BANCO DE ESPAÑA
Eurosistema

30.11.2021

Testimony before the Senate Budget Committee in relation to the draft State Budget for 2022

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Governor

Ladies and gentlemen:

My appearance once again before this House is part of the process of debate of the State and Social Security budgets (hereafter, the Budget) for 2022.

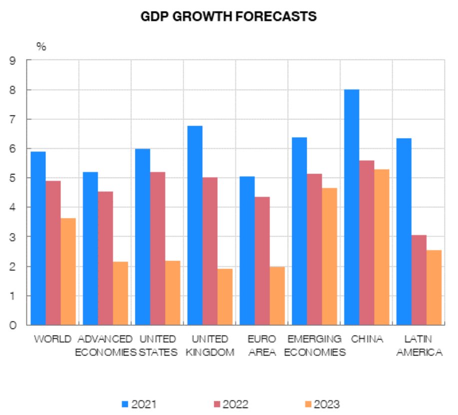
The circumstances today are more favourable than at the time of my last appearance before this Committee, in December 2020. The epidemiological situation has changed substantially, thanks to the large-scale vaccination campaign, although as we see in some other European countries, and with the appearance of new strains of the virus, we are still some distance from a full return to normality and uncertainty remains high.

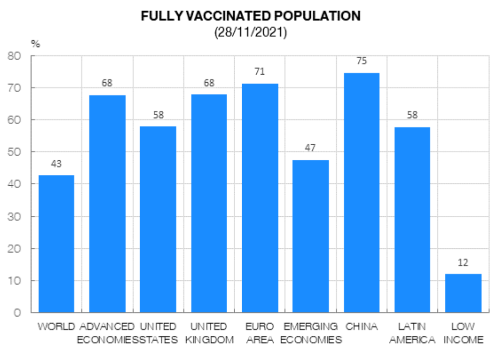
As is customary, I will begin with an overview of past developments and the future outlook for the Spanish economy. This will be followed by an analysis of the main characteristics of the draft Budget. Lastly, I will address the medium-term fiscal policy challenges that we face.

1 Recent developments and outlook for the Spanish economy

1.1 Global environment

THE GLOBAL CONTEXT: THE GLOBAL RECOVERY HAS BEEN SOMEWHAT STRONGER IN ADVANCED THAN IN EMERGING ECONOMIES, WHERE THE PACE OF VACCINATION HAS BEEN SLOWER





SOURCES: World Economic Outlook (IMF, Oct. 2021) and Our World in Data.

Economic activity continues to recover worldwide, thanks to the vaccination campaigns and the extraordinary support provided by economic policies. According to the latest IMF forecasts, global GDP will grow by 5.9% in 2021 and by 4.9% in 2022, after falling by 3.1% in 2020. The rate of growth is expected to moderate to 3.6% in 2023.

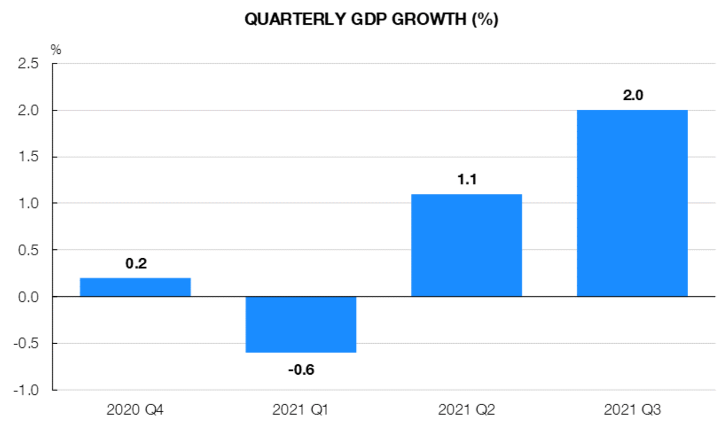
Nevertheless, the pace of recovery is uneven. According to the same forecasts, the advanced economies will return to their pre-pandemic GDP levels next year, but recovery in the emerging market economies is weaker. This is largely due to the slower pace of vaccination.

Also according to the IMF forecasts,[1] euro area GDP is expected to grow by 5% in 2021, allowing it to return to its pre-pandemic level in the fourth quarter, and by 4.3% in 2022. Among the main euro area economies, GDP is expected to grow significantly in France and Italy: by 6.3% and 5.8% in 2021 and by 3.9% and 4.2% in 2022, respectively. Both these countries – like Spain – saw much sharper contractions in 2020. By contrast, in Germany, GDP growth will be lower in 2021 (3.1%), having been revised down owing to the greater impact of the global supply shortage on some industrial sectors.

In any event, this global economic scenario is subject to high uncertainty, owing to a combination of factors. First, the pandemic continues to pose a global threat and the course of the epidemic will continue to affect economic activity, especially in regions with a lower percentage of vaccinated population. Second, the sharp recovery in demand that ensued after the main containment measures were lifted has led to widespread supply chain disruption. Added to this is a sharp surge in commodity prices, which is prompting significant increases in inflation rates in the main countries. I will address all these aspects in my review of the Spanish economy.

1.2 Recent developments in the Spanish economy

SPAIN: GDP RETURNED TO GROWTH IN THE SPRING, DRIVEN BY THE VACCINATION PROCESS AND THE EASING OF RESTRICTIONS ON MOBILITY



SOURCE: INE.

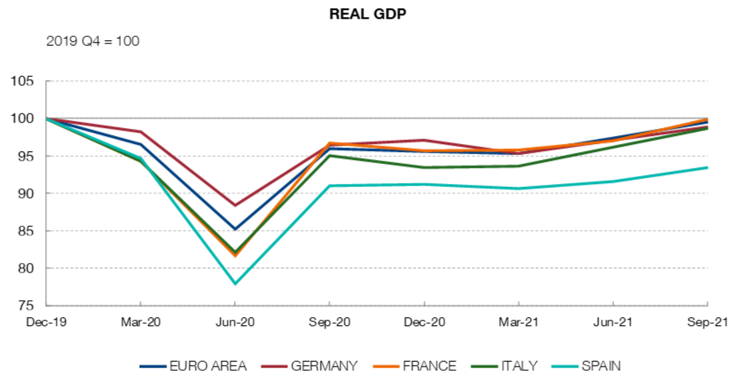
The initial economic impact of the health crisis on our economy was among the largest in the euro area. The gradual recovery has been marked by the subsequent successive waves of the pandemic and by the continued existence of various mobility restrictions.

Following the end of the second state of alert in May of this year, and as the vaccination campaign progressed, the Spanish economy returned to its growth path. GDP rose by 1.1%

[1] The ECB's September forecasts point to growth of 5% in 2021, 4.6% in 2022 and 2.1% in 2023.

and 2% in quarter-on-quarter terms in Q2 and Q3, respectively, underpinned by the strength of private consumption. In particular, spending on services that entail a greater degree of social contact was higher.

SPAIN: GDP IN Q3 WAS STILL 6.6 PP BELOW ITS END-2019 LEVEL (0.5 PP BELOW IN THE EURO AREA)



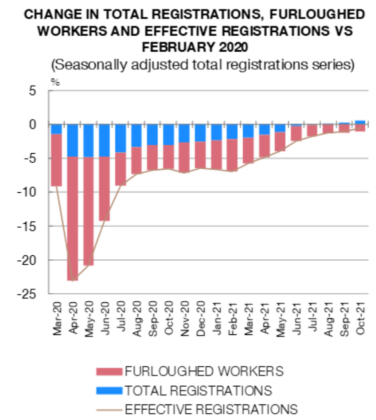
SOURCES: INE and Eurostat.

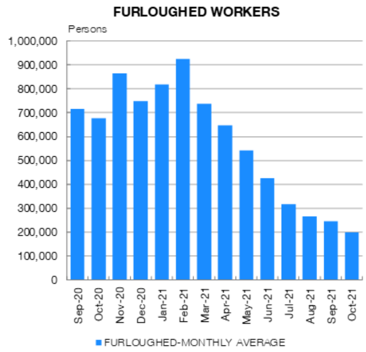
Yet the recovery in activity is still clearly incomplete, as GDP in Q3 was still 6.6 percentage points (pp) below its end-2019 level. Also, the pace of recovery is slower than in other euro area countries: GDP was just 0.5 pp lower than at end-2019 in the euro area, and 1.4 pp lower, for example, in Italy.

The slow pace of recovery is largely due to Spain's higher dependence on tourism, which has been hindered by international travel restrictions. The drop in foreign tourist arrivals prompted a collapse in services exports, which in 2021 Q3 were still 29% below their pre-pandemic levels. This contrasts with the performance of goods exports, which are now 1%

above their pre-pandemic level. However, it also reflects the greater weakness of some domestic demand components, such as household consumption.

EMPLOYMENT IS RECOVERING AT A FASTER PACE THAN GDP. IN OCTOBER, EFFECTIVE SOCIAL SECURITY REGISTRATIONS VIRTUALLY REACHED PRE-PANDEMIC LEVELS





SOURCE: Ministerio de Inclusión, Seguridad Social y Migraciones. Latest observation: October.

In the initial stage of the pandemic, the impact on the labour market was very severe. At April 2020, of total social security registrations before the COVID-19 outbreak, almost one in four persons had either lost their employment or been furloughed.

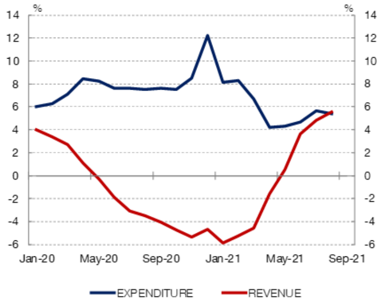
Yet employment is recovering at a faster pace than GDP, seemingly owing to the impact of a set of highly diverse factors. These include the high proportion that the increase in employment in services sectors involving high social interaction (whose productivity level is low compared with that of other sectors) account for in the recovery, and the impact of some of the measures adopted to mitigate the effects of the pandemic (which has led to an increase in employment per unit of output). The growth in public employment in response to the pandemic may have played a part too, and possibly also the early reinstatement of furloughed workers, fostered by expectations of recovery in activity which, in some cases, have not fully materialised.

In October of this year, the number of effective social security registrations (i.e. total registrations excluding furloughed workers) was virtually identical to the February 2020 figure (0.1% lower in seasonally adjusted terms). The data for the first half of November point to a continuation of this positive trend.

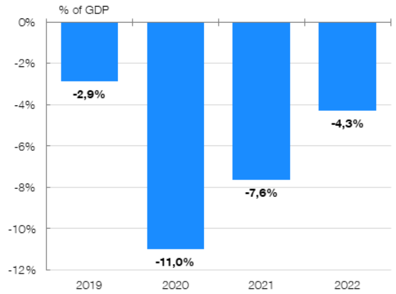
The unemployment rate, for its part, stood at 14.6% in Q3, 1.7 pp below its 2020 level but still 0.8 pp above the pre-crisis level.

THE BUDGET DEFICIT ROSE TO 11% OF GDP IN 2020, OWING ABOVE ALL TO HIGHER EXPENDITURE. IN AUGUST 2021 IT STILL STOOD AT 8.3% (12-MONTH CUMULATIVE)

GENERAL GOVERNMENT REVENUE AND EXPENDITURE (a) (b). 12-MONTH CUMULATIVE
(Year-on-year rate of change)



BUDGET DEFICIT



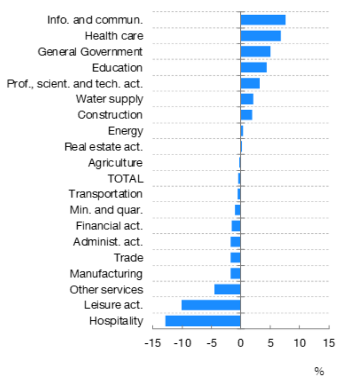
SOURCES: IGAE and INE.
(a) The National Audit Office (IGAE) only provides quarterly data for general government as a whole. Monthly data are estimated drawing on information on the aggregate excluding local government.
(b) Data adjusted by distributing over the entire year each month's extraordinary receipts and spending.

