

TESTIMONY BEFORE THE PARLIAMENTARY BUDGET COMMITTEE

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Governor

28 January 2019



- 1. Forecasts for the Spanish economy**
2. The Draft State and Social Security Budget (Draft Budget)
3. The challenges for fiscal policy

Forecasts for the Spanish economy: assumptions on the external environment and financial conditions



- The latest Banco de España forecasts, published in December 2018, were prepared in conjunction with the Eurosystem, drawing on the information available as at end-November. This showed for 2019:
 - Some easing in global GDP growth.
 - A level of oil prices lower than in 2018.
 - Favourable financing conditions.

Annual rate of change (%) unless otherwise specified

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

SOURCES: ECB and Banco de España.

[Link to Macroeconomic projections for the Spanish economy \(2018-2021\): the Banco de España's contribution to the Eurosystem's December 2018 joint forecasting exercise.](#)

Forecasts for the Spanish economy: overview



- **Activity:** a continuation of the expansionary phase is forecast, albeit at a slower pace than in recent years. This is as a result, among other factors, of a less favourable external environment, of the progressive slackening of the monetary impulse of recent years and of an increase in uncertainty over the global context.
- **Prices:** the forecast is for an easing in inflation owing to the smaller contribution of the energy component, and a gradual increase in the core component, reflecting the growing use of productive factors.

Annual rate of change (%)	December 2018 projections		
	2017	2018	2019
GDP	3.0	2.5	2.2
Employment	2.9	2.5	1.6
HICP (inflation)	2.0	1.8	1.6

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

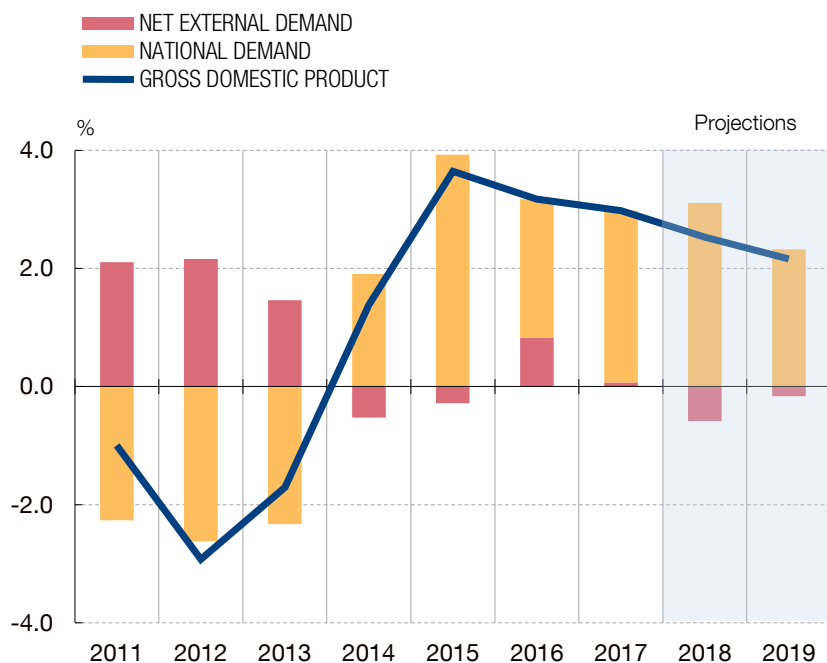
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Forecasts for the Spanish economy: composition of output growth

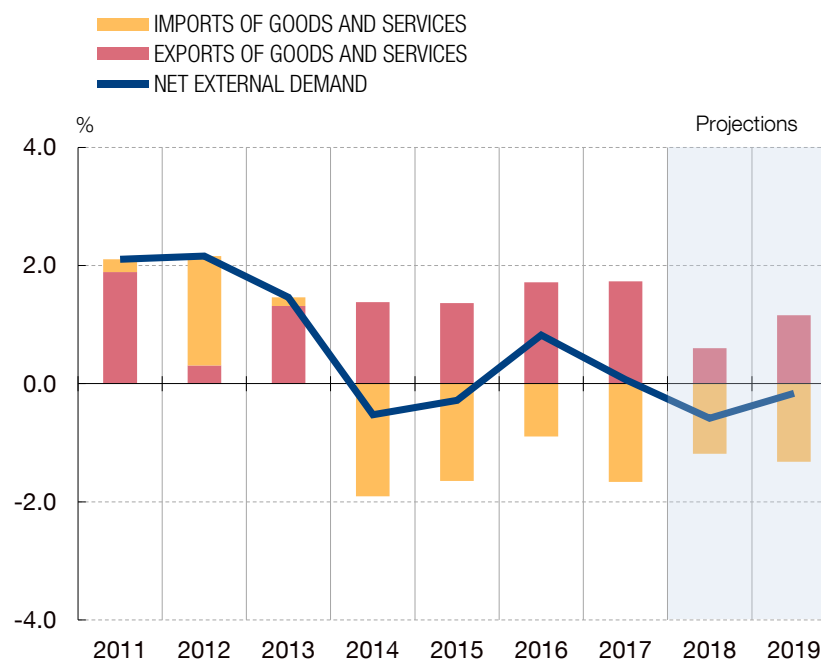


- The expansion in output will continue to rest on national demand; however, a slowdown is projected for all components of this latter variable.
- Net external demand exerted a negative contribution in 2018, which will moderate in 2019.

