveness will be markedly increased. It must also be accompanied by a comprehensive

[62] See Burriel, Kataryniuk and Pérez (2022).

revision of public spending and of the tax system to make them more efficient and enhance their contribution to economic growth.

Lastly, the transformative impact of the NGEU funds, which are crucial for the Spanish economy, needs to be maximised through a careful selection of the projects, their continuous assessment and the complementary implementation of a comprehensive and ambitious set of structural reforms that reduce the obstacles limiting the Spanish economy's growth capacity.