Public finances also deteriorated very significantly as a consequence of the pandemic. In particular, the general government deficit rose to 11% of GDP in 2020, 8.1 pp more than in 2019, owing above all to higher expenditure. Approximately two thirds of the increase of almost €63 billion in public expenditure in 2020 (some 3.7 pp of GDP) related to higher welfare benefits paid to workers and the self-employed, subsidies to firms for social security contributions, and general government spending on health and social care. The decline in government revenue was mainly due to indirect taxation, as the indirect tax take contracted by 11.8%, in line with the indirect tax bases. By contrast, the direct tax take, which fell by just 3%, and revenue from social security contributions, which rose by 0.8%, showed great resilience, thanks to the positive effect on these tax bases of some of the measures rolled out by the Government in response to the pandemic. Overall, government revenue rose as a percentage of GDP in 2020.

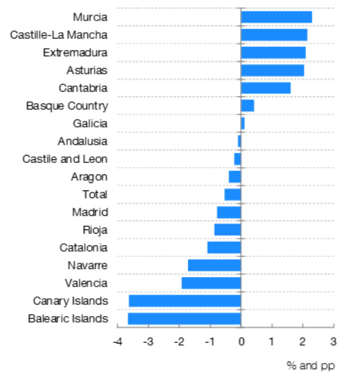
This year, the budget deficit is correcting somewhat, owing to the temporary nature of some of the discretionary measures adopted to address the effects of the pandemic and the cyclical improvement. Nevertheless, at September, the deficit still stood at 8.2% of GDP in cumulative 12-month terms. Public revenue has recovered significantly and expenditure, which still remains well above its pre-pandemic levels, has declined moderately.

THE IMPACT OF THE PANDEMIC REMAINS HIGHLY UNEVEN BY SECTOR, REGION AND POPULATION SEGMENT

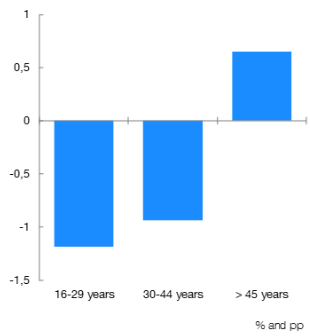
EFFECTIVE S.S. REG. BY SECTOR (a)
CHANGE BETWEEN OCT-21 AND FEB-20



EFFECTIVE EMPLOYMENT RATE
CHANGE BETWEEN 2019 Q3 AND 2021 Q3



EFFECTIVE EMPLOYMENT RATE BY AGE
CHANGE BETWEEN 2019 Q3 AND 2021 Q3



SOURCES: Ministerio de Inclusión, Seguridad Social y Migraciones and INE.
(a) Seasonally adjusted series.

One particularly striking feature of this crisis is the asymmetrical nature of its impact by sector, region and population group.

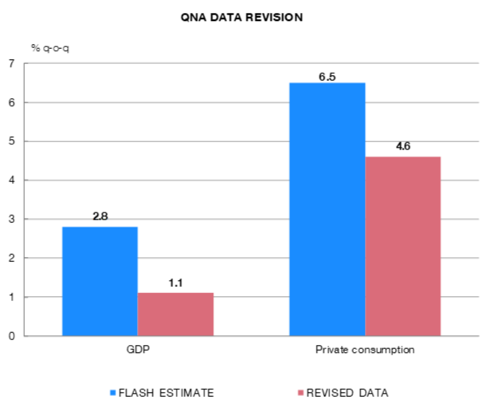
As the pandemic containment measures have been lifted, activity has gradually picked up in the most severely affected sectors, but the impact of the health crisis remains very unequal across sectors. As I indicated earlier, effective social security registrations in the economy overall at October were just 0.1% below their pre-crisis level. Yet they were 12.9% and 10.1% lower, respectively, in hospitality and leisure, while in information and communication and healthcare services effective registrations were significantly above their pre-crisis level (7.6% and 6.8%, respectively).
The different sectoral specialisation is also reflected in the economic impact of the pandemic by region. The effective employment rate for Spain overall in 2021 Q3 was 0.5 pp lower than in 2019 Q3. But in the Canary and Balearic Islands it was respectively 3.6 pp and 3.7 pp lower, while in Murcia and Castile-La Mancha it was respectively 2.3 pp and 2.2 pp higher.

By population group, the crisis is still having a disproportionate effect on certain groups of workers, particularly low-income younger workers with temporary employment contracts, since they account for a high share of employment in the sectors hardest hit by the pandemic. What is more, these effects have corrected only slightly following the start of the recovery. Specifically, the effective employment rate in Q3 was 1.2 pp lower than at the start of the crisis for 16 to 29-year-olds. For the 30 to 44 age group it was 0.9 pp lower, while among older workers it was 0.6 pp higher. This more pronounced impact on more vulnerable workers with more limited income could therefore have resulted in greater inequality.

1.3 Macroeconomic outlook

THE MACROECONOMIC OUTLOOK: FOLLOWING PUBLICATION OF THE BANCO DE ESPAÑA'S SEPTEMBER PROJECTIONS, THE LATEST INFORMATION HAS, OVERALL, BEEN LESS FAVOURABLE

1. **The revision of the Quarterly National Accounts (QNA) published by INE entails a lower level of GDP in 2021 Q2. And GDP growth in Q3 (2%) was lower than projected by the Banco de España in September (2.5%).**
2. **Recent worsening of certain aspects of the external environment: bottlenecks and rising prices of commodities, energy and other intermediate goods.**
3. **However, the most recent information on economic developments in Q4 remains relatively favourable.**



SOURCE: INE.

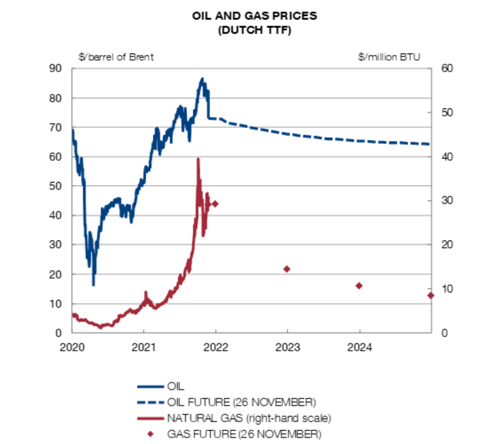
The Banco de España published its latest macroeconomic projections in September. These expected the recovery to continue, under the assumption that the course of the pandemic would improve in Spain and in the rest of the world, that the expansionary stance both of monetary and fiscal demand policies would continue, and that large-scale use would be made of the Next Generation EU (NGEU) funds.

However, since those projections were published, a number of important developments have occurred.

First, GDP growth for 2021 Q2 has been revised down sharply, from the initial 2.8% to 1.1% (there have also been more minor revisions for the preceding quarters). This automatically entails (that is, assuming that the projected growth rates for the coming quarters remain unchanged) a substantial reduction in the average rate of growth of GDP for 2021 and, to a lesser extent, for 2022.

In addition, according to the flash estimate, output rose by 2% in Q3, rather than by the 2.5% estimated by the Banco de España in September.

LESS BENIGN EXTERNAL ENVIRONMENT: BOTTLENECKS, HIGHER COMMODITY AND ENERGY PRODUCT PRICES, AND SIGNS OF ACTIVITY STABILISATION



SOURCES: Refinitiv and IHS Markit.

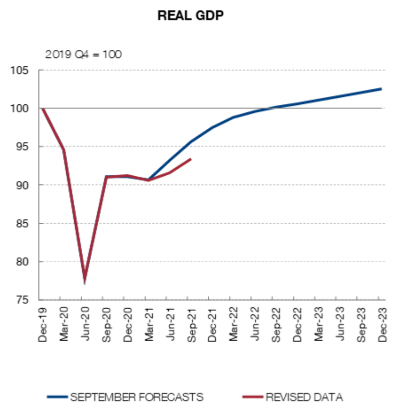
Second, there is growing evidence worldwide of disruptions in global production chains associated with the reopening of economies after the most acute phase of the pandemic. In the case of Spain, the preliminary data from the Banco de España's Business Activity Survey (EBAE) for November show an increase in the percentage of firms stating that their production capacity is being limited by a shortage of materials and/or equipment as a consequence of global supply chain bottlenecks. This is in addition to the rising cost of energy, other commodities and intermediate goods. Overall, these developments tend to point to a deterioration in the global economic environment.

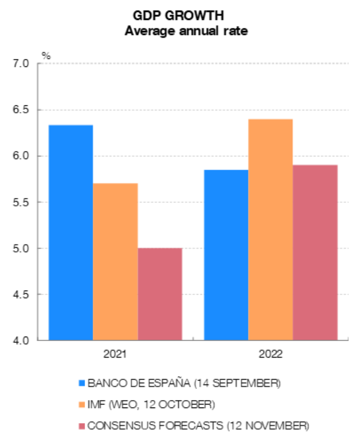
There are various – in some cases interrelated – causes for these disruptions. First and foremost, as a result of the pandemic demand for consumer durables has risen, replacing spending on restricted services and also as a reflection of the acceleration of digitalisation. The supply of consumer durables is relatively inelastic in the short term, as it takes time to increase production capacity. The shortage of supplies such as microchips has translated into bottlenecks in the industry, having most impact on the advanced economies. In this setting, the euro area composite output PMI has been falling since the spring (despite the rebound in the preliminary November data). The largest decline is concentrated in manufacturing (although the services sector has also lost momentum).

The car industry has been particularly hard hit by these disruptions, since it operates with low stock levels (a just-in-time model) and saw a sharp fall in demand during the most difficult months of the pandemic. In recent months, some car manufacturers have had to halt production, stockpile unfinished vehicles and cut their production forecasts for 2021 and 2022.

Moreover, supply and demand mismatches have driven up prices, especially in the case of various industrial metals and transport, and of primary energy sources, such as oil, gas and coal, and secondary energy sources, such as electricity, part of which is generated using some of these primary sources. These higher prices have been passed through to final prices paid by households and firms, compressing their real income and, therefore, with a negative impact on the rate of recovery.

OVERALL: 2021 GDP GROWTH REVISED DOWN TO AROUND 5% BY CONSENSUS FORECASTS. FOR 2022, THE FORECAST NOW STANDS BELOW 6%





SOURCES: INE, IMF and Consensus Forecasts.

Lastly, on the latest available indicators, some degree of economic dynamism appears to have been maintained in Q4, despite this compression of private agents' income and the disruptions in production. In particular, on effective social security registrations data, the labour market continues to behave favourably, although as I indicated earlier, in this recovery employment is performing considerably better than activity.[2] However, the impact of the increase in inflation on households' disposable income, the further build-up of bottlenecks and the recent spread of coronavirus infections in many European countries will

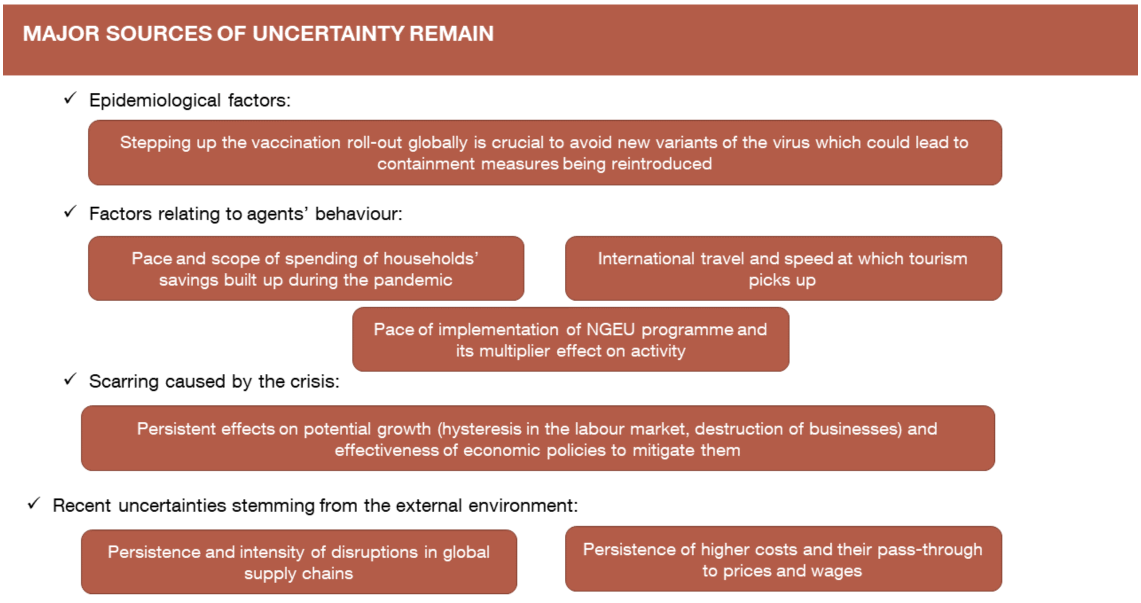
[2] Like GDP growth, employment growth, measured in hours, was also revised down in the revised estimate for Q2. However, in quarter-on-quarter terms, the scale of the revision of employment growth was much smaller: 0.4 pp, to 4%. This illustrates the difficulties faced, in the current recovery phase, to accurately assess the relationship between activity and employment.

probably lead to a small downward revision of quarter-on-quarter GDP growth rates in 2021 Q4 and early 2022.