GDP. ANNUAL GROWTH AND CONTRIBUTIONS



NET EXTERNAL DEMAND. CONTRIBUTIONS



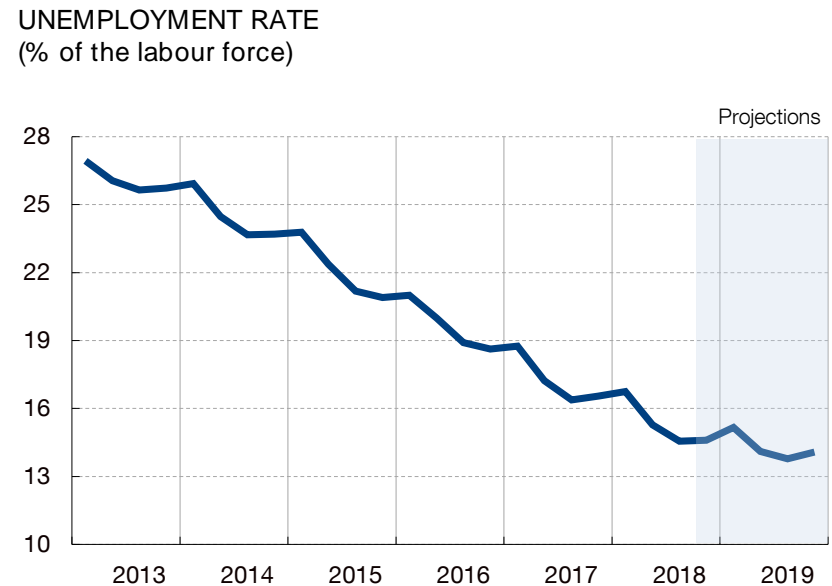
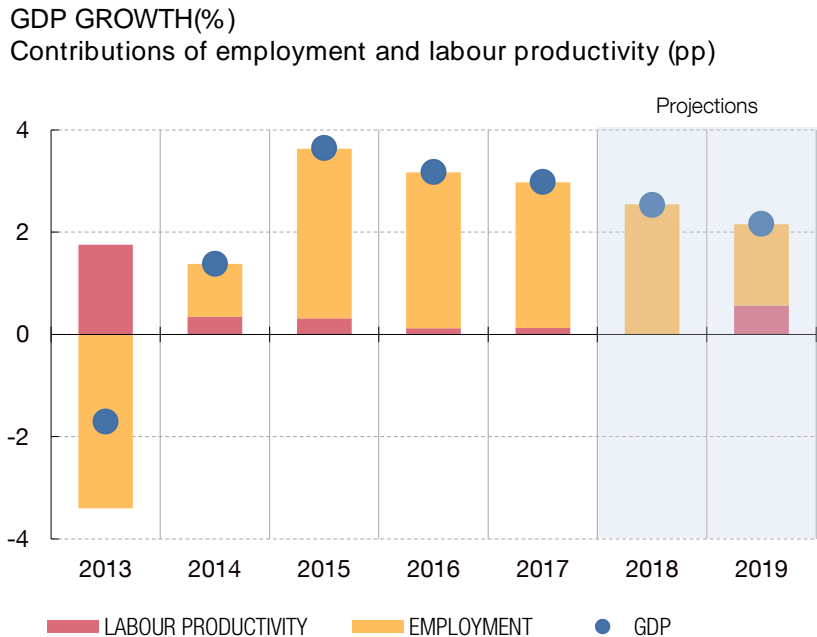
SOURCES: INE and Banco de España.

[Link to Macroeconomic projections for the Spanish economy \(2018-2021\): the Banco de España's contribution to the Eurosystem's December 2018 joint forecasting exercise.](#)

Forecasts for the Spanish economy: employment and unemployment



- As is usual in expansionary phases in Spain, scant growth in apparent labour productivity is forecast.
- Net employment creation will prompt further declines in the unemployment rate, taking it to close to 14% at end-2019, against a background of low increases in the labour force.



SOURCES: INE and Banco de España.

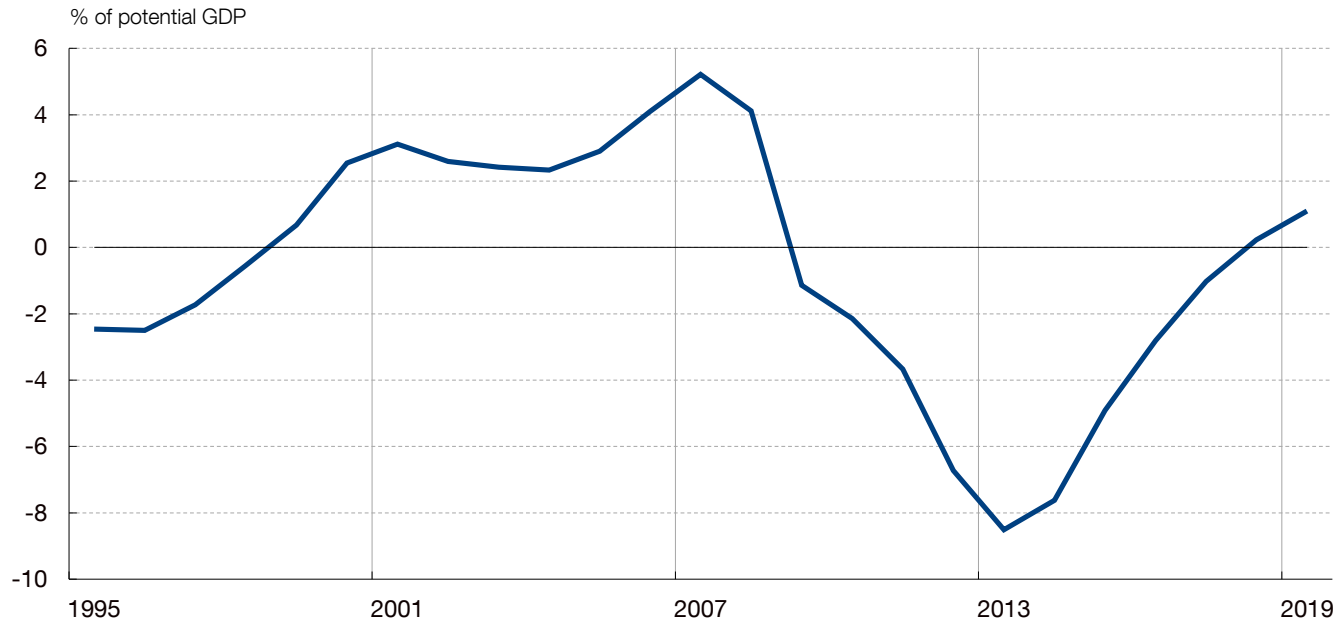
[Link to Macroeconomic projections for the Spanish economy \(2018-2021\): the Banco de España's contribution to the Eurosystem's December 2018 joint forecasting exercise.](#)

Forecasts for the Spanish economy: cyclical position



- On Banco de España estimates, the Spanish economy's output gap (measured as the difference between actual and potential GDP) will become increasingly positive in 2019.

SPANISH ECONOMY'S OUTPUT GAP

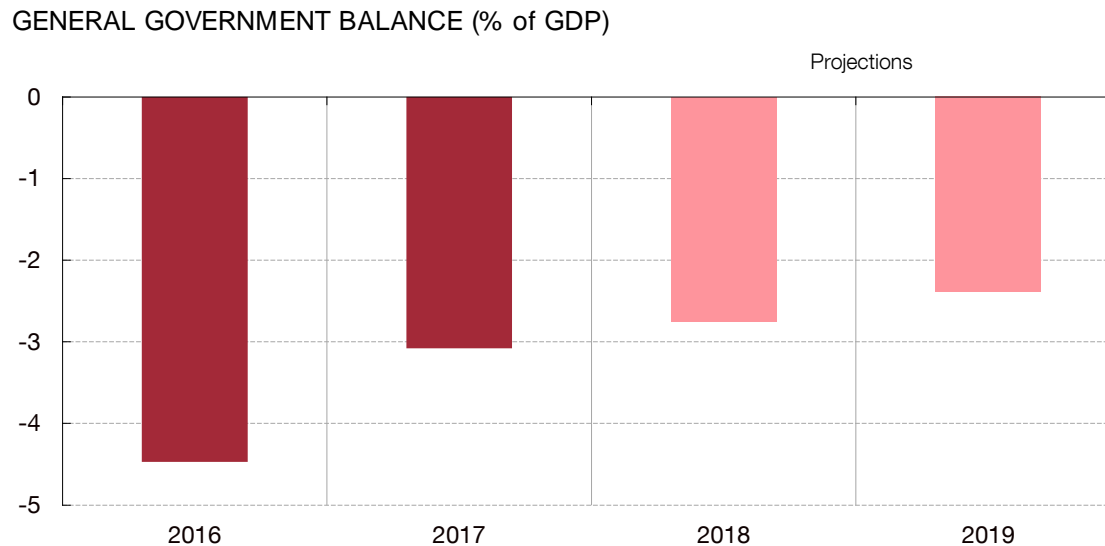


SOURCE: Banco de España.

Forecasts for the Spanish economy: budget deficit



- The December projections included a budget deficit estimate of 2.7% of GDP for 2018 and 2.4% for 2019.
- In accordance with the Eurosystem's methodology, these projections included some of the previously announced public spending measures (revaluation of pensions; rise in public-sector wages; public-sector employment policy), but none of the public revenue measures included in the October Budgetary Plan.
- The latest data confirm the Excessive Deficit Procedure exit scenario in 2019 (budget deficit in 2018 below 3% of GDP).



SOURCES: IGAE and Banco de España.

[Link to Macroeconomic projections for the Spanish economy \(2018-2021\): the Banco de España's contribution to the Eurosystem's December 2018 joint forecasting exercise.](#)

Forecasts for the Spanish economy: main risks.

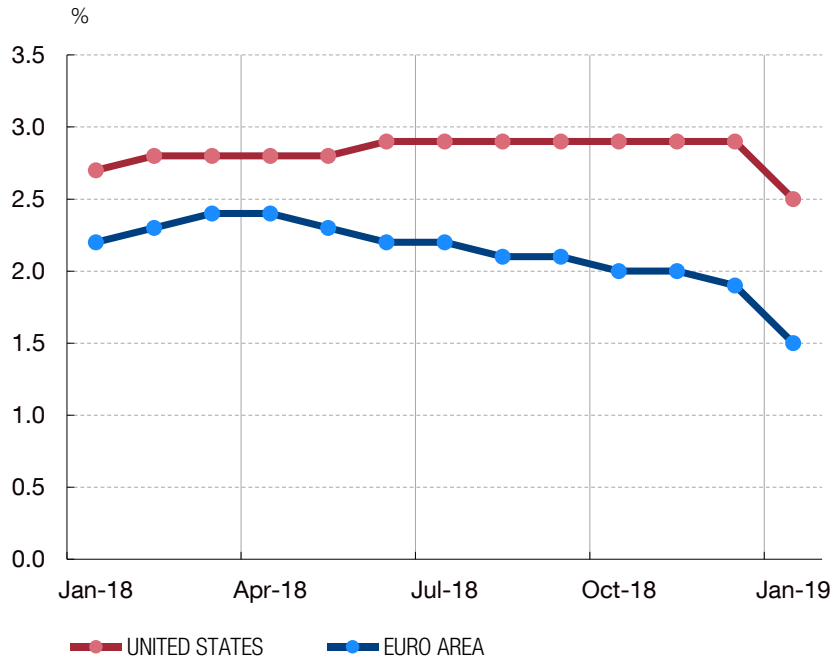
A more unfavourable external environment



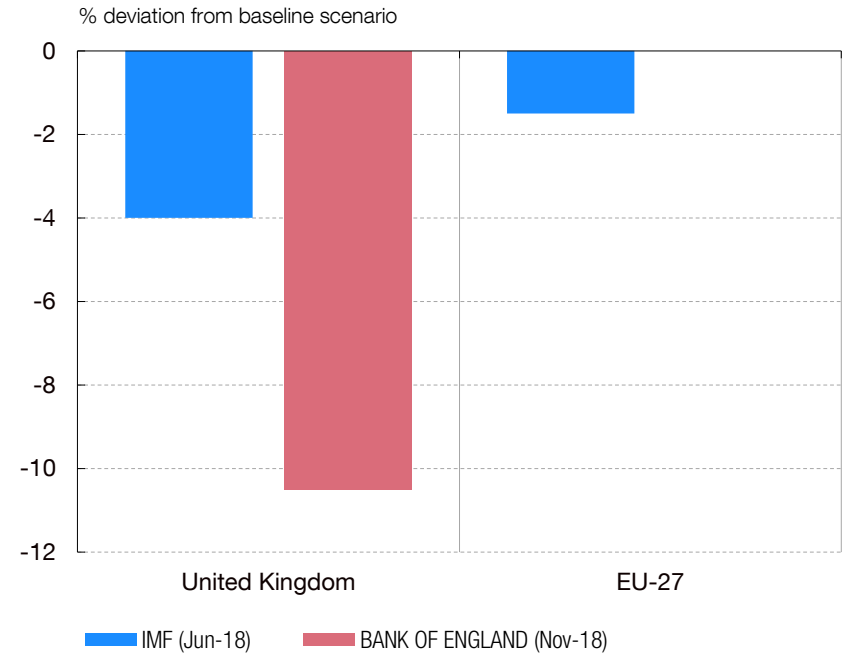
- Downward revision of global and euro area growth prospects

- Uncertainty over the outcome of the UK's withdrawal from the EU (Brexit)

GDP GROWTH FOR 2019



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



SOURCES: Consensus Forecasts, IMF and Bank of England.

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

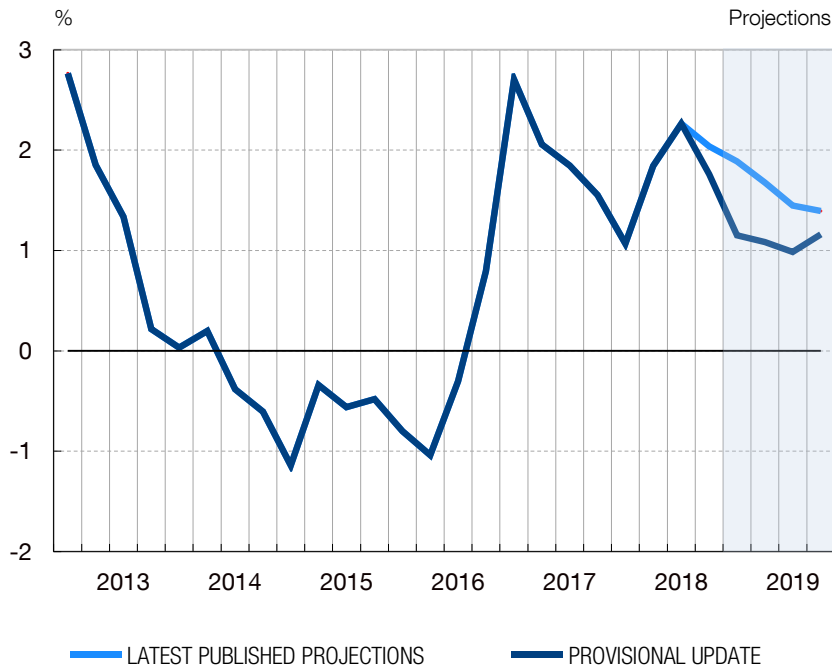
Forecasts for the Spanish economy: main risks.