In coordination with the rest of the Eurosystem, the Banco de España will publish new macroeconomic projections in December. In any event, in view of the developments I have described here, we can anticipate a significant downward revision of growth for the current year in Spain. Indeed, some analysts have already incorporated these latest developments into their projections. Thus, taking the Consensus Forecasts panel, which is monthly, the latest edition, published in mid-November, points to GDP growth of 5% in Spain in 2021, 0.6 pp below the October forecast. Accordingly, over the last two months, analysts have cut their projections by 1.1 pp on average. For 2022, the panel analysts expect GDP to grow by 5.9%, 0.2 pp less than expected a month earlier. The estimates of the analysts who have altered their projections in the last month are slightly more pessimistic: average GDP growth of 4.7% for 2021 and 5.6% for 2022.

On these projections, economic activity will not return to its pre-pandemic levels until around early 2023.

1.4 Main sources of uncertainty

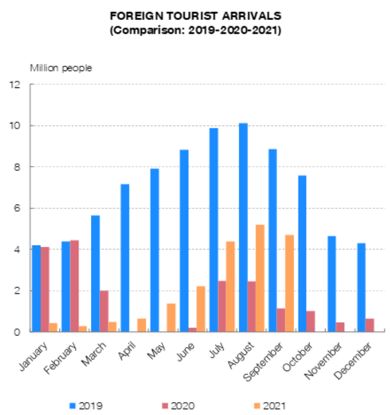


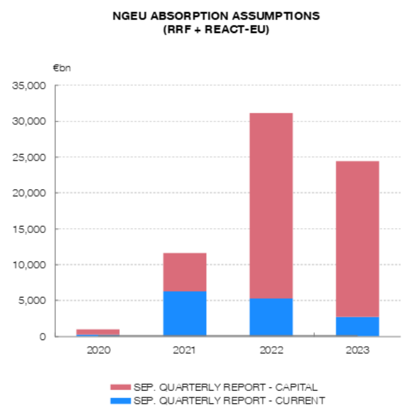
The expectation of recovery is real, but the speed and depth of the recovery are subject to a high degree of uncertainty. In the case of the Spanish economy, the outlook for the coming months depends, above all, on several uncertainties relating to the course of the pandemic, the strength of household consumption, the recovery of tourism, the roll-out of the European funds, the scarring the crisis may leave on the productive system, and the degree of persistence of the bottlenecks and the current inflationary episode. I will now take a brief look at these sources of risk.

First, in our projections we assume that, thanks to the vaccination campaign, the **impact of the pandemic** on economic activity will continue to decline in the coming months. However, as the latest developments in certain central and eastern Europe countries now show, a more adverse course of the pandemic, with rising infection rates, cannot be ruled out. In addition, nor can we rule out more serious infection episodes, linked to a possible spread of more contagious and, in the worst case scenario, vaccine-resistant strains of the virus that would require the re-imposition of containment measures, although the likelihood of such episodes occurring is, in principle, very low. In any event, it is important to note that economies have made great progress in their capacity to adapt to the successive waves of the pandemic.

Second, economic developments in the coming quarters will be influenced by the rate of recovery of private consumption, shaped by households' decisions to spend the **savings accumulated** in 2020 and which account for more than 6% of GDP. In principle, several factors lead to believe that households will make only partial use of these savings in the medium term. Those whose savings have risen the most in comparison with the pre-pandemic period are higher income households whose propensity to consume is generally lower. In addition, a significant portion of the spending that has not materialised since the start of the pandemic owing to the restrictions in place cannot be easily recovered, as it was concentrated on services such as dining out or leisure. Our projections assume that households will make only partial use of these accumulated savings, although we recognise that this assumption is surrounded by a high level of uncertainty.

UNCERTAINTY OVER FUTURE DEVELOPMENTS IN TOURISM FLOWS, THE USE OF NGEU FUNDS AND THE SCARRING THE CRISIS MAY LEAVE





SOURCES: INE and Banco de España.

Third, **tourism exports** are the other demand component that remains subject to great uncertainty. In our September projections we assumed that non-resident tourism volumes would not fully return to their pre-pandemic levels until 2023. Specifically, we assumed, for Q3 of each year which is the high season for tourism, that tourism exports in 2021 and 2022 would reach approximately 45% and 90%, respectively, of their level in 2019, the last pre-pandemic year, and that it would be summer 2023 before they returned to close to that level. But it is not easy to forecast how international tourism will evolve post-pandemic.

The fourth source of uncertainty surrounds the execution of projects associated with the **NGEU** programme which should boost activity in the coming years. Specifically, it should lead to high public and business investment growth rates. The Banco de España first explicitly incorporated the impact of the NGEU programme into its projections in December 2020, once the draft Budget for 2021 provided the first details of the volume of funds allocated for that year. At that point we underlined the high degree of uncertainty regarding the implementation schedule. In practice, the take-up rate has been lower than foreseen in the various projection exercises published subsequently, leading us to transfer, in the September projections, part of the investment flow associated with the European funds from 2021 to 2022 and 2023. Specifically, these projections envisaged that projects worth more than €40 billion would be undertaken between 2021 and 2022, with a significant impact on the rate of growth of GDP in both those years (0.6 pp and 1.8 pp, respectively). In any event, the uncertainty remains very high, both as to when the projects will be executed and their multiplier effect on activity and employment. This will be a decisive factor for economic developments in the coming years.

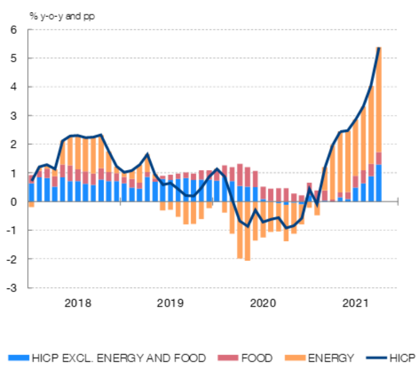
In fifth place, a further unknown is the scale of the long-lasting damage the pandemic may have caused to **employment and the productive system** (in terms of businesses destroyed and higher structural unemployment). The September projections were drawn up under the assumption that the policies deployed since the start of the crisis would, on aggregate, ensure that the damage caused to the productive system and the labour market – in terms of businesses destroyed and higher long-term unemployment – would have a relatively limited impact on the economy. Yet some signs of a deterioration in firms' solvency have been detected, essentially in the sectors hardest hit by the pandemic. Thus, for example, credit quality has deteriorated somewhat in some bank loan portfolios and the numbers of companies being wound up and firms subject to insolvency proceedings have increased, the latter despite the moratorium on these proceedings that will remain in force until mid-2022. In any event, the latest data reflect a certain moderation in these trends. For instance, in May the number of companies being wound up was some 12% above the average 2019 levels, in seasonally adjusted terms, but it has gradually reduced since then, although in September it was still 5% above the pre-pandemic levels.

A sixth source of uncertainty are the **supply bottlenecks** affecting certain energy and non-energy intermediate goods that could persist or even increase, jeopardising the intensity of the recovery. These are impacting industrial sectors in particular; indeed, according to some estimates, they were responsible for a drop of 7% in exports in the first half of 2021 in the euro area overall.[3]

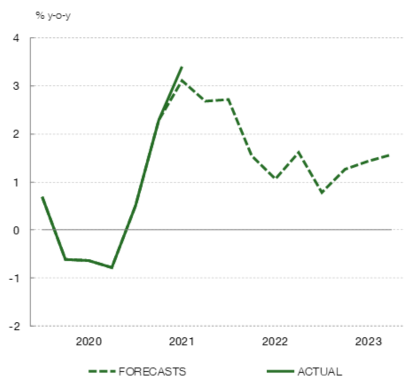
[3] E. Frohm, V. Gunnella, M. Mancini and T. Schuler (2021), "The impact of supply bottlenecks on trade", *Economic Bulletin*, Issue 6, ECB.

UNCERTAINTY OVER THE INTENSITY AND PERSISTENCE OF BOTTLENECKS IN THE SUPPLY OF CERTAIN GOODS AND THE UPTURN IN PRICES

CONTRIBUTIONS (pp) TO THE YEAR-ON-YEAR HICP RATE (%)



HICP: FORECASTS



SOURCES: INE and Banco de España.

Lastly, the recent **increase in inflation** is a key factor affecting the outlook for the Spanish economy. The significant uptick in inflation in Spain, similarly to that seen at the global level, should, in principle, be essentially transitory.[4]

From February, a year after the last month prior to the onset of the pandemic, to November, inflation in Spain has risen from -0.1% to 5.6%.

If we analyse the change between February and October (the last year for which disaggregated data are available), the increase is explained, above all, by energy prices, which contributed 3.7 pp to the inflation rate of 5.4% in October. Energy prices made a larger contribution to inflation in Spain than in the euro area overall. This is because they account for a higher share of our consumption basket and because, in Spain, the responsiveness of retail electricity prices to fluctuations in wholesale prices is above the euro area average. Overall, higher electricity prices accounted for approximately half the increase in the energy component.

However, underlying inflation also increased, from 0% to 1.4%, essentially owing to the services component which rose from -0.1% to 1.6%, while the non-energy industrial goods component went from 0.3% to 0.9%.

The underlying causes of this increase in inflation are essentially transitory and are external to the Spanish economy. Nevertheless, it is also true that the increase is proving to be more persistent than it appeared to be a few months ago and that, in the immediate future, we will continue to see relatively high inflation rates. At the same time, the degree of persistence of the current increases in consumer prices will depend on how long the external shocks last and on the response of domestic agents.

[4] See P. Hernández de Cos (2021), Inflation: recent developments, outlook and monetary policy implications.

Below I outline the various reasons for this assumption that the increase in inflation is based on transitory factors.

The first has to do with the base effects stemming from the fall in 2020 in the prices of some services – such as tourism and leisure – whose consumption was especially hard hit by the pandemic. These positive base effects were especially marked in the case of non-electricity energy goods, a component which fell sharply in 2020 owing to the drop in oil prices. Thus, between February and October 2021, the base effect in this component accounted for 1.3 pp, in cumulative terms, of the increase in headline inflation. In the case of services, the base effects did not surface until summer 2021, but they were responsible for an increase of 0.6 pp. Overall, therefore, around 30% of the growth in inflation is due to these base effects. By its very nature, this effect should, in principle, be purely transitory.