Surprises on the downside for inflation

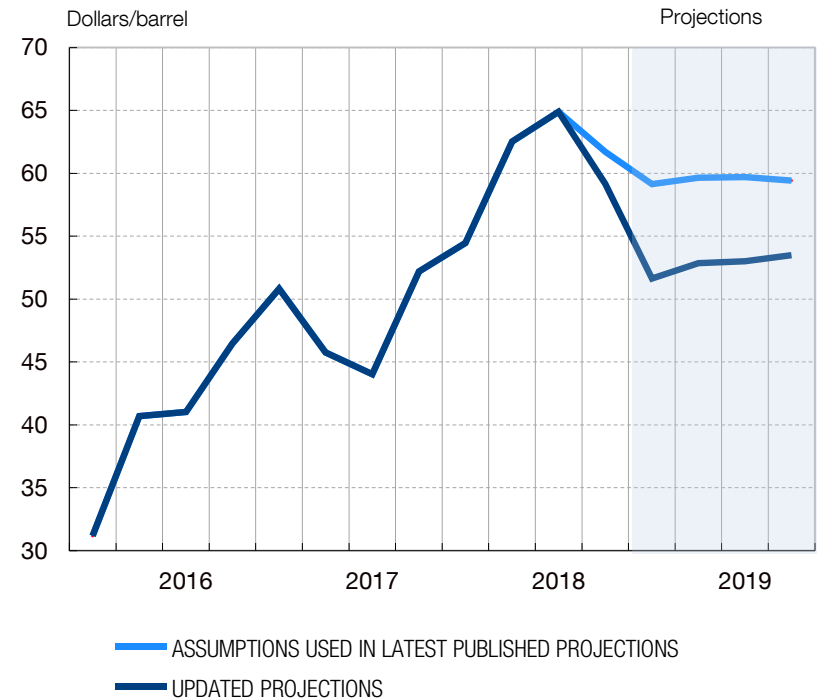


- The November and December inflation figures were a surprise on the downside, especially for energy prices but also for services prices.
 - Further, oil prices on futures markets have been revised downwards.

OVERALL INFLATION



OIL PRICES



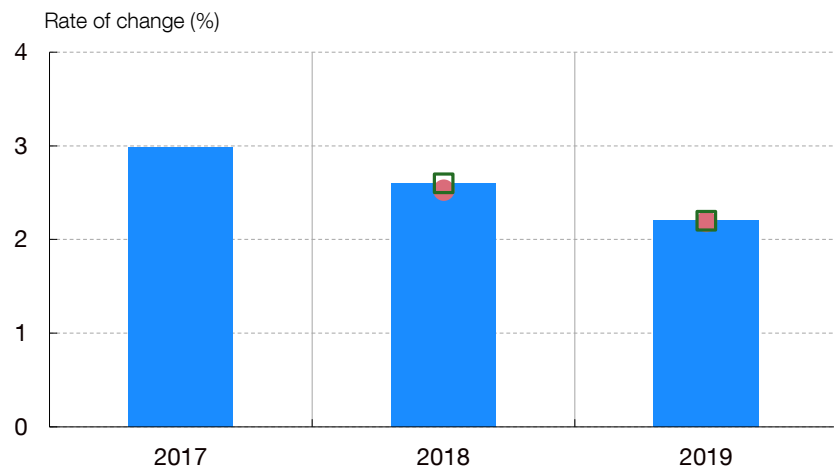
SOURCES: ECB, INE, Reuters and Banco de España.

The macroeconomic projections for the Draft Budget

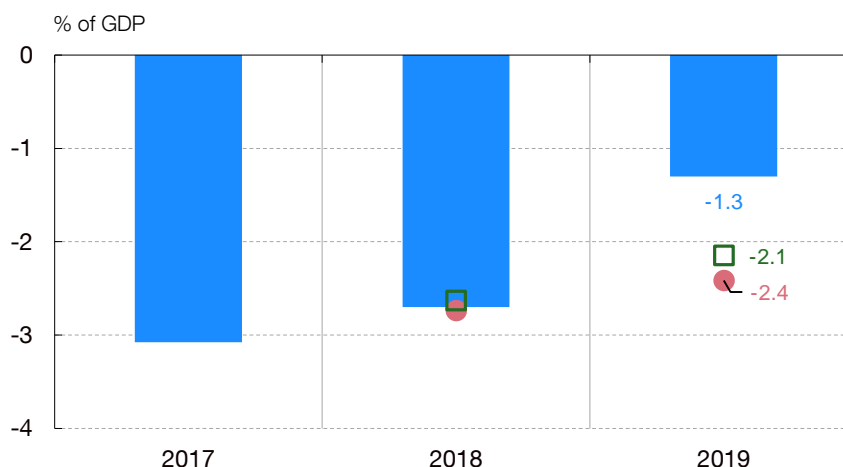


- The assumptions on the external and financial setting of the Draft Budget are similar, in general terms, to those of the latest macroeconomic projections of the Banco de España.
- The Draft Budget places real GDP growth at 2.2%, in line with the latest forecasts by the Banco de España and other analysts.
- The risks signalled, therefore, are also applicable to the projections in the Draft Budget.
- In any event, although the economic growth projections are similar, the Draft Budget includes a significantly more pronounced improvement in the deficit than that projected by other analysts, which hampers comparison.

REAL GDP



GENERAL GOVERNMENT BUDGETARY BALANCE



■ STATE BUDGET 2019 ● BANCO DE ESPAÑA (DECEMBER 2018) □ CONSENSUS FORECAST

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

Outline

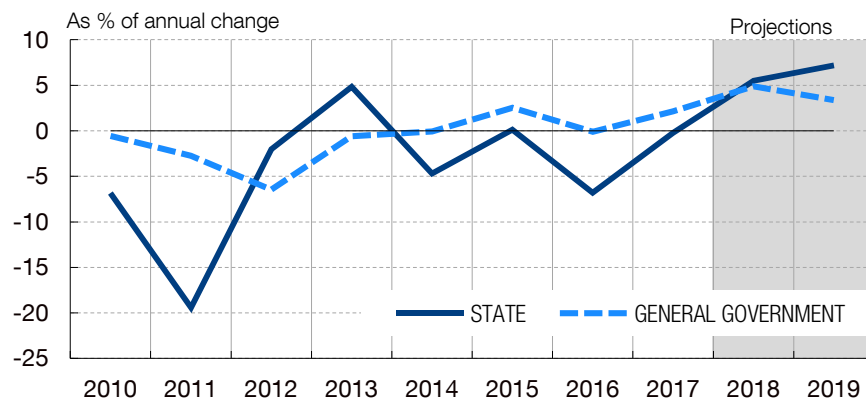
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Public spending in the Draft State Budget

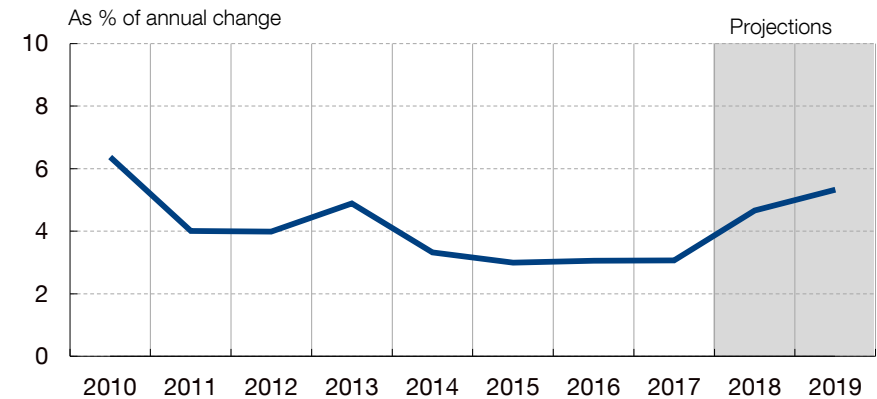


- Main measures in 2019:
 - 1.6% increase in pensions, 3% in minimum pensions and an additional 7% in widows' pensions. Compensation for inflation in 2018.
 - 2.25% rise in public-sector employee wages (+0.25% linked to GDP, +0.25% additional).
 - Recovery of unemployment subsidy for over-52s, increase in spending on dependents, extension of paternity leave to 8 weeks.
- Budgeted consolidated spending for the State and Social Security Budget is more expansionary this year
 - Includes the bulk of the measures described in the October 2019 Budgetary Plan, which anticipated growth in total general government spending of 3.1%.
 - Overall spending on pensions, unemployment, interest and total gross wages is in line with the National Accounts-terms estimates of the models the Banco de España uses for these items, which are most substantially determined by macroeconomic and demographic fundamentals, as well as by the measures adopted.

PRIMARY EXPENDITURE (a)



PENSION EXPENDITURE (a)



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

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

Main public revenue measures in the Draft Budget



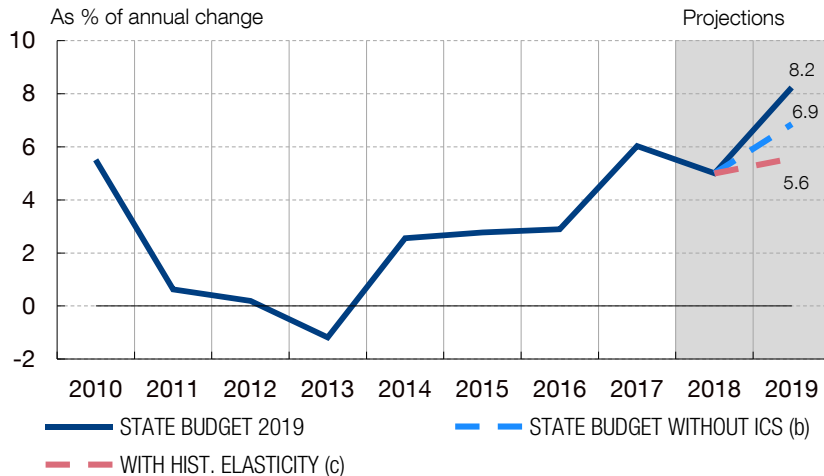
- **Social contributions:** increase in maximum (7%) and minimum (22%, owing to the impact of the National Minimum Wage) contribution bases, and others (self-employed: bases, charges, minimum rate) with an estimated overall official impact of around €2 billion.
- **Corporate income tax:** minimum rate of 15% on taxable income for large corporations (18% for financial institutions and hydrocarbon production companies); the exemption for dividends and capital gains arising abroad is reduced by 5%; reduction in rate on SMEs to 23%, with an overall impact officially estimated at €1.5 billion.
- **Personal income tax:** rise in rates on highest employment income (+2pp income >€130,000 and +4pp income >€300,000), and capital income (+2pp income >€140,000), with an official estimated overall impact of €328 million.
- **Wealth tax:** increase in rates on large fortunes (+1.4pp wealth >€10 million): €300 million.
- **VAT:** reduction in minimum rate (4%) for feminine hygiene and e-book products, and in reduced rate (10%) for veterinary services: impact officially estimated at €77 million.
- **Hydrocarbons tax:** rise of 3.8 cents/litre in tax on diesel: €670 million.
- **New taxes:**
 - Tax on financial transactions: impact officially estimated at €850 million.
 - Tax on specific digital services: impact officially estimated at €1.2 billion.

Revenue forecast in the Draft Budget

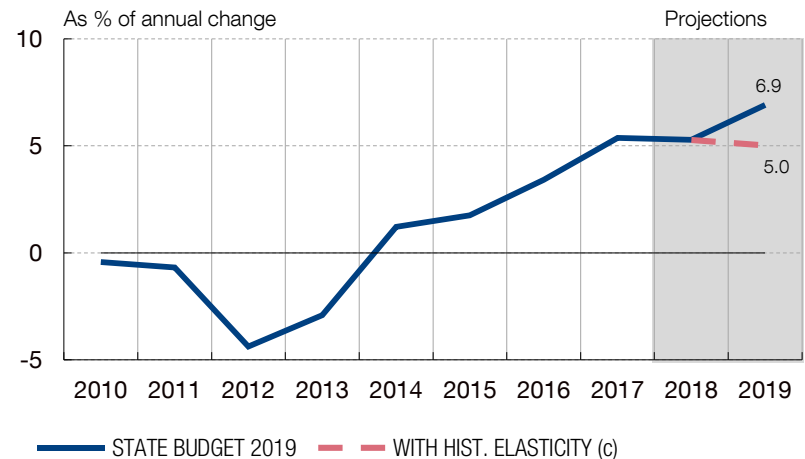


- The Draft Budget assumes growth in tax revenue and social contributions of 8.2% in 2019, in budgetary terms.
- These estimates of public revenue for the Draft Budget are subject to significant downside risks, in National Accounts terms, derived from the fact that:
 - Greater revenue in respect of the immediate supply of VAT information (SII) does not pass through to National Accounts items
 - While there is the usual uncertainty over the response of public revenues to tax bases (tax elasticity), the projections include elasticities higher than the historical averages
 - The estimation of the revenue-raising impact of the tax changes is subject to great uncertainty, in particular when new taxes are involved
 - The potential delay in the entry into force of the measures accompanying the Draft Budget poses an additional risk

REVENUE (a)



EFFECTIVE SOCIAL SECURITY CONTRIBUTIONS



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

a. Sum of shared taxes (personal income tax, corporate income tax, VAT and excise duties) plus effective Social Security contributions.

b. Immediate supply of VAT information. In 2019, the submission date for VAT self-assessments shall be brought forward from the 30th to the 20th each month. This will mean that, for that year, revenue takings will cover 13 months, instead of 12.