The second factor relates to energy – and especially gas – prices, which have risen very significantly. Indeed, if for example we analyse the Spanish wholesale electricity market, by mid-November prices had multiplied by a factor of 4.4 since the end of last year. Almost 80% of this increase is explained by the rise in gas prices, while the higher price of emission allowances contributed almost 10%. In principle, this price increase is expected to be transitory, as anticipated by the futures markets in these commodities which expect prices to fall throughout 2022, but it may persist in the coming months, given the higher energy consumption during the winter, in a setting in which both oil and gas stocks are relatively low.

A third reason that explains this increase in inflation is the proliferation of bottlenecks, which are obstructing or preventing the correct functioning of value chains and driving up the cost of maritime transport. This has led to a sharp surge in industrial production prices, especially in intermediate goods manufacturing prices. And this despite the fact that, so far, firms are only partially transferring the increase in the prices of their inputs to the selling prices of their products. In other words, they are cutting their margins. In any event, this should also be a transitory factor, insofar as supply is able to adapt to the increase in demand following the reopening of the economy.

There is, however, some uncertainty regarding this price scenario.

The first source of uncertainty is the possibility of the increase in energy and non-energy intermediate product costs filtering through to consumer prices. So far, as I indicated earlier, this has been limited. But if costs continue to rise, for instance owing to delays in the ending of bottlenecks or persistent difficulties restoring normal gas supplies in Europe, it will be more difficult for business margins to continue to absorb these higher costs. Moreover, the evidence shows that intermediate goods prices are transferred through with a certain lag, so past increases could contribute to further inflationary pressure on final goods in the coming months.

Wage developments and, therefore, the possible appearance of second-round effects, are a second source of uncertainty. So far these effects are contained, with wages rising by

1.6% to October, 0.2 pp less than in 2020. However, in the latest collective bargaining agreements signed, the increases agreed for 2021 have risen from 1.1% in January to 1.7% in cumulative terms to October.

One factor that supports the expectation that the scale of second-round effects will be modest is the sharp fall in recent years in the proportion of collective bargaining agreements with indexation clauses (from around 70% before the start of the global financial crisis to 17% today).

Moreover, wage increases are higher in sectors where employment is performing more favourably and, therefore, where there is less slack. In other words, wage increases in certain sectors are, for the time being, consistent with a more favourable cyclical position in some sectors, rather than with widespread, indiscriminate pay increases.

In addition, although it is particularly difficult to estimate the degree of slack in the economy against the backdrop of the pandemic, real GDP in Spain is still some way off its pre-pandemic level, and even further from its pre-crisis trend.

In any event, regarding both the above-mentioned factors, clearly the longer they continue, the greater the likelihood that the growth in inflation will become more persistent, because there will be more filtering through of cost increases to end prices and because the increase in end prices will give rise to greater wage demands.

Another point to consider is that the Spanish economy is highly dependent on energy from abroad. Accordingly, the present shock entails a deterioration of real terms of trade and, therefore, real income losses for households and firms, with potentially adverse effects on consumption and investment. In fact, real wages are falling and firms' profit margins are narrowing. And although the high savings accumulated by households during the crisis should mitigate these negative effects, a very significant portion of these savings belong to high income households which normally have a relatively low propensity to consume.

It is clear, therefore, that the current inflationary episode introduces an added risk to activity. In the specific case of the growth in electricity prices, the internal estimates we have obtained through various methodologies may serve as a guideline. They point to an impact of 0.2 pp to 0.3 pp of GDP after three years for a permanent increase of 10% in the electricity price paid by consumers.

1.5 The role of economic policy in the present situation

THE ROLE OF ECONOMIC POLICY IN THE CURRENT SITUATION

1. **In the current and foreseeable context, monetary and fiscal policy should avoid a premature withdrawal of stimuli.**
   - **1.1 Recent inflation developments remain consistent with a return to a situation of moderate inflationary pressure in the medium term. Thus, the monetary policy approach should remain patient in terms of any future revision of the current accommodative stance.**
   - **1.2 Fiscal policy support will be necessary in 2022, but on a more selective basis, focusing on firms and population segments still affected by the crisis and for a limited period of time to avoid expanding the structural deficit.**
2. **In parallel, efforts should begin to design a consolidation programme to gradually reduce the high budget deficit and public debt, with a view to launching the programme once the recovery has taken hold.**
3. **Economic policy should also help firms and workers adapt to the new economic reality arising from the pandemic. This will require allowing the use of the adjustment mechanisms provided for by legislation, and ensuring that they can adapt to firms' specific conditions, improve debt restructuring procedures and strengthen training policies and job-search assistance for workers.**
4. **Medium-term challenges should likewise be addressed with a resolute agenda of structural reforms, likewise supported by the use of the European funds.**

The rapid and robust economic policy response to the pandemic has been vital to mitigate its effects. The unprecedented magnitude of the shock was met with an equally unprecedented economic policy response, which has eased the short-term costs, averted even more extreme adverse scenarios and will probably lessen the medium and long-term damage from the crisis. Two examples of the robustness of this response are the European Central Bank's pandemic emergency purchase programme (PEPP) and the increase in the euro area budget deficit of more than 6.5 points of GDP in 2020.

The recovery remains subject to many uncertainties and depends also on future economic policy. The damage caused by a premature withdrawal of support measures from the agents concerned could exceed the possible costs of keeping such measures in place until the recovery shows signs of sufficient solidity.

In the case of monetary policy, to analyse the implications of the present situation our starting point should be the ECB's new strategic framework, which establishes a symmetric medium-term inflation target of 2%.[5] As I indicated earlier, the latest inflation developments are still consistent with a return to moderate inflationary pressure in the medium term. Hence the need for a patient approach when reassessing the present accommodative monetary policy stance, with a view to steadying the medium-term inflation rate around 2%.[6] Nevertheless, we must be on the lookout for possible signs of deanchoring of expectations, as this would be the main factor that could make this high inflation episode more persistent.

Regarding fiscal policy, an expansionary stance must be maintained, but it should be increasingly targeted on the sectors and agents hardest hit by the crisis and on medium and long-term growth considerations. Thus, it is crucial to identify possible changes and structural damage. Economic policy should not indefinitely sustain activities whose share in

[5] See P. Hernández de Cos (2021), The European Central Bank's new monetary policy strategy.
[6] See P. Hernández de Cos (2021), Inflation: recent development, outlook and monetary policy implications.

the future economy could be structurally diminished, but rather should help them adapt to the new reality and to efficiently reallocate resources.

It is also important that the measures taken be temporary, so as not to add to the structural deficit. And once the pandemic is over, fiscal space must be regained and government debt reduced, via a gradual multi-year strategy. This process should be designed in advance, to be implemented as soon as the recovery takes firm hold. I will refer to this question later in more detail.

In the case of the corporate sector, it remains important, for example, that assistance be focused on reversing the deterioration in solvency caused by the crisis at firms that are considered viable. On 23 November the Spanish Council of Ministers extended some of the support measures for the corporate sector to mid-2022. This could help, by enabling viable firms that have been harder hit by the crisis and whose business is recovering at a slower pace to benefit from this assistance for longer.

Moreover, economic policy should help firms adapt to the new post-pandemic reality. This will require, first, enabling the use of the adjustment mechanisms available under existing legislation – particularly labour legislation – and ensuring that they are tailored to the specific conditions of firms.

Second, court and out-of-court insolvency proceedings need to be more efficient, to enable a larger number of viable firms to survive and provide for the orderly market exit of non-viable firms.[7] In this respect, on 3 August the Council of Ministers approved the draft Insolvency Law Reform Bill which introduces sweeping changes to the pre-insolvency arrangements and insolvency proceedings that govern insolvency for firms, the self-employed and consumers.

Regarding the labour market, it is essential that the reform proposals currently under discussion continue to provide firms with tools that will allow them to adapt employment conditions to the cyclical position and to the specific situation of the different productive sectors and firms. This is particularly important in the wake of the pandemic, given the very different positions from which each sector and firm will face the current situation and future challenges. An overall approach is also desirable, to address all the main structural shortcomings of the labour market, such as our high unemployment and temporary employment rates, in particular with a fairer and more efficient distribution of protection among workers. Lastly, active labour market policies must be improved, to prevent the loss of human capital among workers who have lost their jobs and to facilitate their reallocation to sectors with more future in the post-pandemic world.

Taking a more long-term view, the structural challenges that the Spanish economy faced before the pandemic, and which have now gained relevance, must also be considered. These include, in particular and in addition to the inappropriate functioning of our labour

[7] See M. García-Posada Gómez (2020), Analysis of insolvency proceedings in Spain against the backdrop of the COVID-19 crisis: insolvency proceedings, pre-insolvency arrangements and the insolvency moratorium, *Occasional Paper* No 2029, Banco de España.

market, our low productivity, the fight against climate change, population ageing and high inequality. Others, such as the challenges stemming from digitalisation, have emerged or intensified as a result of the pandemic. All these challenges can only be addressed with a resolute structural reform agenda, underpinned also by the take-up of the European funds.[8]

THE ROLE OF ECONOMIC POLICY IN THE CURRENT SITUATION (II)

5. Lastly, economic policy should be properly managed in the current context of rising inflation:

- This is one more argument justifying the selective approach of fiscal policy, avoiding the widespread use of indexation in expenditure items.

- The support required for vulnerable households to withstand the inflationary bout must be accompanied by a profound reflection on the potential structural shortcomings of our energy market.

- Firms and workers must internalise the essentially transitory nature of the rise in prices and seek a fair distribution of the diminished income in the national economy compared with the rest of the world that the recent cost increases entail, in many cases concentrated on goods and services that our economy needs, but does not produce.

Lastly, I wish to mention, as the main development with respect to my previous appearances, the added challenge that the current inflationary episode poses for correct economic policy management. The latest developments make for a complex setting for economic policy. Previous to the pandemic, the ECB had experienced difficulties reaching its inflation target over a very long period. Against this backdrop, and as I indicated earlier, the ECB's Governing Council is determined to continue to provide the necessary monetary stimulus to enable inflation to reach the 2% target on a permanent basis in the medium term, without responding prematurely to temporary shocks.

Fiscal policy must adopt a medium-term perspective in which, once the recovery takes a firm hold, fiscal consolidation becomes a priority. As I have just underlined, this does not mean that we should cease to provide support for the parts of society that are bearing the brunt of the consequences of the pandemic and the current increase in inflation. But it is an additional argument in favour of selective support measures rather than a widespread fiscal impulse that could amplify the existing bottlenecks in the most stressed sectors and ultimately result in added inflationary pressure.

Lastly, firms and workers need to internalise the essentially transitory nature of some of the main factors behind the current rise in prices. They need to seek a fairer distribution of the diminished income in the national economy vis-à-vis the rest of the world that the recent cost increases entail and which are concentrated in many cases on goods and services that our economy demands but does not produce, be they intermediate goods for the production process or final consumer or investment goods. Otherwise, we might fuel a price-cost

[8] P. Hernández de Cos (2020), "The main post-pandemic challenges for the Spanish economy", Appearance before the Parliamentary Committee for the Economic and Social Reconstruction of Spain after COVID-19 – Congress of Deputies.

feedback loop, with adverse effects for competitiveness, economic activity and, ultimately, our personal well-being.

2 Draft State and Social Security Budget

I will now analyse the main items of the draft State Budget for 2022 which was submitted to Parliament on 13 October.

Before entering into this discussion, I wish to highlight two important points. First, the draft Budget has been drawn up in a setting in which the escape clause that permits temporary suspension of the fiscal rules remains in force for 2022, as it was in 2021. This eases the requirements for budget deficit and government debt correction, to allow fiscal policy support to mitigate the economic consequences of the pandemic.

Second, on 15 October the Government published its draft budgetary plan. This new information allows me to extend my analysis of the budgetary situation to general government as a whole, rather than confining it to the State and Social Security. As a final clarification, unless otherwise indicated I will refer at all times to the figures of the consolidated State, Social Security and General Government Budget, excluding the NGEU funds which I will analyse in detail later.