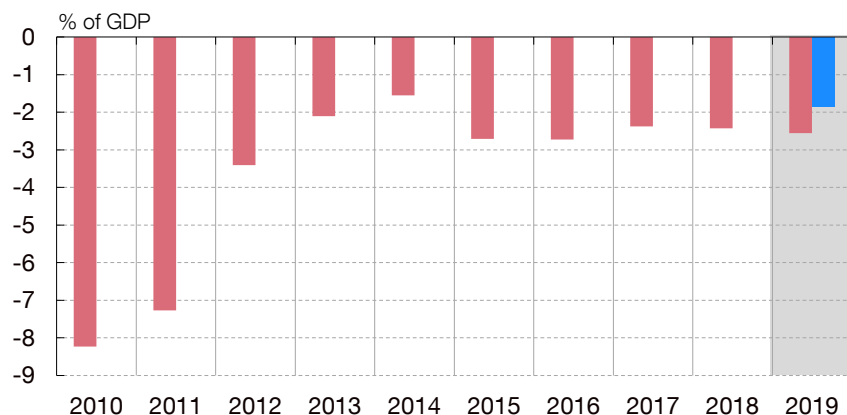
c. Historical elasticities estimated by the European Commission.

The budget deficit target and the fiscal policy stance in 2019

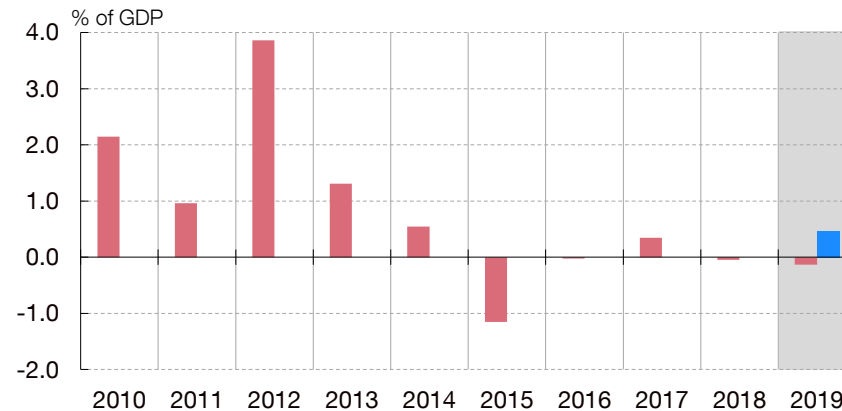


- Taking as a basis the Banco de España's December projections, and including the Draft State Budget measures not then included, a preliminary estimate places the general government deficit in 2019 at around 2% of GDP, compared with the figure of 2.4% estimated in December and that of 1.3% set as a target. The forecast for growth is revised slightly downwards.
 - A lesser revenue-raising impact of the new taxes compared with that officially estimated, a delay in the entry into force of the tax measures included in the Draft Budget or a potential materialisation of the aforementioned downside risks to the growth outlook will raise the projected deficit, while a more dynamic response by tax revenues to the macro bases than that historically estimated or a containment of discretionary spending will have the opposite effect.
 - In any event, the Banco de España will publish a full update of its projections, with the latest information, including budgetary information, around end-March.
 - On these preliminary estimates, the fiscal policy stance in 2019 (measured by the change in the structural budget balance) will be approximately neutral. The entire reduction observed in the budget deficit since 2013 was due to the effect of the economic cycle.

GENERAL GOVERNMENT STRUCTURAL BALANCE



STRUCTURAL BALANCE CHANGE



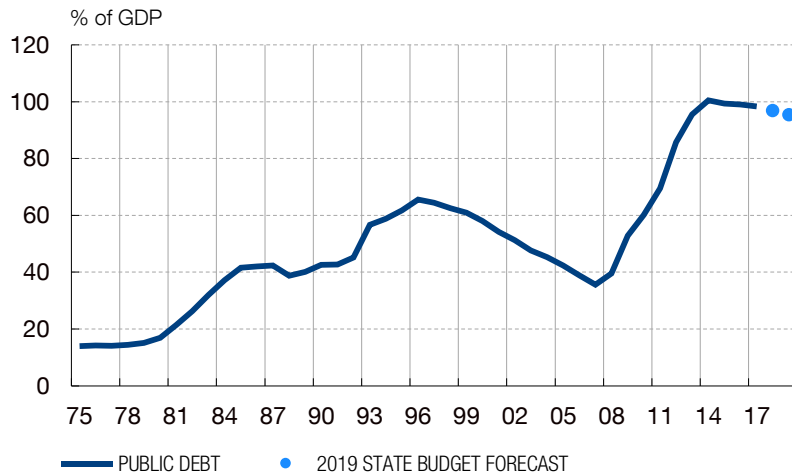
■ BANCO DE ESPAÑA (WITH 2019 STATE BUDGET MEASURES)

■ 1.3% DEFICIT FULFILMENT

General government debt in the Draft Budget

- According to the Draft Budget, the ratio of general government debt to GDP is expected to fall by 1.5 pp to 95.4% in 2019, which will prolong the path of gradual reduction seen since 2014.
 - This dynamic would be attributable to the expected favourable trend of nominal growth in the economy.
 - If the aforementioned upside risks to the budget deficit were to materialise, that would entail a smaller reduction in the debt ratio.

PUBLIC DEBT



BREAKDOWN OF GENERAL GOVERNMENT DEBT

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

SOURCES: Banco de España and 2019 State Budget.