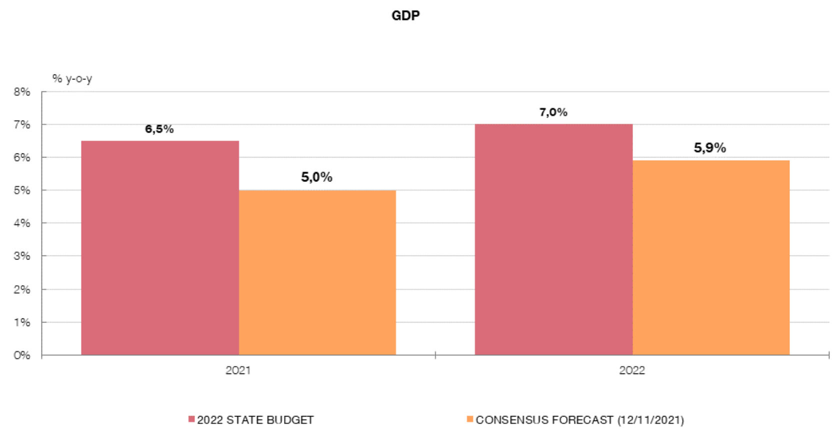
2.1 Macroeconomic forecast

The draft Budget for 2022 sets out a macroeconomic scenario in which GDP is expected to grow by 6.5% this year and by 7% in 2022.

These assumptions project a more favourable economic scenario than that envisaged in our September 2021 projections, which as I have indicated earlier will be revised down in a few weeks' time in view of the latest available information. Our view that growth will be lower than forecast in the September projections is shared, in general, by other public and private institutions. Thus, for example, the GDP growth assumed in the Budget is approximately 1.5 pp higher for 2021 and 1 pp higher for 2022 than the private analyst consensus average.[9]

[9] The IMF forecasts growth of 6.4% for 2022, 0.6 pp below the Budget estimates.

MACROECONOMIC FORECAST: THE GROWTH FORECAST FOR REAL GDP INCLUDED IN THE DRAFT BUDGET EXCEEDS THE ANALYSTS' CONSENSUS FOR BOTH 2021 AND 2022



SOURCES: Ministerio de Hacienda y Función Pública, INE and Banco de España.
a) Projections cut-off date: 14 September 2021.

As regards prices, the Budget expects the private consumption deflator to grow by 1.3%, 0.2 pp lower than the Banco de España's September forecast. However, if we update those projections relatively automatically based on the latest available information, the average rates of change of the harmonised index of consumer prices (HICP) for 2021 and 2022 would be revised up by some 1 pp to around 3% for this year and next.

In the case of the budget deficit and government debt ratios, it is important to take into account nominal GDP and, therefore, both real economic output and its deflator. Under the Budget, nominal GDP is expected to grow by 7.8% in 2021. This may be considered a relatively optimistic estimate, as a consequence of the growth forecast for real GDP, while the estimate for the GDP deflator is in keeping with the latest information. For 2022, the nominal GDP growth rate projected is in keeping with the latest developments, although it is the result of two effects that offset each other, since real GDP growth can be expected to be lower and growth in the GDP deflator to be higher.[10]

The recent acceleration in prices has effects of opposite sign on public finances. First, on the revenue side, a higher increase in consumer prices leads to higher VAT revenues. The pass-through to other tax bases, such as personal income tax, depends on whether or not the rate of change of personal income is similar to the rate of change of consumer prices. In any event, no adjustment for inflation of the tax rate means that higher nominal incomes will face higher tax brackets. However, there are also other effects that cannot be easily quantified, which means that the final impact on the deficit is ambiguous. This is because it depends on the elasticity of tax bases to changes in prices and on the impact of inflation on public expenditure (a relevant consideration, considering that part of this expenditure – for example pension expenditure – is indexed to inflation). Whether the increase in inflation has been incorporated into the draft budgetary plan, or appears unexpectedly during budget execution, is also important to determine its effects on the budget deficit.

[10] In any event, insofar as nominal GDP growth in 2021 is lower than forecast in the Budget, nominal GDP in 2022 will be lower.

Moreover, the current inflationary episode stems from imported prices. The pass-through to domestic prices is expected to be limited. Should it be high, a potential acceleration of the GDP deflator, considered in isolation, would reduce the real value of government debt expressed as a ratio to GDP.[11]

These reflections illustrate the numerous effects and the difficulties in determining, *a priori*, their net impact, but they may serve as a guide to understand the effects of inflation on public finances. Ultimately, these effects will be shaped by two interrelated considerations: the degree of persistence of higher consumer price inflation and the extent to which it is passed through to other nominal variables.

As we have seen, the available information suggests that this inflationary episode could be transitory and could essentially be confined to import prices. In any event, it is also important for public finances that it be closely monitored, so as to understand, among other things, its impact on the fiscal aggregate forecasts contained in the draft Budget.[12]

For 2021, in principle, the increase in energy inflation should drive up tax bases, but this will be countered by the entry into force of offsetting measures.[13] On the expenditure side, the effect of higher inflation will be primarily concentrated on the components that have a closer relationship with inflation, such as pensions, owing to the compensatory payment that pensioners will receive in the year. From a broader time perspective, as I said earlier, the fact that certain expenditure items are linked to inflation will increase its possible impact on public finances.

2.2 Projected government receipts

The draft Budget estimates that revenues will grow by 8% in 2022 compared with the 2021 outturn projection. This increase is explained by the changes expected in tax bases, the delayed impact of the 2021 measures (€2 billion on the Government's estimate) and the disappearance of the COVID-19-related social security contribution exemptions, since the Government estimates that the new tax measures will have no impact on revenue in 2022.

Below I will base my analysis of the projected government receipts on three aspects: the 2021 outturn projection, the new measures for 2022, and the risks to the projection.

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[11] Increases in nominal GDP stemming from higher growth in prices would affect the real value of issued debt. The empirical evidence available suggests that sovereign yields efficiently factor in information on changes in inflation expectations.

[12] See P. Hernández de Cos, S. Hurtado, F. Martí and J. Pérez (2016), (2016), Public finances and inflation: the case of Spain.

[13] See Royal Decree-Law 12/2021 of 24 June 2021 adopting urgent measures on energy taxation and energy generation, and on management of the water regulation fee and water charges.

GOVERNMENT RECEIPTS: ACCORDING TO THE BUDGET OUTTURN PROJECTION, TAX REVENUE IN 2021 WILL BE LOWER THAN INITIALLY PROJECTED

QUANTIFICATION OF THE REVENUE-RAISING IMPACT OF THE MAIN REVENUE MEASURES PROPOSED IN THE DRAFT STATE BUDGET FOR 2022

€m		Initial budget 2021	Budget outturn projection 2021	Difference
TAXES INCLUDED IN STATE BUDGET FOR 2021		**1412**	**1012**	**400**
VAT:	Sugary beverages	340	240	100
PERSONAL INCOME TAX:	Rates for high-income earners	144	144	0
CORPORATE INCOME TAX:	Exemption for overseas income	473	173	300
OTHER INDIRECT TAXES:	Higher rate on insurance premiums	455	455	0
OTHER TAXES NOT INCLUDED IN STATE BUDGET FOR 2021		**3170**	**495**	**2675**
ENVIRONMENTAL TAXES:	Plastic containers	491		491
	Landfill waste	861		861
OTHER INDIRECT TAXES:	Digital services	968	155	510
	Financial transactions	850	340	813
TOTAL		**4582**	**1507**	**3075**
as % of GDP		**0.38**	**0.12**	**0.25**

SOURCES: 2022 Draft Budgetary Plan and Banco de España.

First, the 2021 outturn projection records a revenue shortfall of some €3.1 billion compared with the initial estimate. This deviation is explained by lower than expected tax revenue (€6.7 billion lower), which is only partially offset by higher than initially expected revenue from social security contributions (€3.6 billion higher).

Almost half of the tax revenue shortfall (€3 billion) is explained by the lower revenue-raising capacity of the new tax measures introduced in 2021 and by the fact that some of the measures announced were not finally implemented. By order of magnitude of the current projected deviation, the taxes on financial transactions and certain digital services, the limit on double taxation exemptions for large corporations and the higher rate of VAT on sugary drinks stand out, in addition to the taxes on single-use plastic containers and landfill waste, neither of which were introduced. These observations underline the importance of prudently assessing the effects of discretionary revenue-raising measures, especially where there is scant evidence on their impact, as in the case of the introduction of new taxes.

Second, the Budget includes two new tax revenue measures. In the case of corporate income tax, a minimum rate of 15% is set on the tax base of consolidated groups, or companies with turnover equal to or over €20 million.[14] In personal income tax, the general limit on deductions for contributions to individual pension schemes is reduced from €2,000 to €1,500. Also, the limit on deductions for contributions to corporate pension schemes is raised from €8,000 to €8,500. According to the draft Budget estimates, these measures will have a very minor impact in 2022.

[14] This minimum rate will be 10% for newly created companies and 18% for credit institutions and oil and gas exploration.

GOVERNMENT RECEIPTS: THE NEW TAX MEASURES WILL HAVE LITTLE IMPACT ON REVENUE IN 2022

QUANTIFICATION OF THE REVENUE-RAISING IMPACT OF THE MAIN REVENUE MEASURES PROPOSED IN DRAFT STATE BUDGET FOR 2022

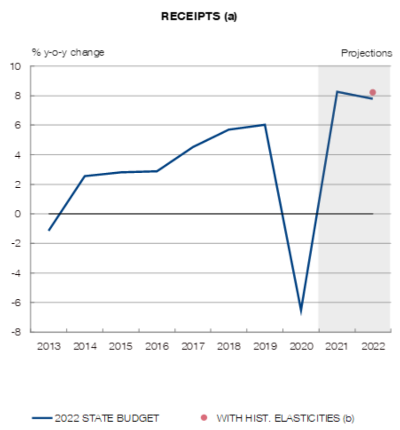
€m		Incremental effect	
		2022	2023
MEASURES INCLUDED IN STATE BUDGET FOR 2022		**0**	**498**
PERSONAL INCOME TAX:			
	Additional reduction in pension plan deductions		77
CORPORATE INCOME TAX:			
	Minimum rate of 15% and reduction of tax relief on residential rental income		421
TOTAL		**0**	**498**
as % of GDP		**0**	**0.04**

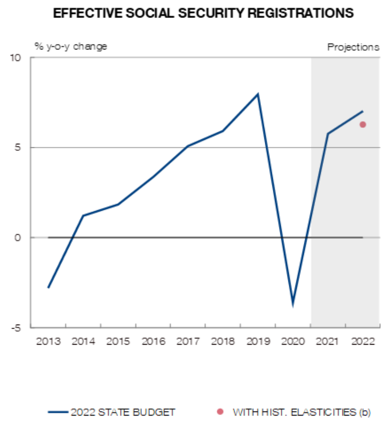
SOURCES: 2022 Draft Budgetary Plan and Banco de España.

Lastly the risks to government receipts are on the downside.

First, if we combine the macroeconomic forecasts in the Budget with the models used by the Banco de España, we obtain a slightly optimistic forecast of revenue from social security contributions, which could be partially offset by prudent expectations for revenue from other taxes.

GOVERNMENT RECEIPTS: CONTINGENT ON FULFILMENT OF THE MACROECONOMIC FORECASTS OF THE DRAFT STATE BUDGET, PROJECTED REVENUE IS IN LINE WITH HISTORICAL ELASTICITIES, BUT SUBJECT TO DOWNSIDE RISKS IN THE EVENT OF LOWER-THAN-EXPECTED ECONOMIC GROWTH





SOURCES: 2022 State Budget 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. Historical elasticities estimated by the European Commission and 2022 State Budget measures.

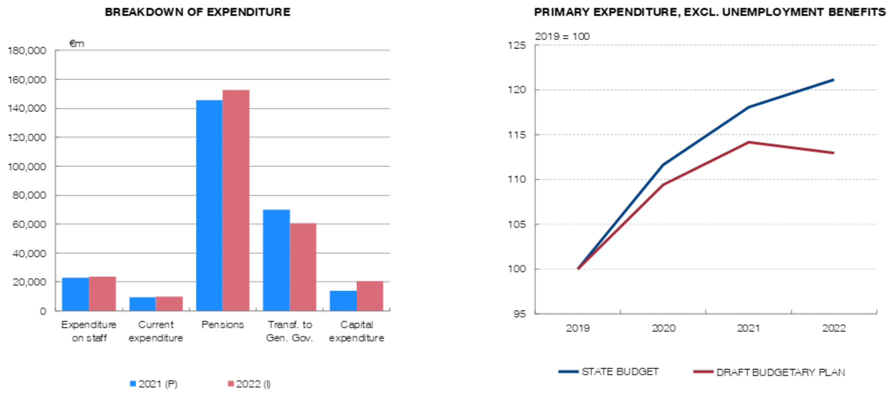
Second, if economic growth is lower than projected in the Budget, the growth in tax bases and, therefore, in revenue, would also be lower, although this effect could be partially offset by higher growth in the deflator.

2.3 Public expenditure

The draft Budget forecasts a 2.3% increase in expenditure in 2022 compared with the 2021 outturn projection. This higher spending takes place against a background of containment of items that are particularly sensitive to the economic cycle, such as unemployment benefits or other transfers to the rest of the general government sector in connection with the management of the health crisis. However, such containment has been amply offset by the increase in pensions and capital expenditure. I shall now analyse in greater depth the composition of the projected increase in spending and the path of this aggregate over a longer time frame, including the start of the pandemic.

First, regarding the expenditure composition, the draft Budget forecasts an increase in spending on pensions and staff (€7 billion and €1 billion, respectively). Similarly, capital expenditure, which includes gross fixed capital formation and capital transfers, is expected to increase by €6.5 billion. In addition, there are other sources of increased spending, such as the rental housing voucher and new cultural voucher for young people, the amount of which is negligible according to Government estimates. Conversely, the economic recovery is expected to lead to a contraction of certain spending items. Thus, for example, a reduction is forecast in unemployment expenditure, placing this item at 37% below its 2020 figure, though still 18% above 2019 spending. The improved economic situation is also expected to entail lower spending on pandemic management, especially by regional governments, which would account for the reduction of almost €10 billion in current transfers to the rest of general government.

GOVERNMENT EXPENDITURE: INCREASED EXPENDITURE ON PENSIONS AND CAPITAL TRANSFERS, PARTLY OFFSET BY LOWER TRANSFERS TO OTHER GENERAL GOVERNMENT SECTORS



SOURCES: European Commission, 2022 Draft Budgetary Plan and Banco de España.

However, expenditure developments are not free from major sources of uncertainty. Specifically, as regards spending on pensions, the forecast in the draft Budget evidences some upside risks arising from inflation developments. As I mentioned earlier, the latest available information indicates an upward surprise in the pace of inflation in the final months of the year, with respect to the draft Budget projections. Thus, according to the analysis conducted by the Banco de España, pension spending may be some €1.5 billion above the figure envisaged in the draft Budget for 2022. Compounding this possible slippage would be the estimated cost of compensation relating to 2021 pensions, which could mean an additional €2 billion.

GOVERNMENT EXPENDITURE PROJECTIONS: MAIN RISKS

1. **The increase in budgeted capital transfers (+€6.5 billion) added to the use of the Recovery and Resilience Facility (RRF) funds (€22.4 billion) is unprecedented and could give rise to significant under-implementation risks.**
2. **Upside risks in pensions, if the rise in inflation in the closing months of this year is higher than forecast in the Draft State Budget.**
3. **Interest charges are forecast to increase somewhat above the amount estimated using Banco de España models.**

As for capital expenditure, it should be borne in mind that the increase forecast in the Budget is on top of that stemming from the NGEU funds, which is expected to amount to €22.4 billion in 2022 from the Recovery and Resilience Facility (RRF), to support the economic recovery under way. Overall, these two sources account for an unprecedented volume of investment for the Spanish economy, which may come up against major difficulties when it comes to implementation. By way of example, in the recent past, the outturn percentage for investment has been lower than that of other items, standing at around 90%.

Lastly, the Budget forecasts an increase of €3.3 billion in interest charges compared with the 2021 outturn projection, above the amount estimated by the Banco de España models.

In short, analysis of the expenditure composition in the draft Budget suggests something of a shift in public expenditure from items that are increasingly less squeezed as a result of the economic recovery towards spending on investment projects, and especially other current expenditure items such as pensions.

In a country as decentralised as Spain, it is difficult to properly assess spending policies without an overall view of general government spending. That is why it is so important to supplement the information contained in the draft Budget with that provided by the draft budgetary plan. In this connection, the Budget envisages a 2.3% increase in State and Social Security spending, compared with the 2.1% reduction for overall general government under the draft budgetary plan. Bearing in mind the difficulties in comparing the two sources for accounting purposes,[15] these differences would suggest a reduction in regional

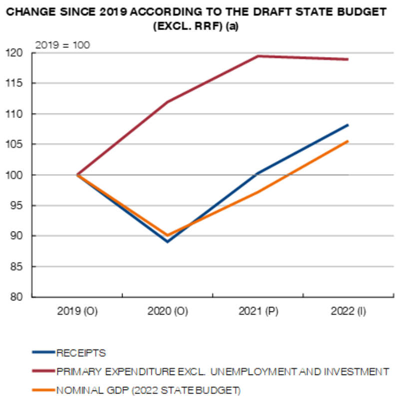
[15] Note that different accounting methods are used for the draft Budget and the draft budgetary plan: whereas the former uses the cash basis principle, the latter is prepared on the basis of the National Accounts accrual convention.

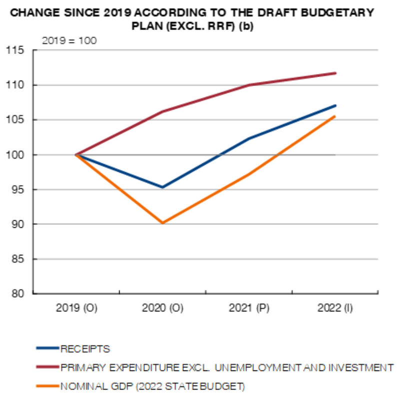
government spending, which is consistent with the significant decline in pandemic-related health spending, which has been undertaken mainly by general government.

I would like to conclude my analysis of spending from a longer time perspective. Public expenditure increased substantially in 2020 and 2021 owing to the health crisis, unlike nominal GDP and government receipts. The draft Budget envisages growth in government receipts (8%) and nominal GDP (8.6%) in 2022, partly reversing these trends, although public spending will continue to increase (by 2.3%).

As I have previously discussed, a significant portion of this increase does not appear to be directly related to the exceptional circumstances arising from the health emergency. In this respect, excluding the items related to unemployment benefits and public investment, and to construct an approximate structural current expenditure metric, primary State and Social Security expenditure is expected to increase by 18.9% compared with 2019, contrasting with increases of 8.3% and 5.6% in the case of receipts and nominal GDP, respectively. For overall general government, the increase in spending between 2019 and 2022 is 11.7%, according to the draft budgetary plan, compared with the 7% increase in the case of total receipts. Given that the increase in expenditure appears to have a structural component, these figures illustrate the importance and scale of the fiscal consolidation challenge that will have to be addressed once the recovery is confirmed after the pandemic.

GOVERNMENT EXPENDITURE WILL REMAIN SUBSTANTIALLY ABOVE PRE-CRISIS LEVELS



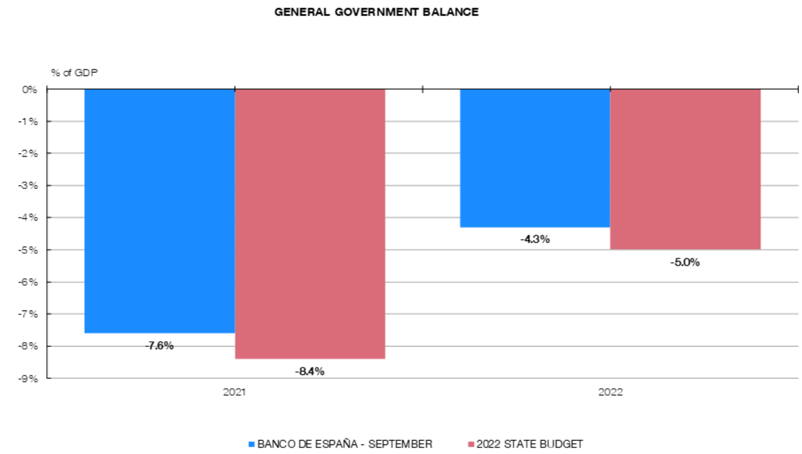


SOURCES: 2022 Draft Budgetary Plan and Banco de España.
(a) Values in cash terms.
(b) Values in National Accounts terms.

2.4 The budget deficit target and the fiscal policy stance

The draft Budget estimates that the overall general government budget deficit will be 8.4% of GDP this year, falling by 3.4 pp to 5% in 2022. There are two risks that, operating in opposite directions, would affect fulfilment of this target. First, as I have mentioned earlier, the macroeconomic projections accompanying the draft Budget are subject to downside risks. The materialisation of these risks would generate an increase in the budget deficit. However, historical evidence indicates that execution of public investment expenditure, one of the items that most increases in the draft Budget, is usually significantly below the initially budgeted spending. Accordingly, the projection for overall general government expenditure would be subject to downside risks, which could offset the risks to the budget deficit arising from potentially lower economic growth. Similarly, it should be borne in mind that the 2021 budget outturn figures show greater-than-expected buoyancy of tax revenue, which could lead to a lower than projected budget deficit at end-2021.

BUDGET DEFICIT: REDUCTION OF 3.4 PP IN GDP TO 5%. THE UPSIDE RISKS TO THIS PROJECTION, IN THE EVENT OF LOWER-THAN-FORECAST ECONOMIC GROWTH, COULD BE OFFSET BY POTENTIALLY LOWER-THAN-EXPECTED CAPITAL TRANSFERS AND DEFICIT AT END-2021



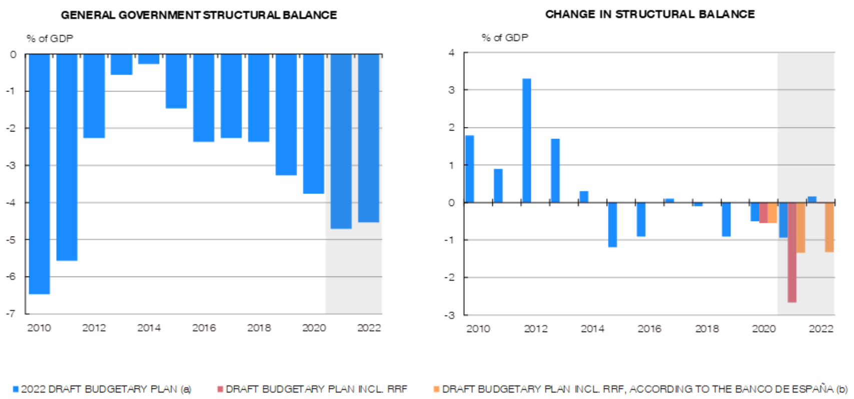
SOURCES: Ministerio de Hacienda y Función Pública, INE and Banco de España.
a) Projection cut-off date: 14 September 2021.

The fiscal policy stance, which is a measure of the economic stimulus provided by general government, is not an easily quantifiable concept given the difficulties in correctly identifying what point of the cycle we are at, especially in a setting such as the present one, of an asymmetrical recovery following a severe shock. Aside from these difficulties, when considering the fiscal policy stance by taking the change in the structural budget balance, the effect of the European funds channelled through the RRF should also be included. These funds do not affect the level of the deficit in accounting terms, but they do bear on the fiscal policy stance in that they entail a significant increase in spending. However, given the financing arrangements involved, they are not the outcome of receipts raised directly from resident agents.