Outline

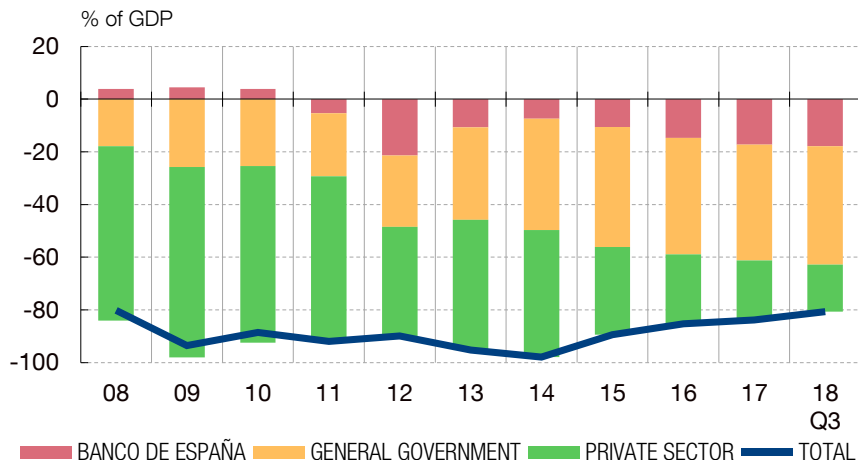
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High public debt



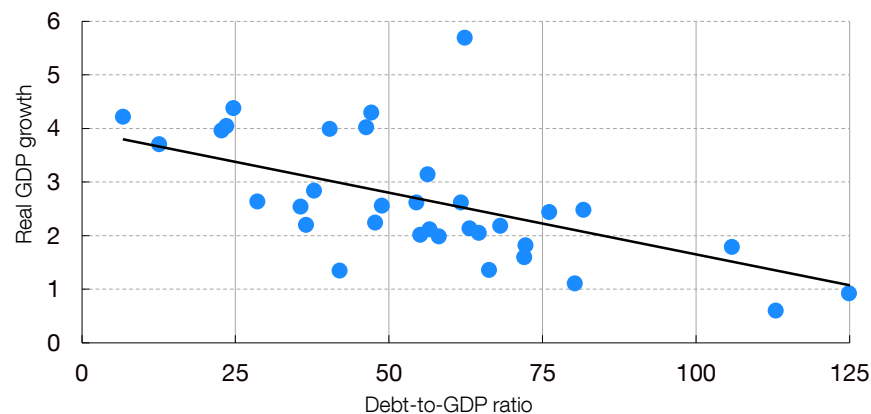
- Maintaining high levels of public debt over prolonged periods may have adverse effects on economic growth.
 - These adverse effects arise insofar as public debt absorbs resources that could be assigned to more productive uses and alters the aggregate financing conditions in the economy, distorting private investment decisions.
 - High debt diminishes the stabilising capacity of fiscal policy in response to adverse situations.
 - It necessitates the sustaining of substantial primary surpluses that may require higher levels of taxation or lower levels of productive spending.
 - It gives rise to greater vulnerability to changes in investor sentiment on the capital markets.
- The favourable macroeconomic environment should be harnessed to make headway on fiscal consolidation, which requires the definition of a detailed medium-term programme for the reduction of public debt.

NET IIP. SECTORAL BREAKDOWN



SOURCE: Banco de España.

PUBLIC DEBT AND GDP GROWTH (a)



SOURCES: Eurostat, OECD and Banco de España.

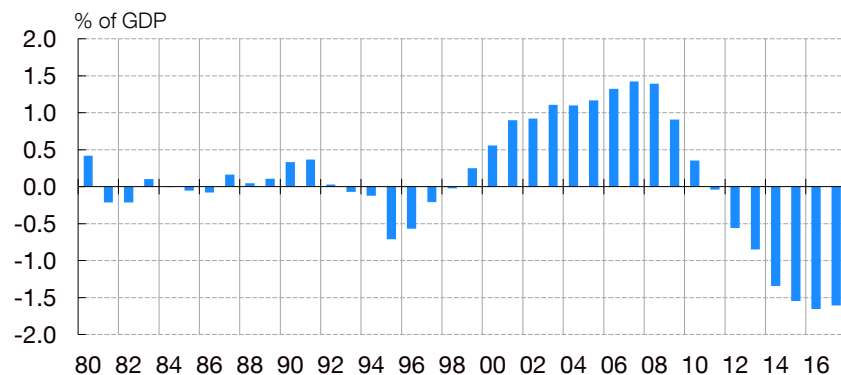
a. Regression with average values for the EU and OECD countries in the 1995-2015 period.

The challenge of population ageing



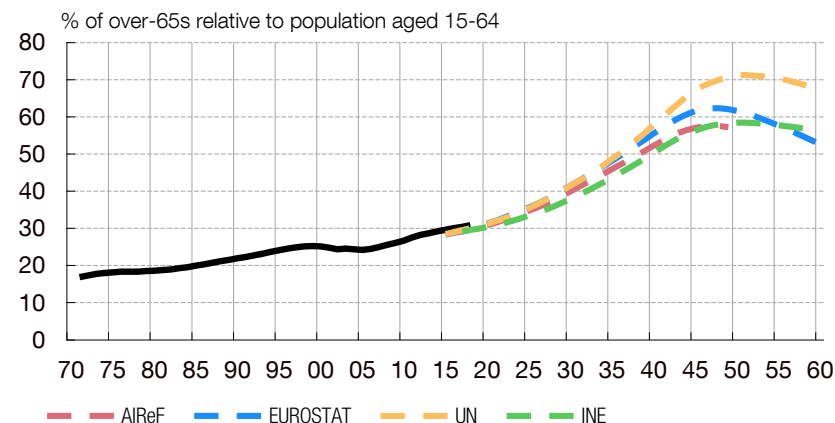
- The demographic projections available augur a substantial increase in the dependency ratio, which might double in the coming decades, and which will generate significant pressure on public spending on pensions, health and long-term care.
 - The return to inflation-indexed pensions will give rise to a significant increase in public spending in the medium term. Ensuring the financial sustainability of the system will therefore call for additional measures on the revenue and/or expenditure sides of the system.
- Population ageing also has a negative impact on the participation rate, productivity and the potential growth of the economy. Tackling this phenomenon thus requires a broad approach, both as regards the time period envisaged and the tools to be used.

NON-FINANCIAL BALANCE OF THE SOCIAL SECURITY SYSTEM



SOURCES: Social Security and National Accounts.

DEPENDENCY RATIO



SOURCES: AIReF, Eurostat, United Nations and INE.