The fiscal policy stance, measured by the change in the structural balance contained in the draft budgetary plan, would thus go from being expansionary in 2021 (-0.9 pp) to being practically neutral in 2022, once the impact of the European funds is included. However, considering the timing of the spending of the European funds envisaged in the Banco de España's projections, the fiscal policy stance would be significantly expansionary in 2022. This divergence is because our scenario envisages a lower outturn of RRF-related spending in 2021 than the draft budgetary plan, while both sources envisage a similar level in 2022, entailing an increase in public spending next year and thus resulting in a greater fiscal stimulus during that year.[16]

[16] Aside from the analysis of the change in the structural balance, the markedly negative level that this variable will continue to post in 2022 suggests that fiscal policy will continue to provide economic stimulus during that year. In a recent report, the European Fiscal Board advocates using the level of the structural primary balance to define the fiscal

IN ANY EVENT, THE FISCAL POLICY STANCE REMAINS EXPANSIONARY AND THE SIZEABLE STRUCTURAL DEFICIT IMPAIRMENT DURING THE CRISIS IS CONFIRMED



SOURCES: European Commission, 2022 Draft Budgetary Plan and Banco de España.
(a) The structural balance of the Draft Budgetary Plan for 2010-2019 is obtained from European Commission forecasts.
(b) Obtained by combining the structural balance in the Draft Budgetary Plan with RRF-related spending estimated by the Banco de España.

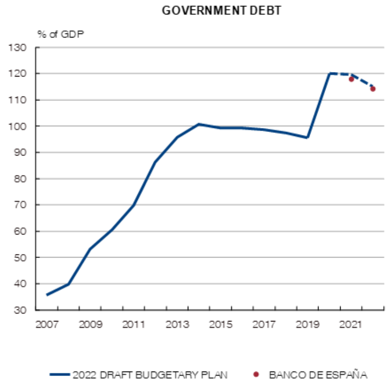
2.5 Public debt

Allow me to conclude my assessment of the draft Budget with some brief comments on public debt. According to the draft budgetary plan, the public debt-to-GDP ratio is estimated to have peaked in 2020, initiating thereafter a very gradual downward path. This decline is expected to be around 4.5 pp in 2022, leaving the ratio at close to 115%, and would be due exclusively to the growth of nominal output, which would more than offset the increases in debt prompted by the budget deficit and interest payments.[17] In any event, the path of this variable is highly conditional upon macroeconomic developments, meaning that a slower-than-expected economic recovery would bear negatively on the projected path of the public debt ratio. Higher-than-expected growth in the GDP deflator would have the opposite effect.

policy stance. The Board thus recommends referring to the change in the structural balance as "fiscal impulse" and to the level as "fiscal position" or "fiscal stance".

[17] Stock-flow adjustments, which according to the draft budgetary plan would not contribute to the change in the public debt ratio in 2022, reflect the set of transactions and flows that do not affect the deficit, but do have a bearing on debt (and vice versa). Thus, for instance, NGEU grants received do not have an impact on the budget deficit, but may indeed affect public debt if the volume of these grants does not match, in a specific year, the expenditure outturn.

GOVERNMENT DEBT: GDP IS EXPECTED TO FALL BY 4.5 PP IN 2022 AS A RESULT OF NOMINAL ECONOMIC GROWTH



BREAKDOWN OF CHANGE IN GENERAL GOVERNMENT DEBT ACCORDING TO THE 2022 DRAFT BUDGETARY PLAN

	2020	2021	2022
Debt as a % of GDP	120.0	119.5	115.1
Debt change (in pp of GDP)	24.4	-0.4	-4.5
Owing to:			
Balance	8.7	6.2	3.0
Interest paid	2.2	2.1	2.0
Nominal rate of GDP change	10.4	-8.7	-9.5
Stock-flow adjustments	3.0	-0.1	0.0

SOURCES: 2022 Draft Budgetary Plan and Banco de España.

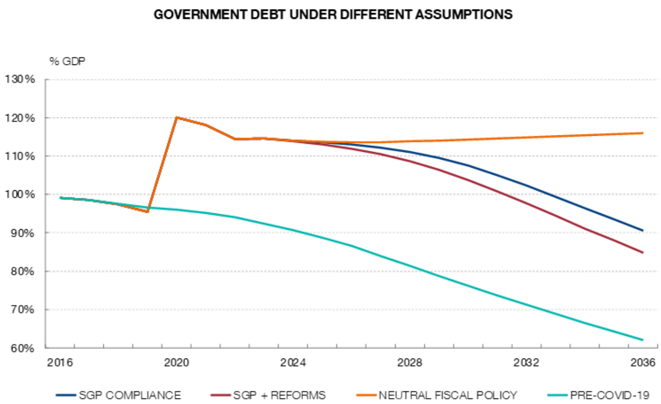
3 Fiscal policy challenges

In the third part of my testimony, I will discuss what I consider to be the two main challenges for Spanish fiscal policy in the medium and long term. First, ensuring the sustainability of public finances and, second, improving their quality by achieving a composition of government receipts and expenditure that is conducive to economic growth.

3.1 Bolstering the sustainability of public finances

Spain’s public finances were showing signs of fragility even before the onset of the health crisis. They have deteriorated further as a result of the fiscal policy response required to combat the economic effects of the pandemic. This fragility has materialised in some standard metrics of fiscal health. Thus, according to the European Commission’s estimates, Spain's structural balance has increased from 3.7% of GDP in 2019 (2.5 pp higher than the average for the euro area economies) to 4.9% in 2021. Similarly, between end-2019 and 2021 Q3, the public debt-to-GDP ratio rose by more than 26 pp to 122.1% of GDP. The Q2 figure (123% of GDP) was substantially higher than the euro area average (98.3%).

A FISCAL CONSOLIDATION PROGRAMME MUST BE CAREFULLY DESIGNED AND SPEEDILY ANNOUNCED, READY TO BE GRADUALLY IMPLEMENTED ONCE THE CRISIS IS OVER



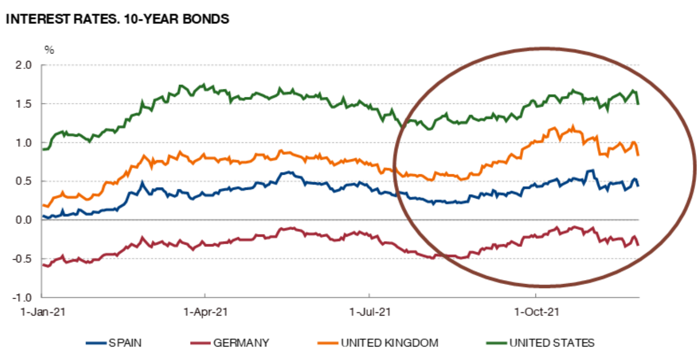
SOURCE: Banco de España.

Also, the simulations conducted by the Banco de España suggest that, under credible assumptions regarding future economic growth and interest rate developments, in the absence of policies to correct the current budgetary imbalances, the public debt ratio will hold at very high levels over the next 15 years.

In this respect, it is important to note that the available evidence suggests that a persistently high level of public debt over a prolonged period could entail at least two sources of vulnerability.

First, greater volatility in financial markets and investors requiring a higher rate of return on government debt purchases cannot be ruled out. In this respect, thanks to the extraordinary measures implemented by the ECB, the financing costs for the Spanish Treasury have remained at historically very low levels. The new macroeconomic setting, with the gradual recovery in activity and prices, has already had an effect on long-term sovereign bond yields in other European countries. An example is the 10-year Spanish government bond yield, which currently stands at around 0.4%, compared with 0% at the turn of the year. The longer average government debt maturities observed in Spain in recent years would, however, limit the pass-through of these rises to the interest burden.

THE RISE IN DEBT YIELDS IN 2021 ILLUSTRATES THE VULNERABILITY OF PUBLIC FINANCES TO CHANGES IN FINANCING CONDITIONS



SOURCE: Refinitiv Datastream. Latest observation: 26/11/2021.

Second, a high level of public debt means that resources must be set aside to finance it, whether in the form of higher taxes or cuts in potentially productive spending, which could be put to other uses. In addition, it can adversely affect financing conditions for private agents.

On this basis, and as I have stressed on other occasions, the deterioration in public finances is a challenge that must be addressed with a fiscal consolidation plan that provides the fiscal authorities with leeway to respond to possible adverse economic shocks in the future. This plan should be rigorously and promptly designed, and implemented gradually once the recovery takes hold. To help lend credibility to the process, it should specify the budgetary targets, the composition of the adjustment necessary for achieving those targets and the implementation time frame. In this respect, the preparation of Spain's Stability Programme Update, to be submitted next spring, may be a good time to lay the foundations for this plan.

3.2 Enhancing the quality of public finances

In addition to ensuring the sustainability of public finances, Spain’s other major fiscal challenge is to improve the quality of public finances. These two challenges should not be considered separately. Restructuring public finances to contribute to the structural transformation that the Spanish economy must undergo in the coming years will boost potential growth and thus improve the sustainability of public finances.

To analyse the second of these major challenges, I will focus on two dimensions: the composition and efficiency of government receipts and expenditure in Spain and the role that the NGEU programme can play.

3.2.1 The composition and efficiency of government receipts and expenditure

The relative importance of each receipts and expenditure item in the public finances should reflect society’s preferences in terms of the policies these items represent. However, this should not prevent these decisions from being based on an in-depth analysis of whether the receipts and expenditure items can achieve their goals effectively and efficiently. As a starting point, it may be useful to compare the structure of these items with those of our European peers.

The structure and efficiency of government expenditure in Spain

Based on pre-crisis levels (2019), a comparison of the composition of government spending in Spain with that of the EU as a whole[18] reveals that Spain spends 4% and 2.8% of GDP, respectively, on education and public investment, 0.9 pp and 1.5 pp lower than the EU average.[19]

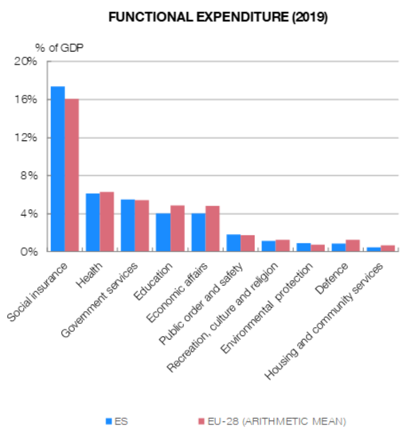
These differences are significant, in that they refer to items which have an impact on the accumulation of physical and human capital in the economy.[20] Indeed, there is evidence that the accumulation of productive public capital acts as a catalyst for private investment, fostering productivity gains across the economy. Similarly, spending on education boosts the level of human capital, leading to an increase in the set of skills and knowledge both of

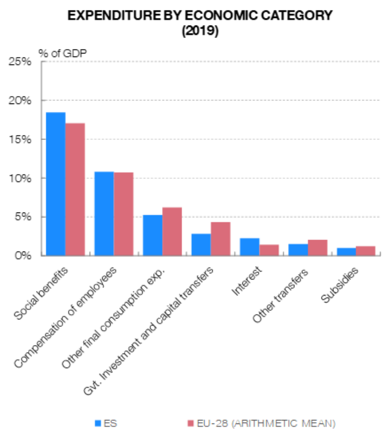
[18] The EU figures detailed in this section correspond to the arithmetic mean of the 27 EU Member States plus the United Kingdom.
[19] Compared with the European average, Spain’s budget allocation to R&D spending is also lower (1.2% compared with 1.4% of total government spending in 2019, according to Eurostat data).
[20] Indeed, the scant momentum of public investment in Spain in recent years has resulted in a gradual reduction in the stock of public capital, since an insufficient volume has been invested to cover the depreciation of installed capital. This has been even more marked in the case of intangible assets, which comprise those investment items most related to economic growth (such as investment in R&D). See Fundación BBVA (2021), “El stock de capital en España y sus Comunidades Autónomas. Revisión metodológica y evolución reciente de la inversión y el capital 1995-2020”.

workers and business owners, thus improving their productivity levels.[21] Also, the accumulation of physical and human capital, which affect the economy's productivity and, therefore, its growth potential, have a positive impact on the sustainability of public finances.[22]

Conversely, there are other public expenditure items in Spain which represent a higher share of the economy than in the European Union overall as a whole. This is true of expenditure on social protection (which essentially includes pensions and other benefits such as unemployment, sickness and disability benefits) and interest payments. In 2019 these items, standing at 17.4% and 2.3% of GDP, respectively, were 1.3 pp and 0.9 pp higher than the EU average. However, in this case the comparisons between countries are highly influenced by the differences in demographic structures, unemployment rates and government debt levels. In particular, population ageing in Spain explains a very significant portion of the increase in the share of expenditure on social protection over the last 20 years (8 pp of GDP). According to the Stability Programme Update (SPU), a further increase (2 pp, to reach 43% of total general government spending in 2024) will likely occur over the coming years.