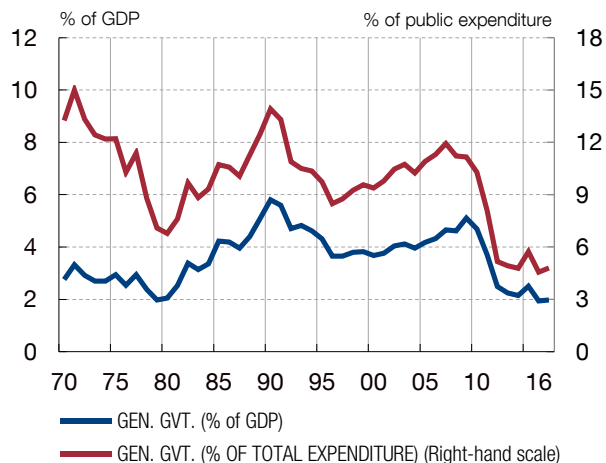
$$\frac{\text{pension spending}}{\text{GDP}} = \underbrace{\frac{\text{n pensions}}{\text{population}}}_{\text{Dependency ratio}} * \underbrace{\frac{\text{population}}{\text{n employees}}}_{\text{Inverse of employment rate}} * \underbrace{\frac{\text{average pension}}{\text{average wage}}}_{\text{Replacement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

The quality of public finances

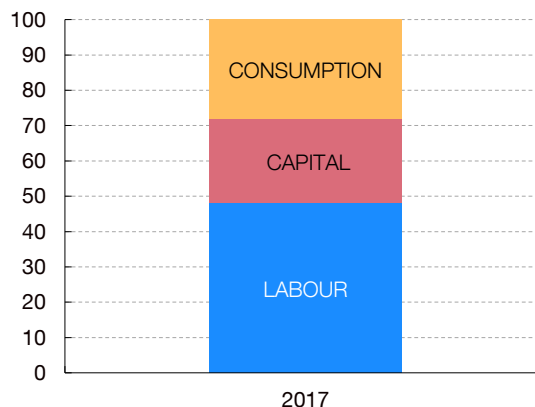


- The fiscal consolidation process should be compatible with a greater contribution of public finances to the potential growth of the economy.
 - On the spending side there appears to be room to continue increasing expenditure efficiency and re-directing its composition towards those items with a greater influence on the accumulation of physical, technological and human capital. In this respect, the review of public spending under way is fundamental.
 - On the revenue side, there is room to consider a review and definition of the basket of taxes, moving towards structures more favourable to potential growth.
 - There is broad consensus that local and regional government financing arrangements should be reformed, with the aim of tailoring available revenue to needs, based on prior objective estimates of such needs, ensuring transparent distribution and increasing the degree of fiscal co-responsibility.

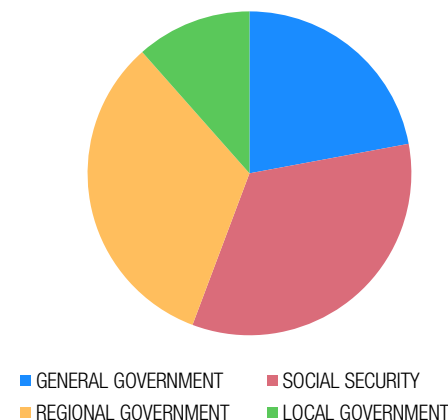
GENERAL GOVERNMENT INVESTMENT



TAX STRUCTURE IN SPAIN



PUBLIC EXPENDITURE IN SPAIN (2017)



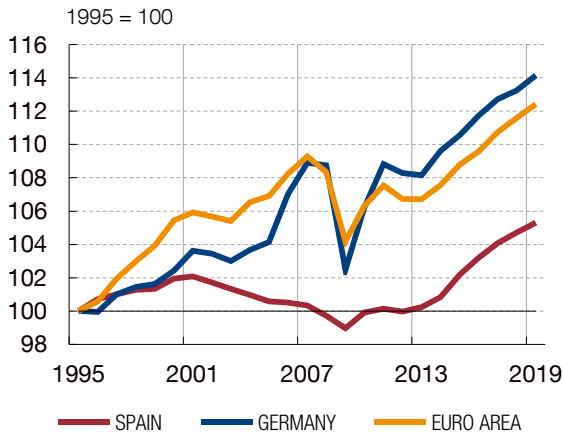
SOURCES: IGAE, INE and Banco de España.

Other structural challenges

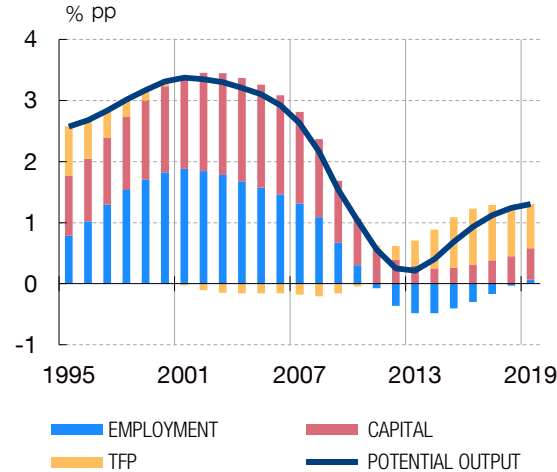


- It is necessary that the fiscal consolidation process, be accompanied by an ambitious structural reform agenda to increase the economy's potential growth based on:
 - Increases in labour market efficiency through the reduction of temporary employment and an improvement in employability, especially of the lesser-skilled.
 - Improvements in productivity dynamics through investment in human capital, the promotion of innovation and the elimination of inappropriate obstacles to business competition.
- The banking sector should tackle its outstanding challenges, such as the reduction in non-productive assets, the improvement of its capital and profitability structure, the strengthening of its reputation and the harnessing of technological developments.

TOTAL FACTOR PRODUCTIVITY



POTENTIAL OUTPUT GROWTH AND CONTRIBUTIONS



LONG-TERM UNEMPLOYMENT RATE AND TEMPORARY EMPLOYMENT RATE (a)



SOURCES: Eurostat, INE and Banco de España.

a. Annual data for Q2.

b. Unemployed seeking work for more than one year.

Conclusions



- The latest data confirm the exit scenario in 2019 from the excessive deficit procedure (budget deficit in 2018 below 3% of GDP).
- The Draft Budget places real GDP growth at 2.2%, in line with the Banco de España forecasts published on 14 December. The recent worsening of the external environment of the Spanish economy introduces downside risks into these estimates.
- The estimates of growth in tax revenue and in social contributions in the Draft Budget (8.2% in 2019) are subject to significant downside risks.
- The inclusion of the measures envisaged in the Draft Budget in the Banco de España's macroeconomic projections would be compatible with a budget deficit of around 2% of GDP, and with a moderate adverse impact on economic growth in 2019.
- On these preliminary estimates, the fiscal policy stance in 2019 (measured by the change in the structural budget balance) would be approximately neutral. The entire reduction observed in the budget deficit since 2013 has been due to the effect of the business cycle.
- The high levels of general government debt and of the structural budget deficit call for advances in fiscal consolidation in order to regain scope for an active fiscal policy and to reduce this source of macrofinancial vulnerability.
- What is needed is fiscal policy planning that includes a clear medium-term strategy to reduce public debt, underpinned by a composition of public finances conducive to economic growth.
- This process should be accompanied by an ambitious structural reform agenda to improve the workings of factor and product markets, to raise potential growth and to address the many challenges posed by progressive population ageing.