THE EFFICIENCY AND COMPOSITION OF GOVERNMENT EXPENDITURE SHOULD BE IMPROVED TO ENHANCE POTENTIAL GROWTH





SOURCE: Eurostat.

At this point, I would like to highlight various questions I consider relevant concerning our pension system.

As we all know, the demographic trends that are expected over the coming years, particularly the spike in the dependency ratio,[23] will place the pension system under considerable pressure. The 2011 and 2013 reforms sought to address these pressures by introducing mechanisms which linked the system's expected receipts and expenditure (the

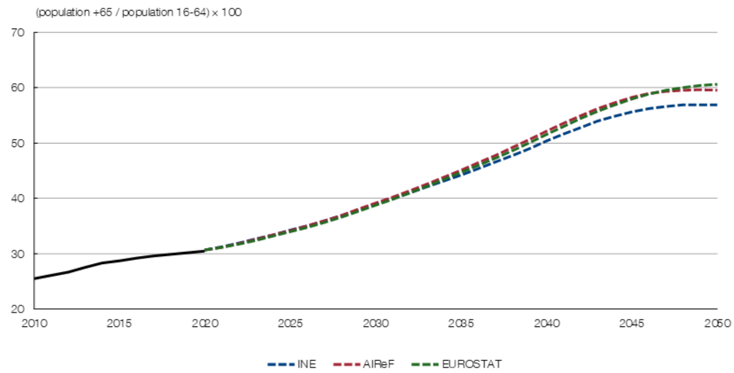
[21] Furthermore, it is important to highlight that these public expenditure items also help strengthen intergenerational equity. See D. Card, C. Domnisoru and L. Taylor (2018), "The Intergenerational Transmission of Human Capital: Evidence from the Golden Age of Upward Mobility", *NBER Working Paper* 25000.
[22] See "Research and innovation: Fighting the pandemic and boosting long-term growth", Chapter 3 of the IMF's October 2021 World Economic Outlook.
[23] Under the INE, AIReF and Eurostat baseline scenarios, this ratio (defined as the ratio of the population aged 65 and over to the population aged 16 to 64) will rise from 30% at present to between 57% and 61% in 2050.

pension revaluation index) or made initial pensions contingent upon changes in life expectancy. These mechanisms significantly enhanced the financial sustainability of the pension system in the medium term. However, should the pension system's revenue not increase, the adjustment would be made in particular by reducing the benefit rate.[24]

These mechanisms have recently been deactivated and replaced initially by an inflation-linked pension revaluation system. This decision, contained in the draft Law guaranteeing the purchasing power of pensions and other measures to bolster the financial and social sustainability of the pension system, is expected to drive pension expenditure up by 3.3 pp of GDP between 2019 and 2050, according to AIReF's latest estimates. The increase in expenditure arising from the repeal of the sustainability factor approved in 2013 would entail an estimated additional 0.9 pp of GDP between 2019 and 2050, according to AIReF.

ON THE ESTIMATES AVAILABLE, REVENUE AND EXPENDITURE MEASURES ADDITIONAL TO THOSE SPECIFIED TO DATE IN THE DRAFT LAW CURRENTLY BEFORE PARLIAMENT WILL BE NEEDED TO COVER THE HIGHER PENSION EXPENDITURE RESULTING FROM A HIGHER DEPENDENCY RATIO, TAKING INTO ACCOUNT BOTH THE IMPACT OF THE RETURN TO INFLATION-INDEXED PENSIONS AND THE REPEAL OF THE SUSTAINABILITY FACTOR

DEPENDENCY RATIO: BASELINE SCENARIOS



SOURCES: INE, AIReF and Eurostat.

In addition, the draft law on the reform of the pension system provides for a permanent increase in the transfers from the central government to Social Security, to meet the latter's so-called extraneous expenses, estimated at around 2% of GDP. Higher transfers from the central government serve to correct Social Security's current deficit but evidently have zero impact on public finances overall and, therefore, on their sustainability.

Moreover, other measures introduced to align the effective and statutory retirement ages may alleviate the pension system's shortfall, but their estimated effectiveness is subject to high uncertainty. The Government estimates an impact, in terms of lower spending, of between 1.1 pp and 1.6 pp of GDP in 2050.

Lastly, the sustainability factor will be replaced by the "Intergenerational Equity Mechanism" which, by means of a specific-purpose increase in social security contributions, aims to bolster the Social Security Reserve Fund and adopt new measures as from 2032, depending

[24] For more details, see P. Hernández de Cos (2021), "The Spanish pension system: an update in the wake of the pandemic", *Occasional Paper* No 2106, Banco de España.

on developments in pension spending relative to GDP. The specifics of these new measures will need to be negotiated in due course. According to government estimates, there would be an initial increase in social security contributions of 0.2% of GDP between 2023 and 2032, which could generate accumulated income amounting to 2.3% of GDP in the Reserve Fund by 2032, including the possible increase in value of the stock over time. Moreover, it has been established that the Intergenerational Equity Mechanism adjustment may not exceed 0.8 pp of GDP per year, including any potential new measures.

Overall, therefore, according to the available estimates, revenue or expenditure measures additional to those specified to date in the draft law currently before Parliament will be needed to meet the higher pension expenditure resulting from a higher dependency ratio, taking into account both the impact of the return to inflation-indexed pensions and the repeal of the sustainability factor.

To conclude my analysis of the quality of public expenditure, I would like to stress how important it is for such expenditure to be efficiently designed and implemented. This is particularly relevant when faced with the need to embark on a gradual fiscal consolidation process. In this vein, recent AIReF projects suggest that there have been considerable improvements in some particularly important expenditure items, such as pharmaceutical spending, subsidies and active labour market policies.[25] That is why, as I have noted on other occasions, it would be desirable for all these recommendations to be considered systematically in the budget preparation process.

The structure and efficiency of government receipts in Spain

Reform of the structure of public finances should also focus on a comprehensive review of the tax system, to ensure that the tax structure fosters economic growth. To this end, last April the Ministry of Finance set up an expert committee which is expected to deliver its opinion by February 2022.

However, allow me to take this opportunity to highlight what, in my view, are the key aspects to be addressed in a reform of the Spanish tax system.

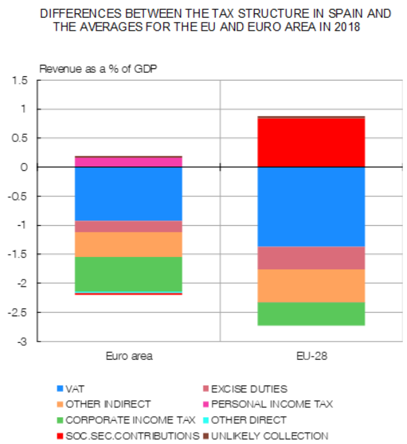
The first is to redraw the structure of government receipts in Spain. As with spending, it may be useful to draw a comparison with other European countries as a starting point. Such a comparison reveals that Spain has a lighter indirect tax burden, particularly in terms of VAT, where the difference in tax revenue vis-à-vis the EU average was 1.5 pp of GDP in 2019. This gap helps to explain part of Spain's lower tax revenue compared with the EU as a whole in that year (39.2% vs 43.1%). Corporate income tax revenue was also lower (almost 0.7 pp of GDP lower) than the EU average. Conversely, revenue from personal income tax and social security contributions are comparatively higher in Spain.

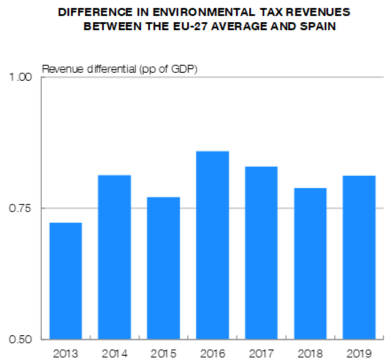
Second, I would like to underline the need for the tax system to contribute to reducing the negative impact of climate change. Compliance with the ambitious medium and long-term goals which Spain has assumed involves deploying a raft of public spending measures, a

[25] See the AIReF Spending Review.

significant portion of which are to be implemented by general government.[26] To help achieve these goals, it would be desirable for our tax system to bring environmental taxation closer to that of our European peers (in 2019 Spanish environmental tax revenue was 0.8 pp of GDP below the EU average).

A COMPREHENSIVE REVIEW OF THE TAX SYSTEM IS NEEDED





SOURCE: Eurostat.

Third, I would like to stress the need for an in-depth review of the wide range of tax benefits available under the Spanish tax system. In many cases, Spain's lower tax revenues are due not to lower tax rates but to high tax relief. Currently, not only are tax benefits high (according to the (Tax benefits report (*Memoria de beneficios fiscales*) accompanying the Budget, an estimated €41.9 billion in tax revenue is lost in connection with these benefits), but in some cases they are also failing to achieve the goals for which they were designed.[27]

In any event, I would like to conclude my assessment of how our tax system could be improved by reiterating that it would be desirable for the tax reforms in some specific areas, such as taxes on capital and corporate earnings and environmental taxes, to be commonly agreed internationally. This would avoid any distortions arising from the fact that there are tax bases that can be easily relocated. In this connection, the headway made in recent months in terms of the harmonisation of some taxes is certainly promising.

3.2.2 The role of the NGEU programme

The two-fold objective of the NGEU programme (to support economic recovery while at the same time enabling the economy's structural transformation) and its sizeable envelope offer a unique opportunity for Spain. This approach could help partially correct the Spanish economy's shortfalls as regards the accumulation of human and productive physical capital to which I referred earlier, while allowing it to allocate the funds needed to address the challenges it faces, such as the growing digitalisation of activity, the ecological transition

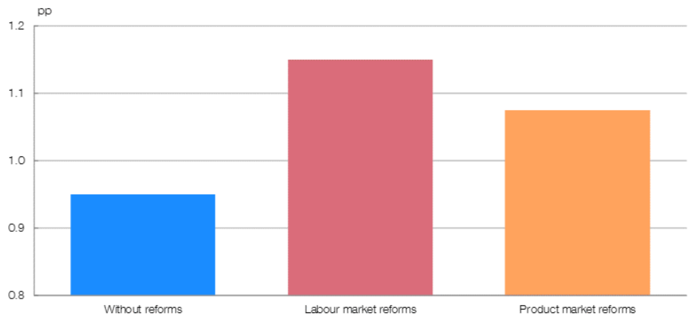
[26] The Climate Change and Energy Transition Law passed this year intends to mobilise more than €200 billion in additional investment between 2021 and 2030. See Law 7/2021 of 20 May 2021.
[27] See AIReF (2020), Tax Benefits Study.

and population ageing. Also, insofar as the NGEU programme seeks to increase potential growth and to modernise and digitalise general government, a positive impact on efficiency and the sustainability of public finances can be expected.

Allow me some thoughts on how to approach the programme and the use of these funds.

MAXIMISING THE TRANSFORMATIVE POTENTIAL OF THE NGEU FUNDS REQUIRES A COMPREHENSIVE SET OF STRUCTURAL MEASURES AND A SYSTEM TO ASSESS PROJECT EFFICIENCY IN REAL TIME

ERDF FISCAL MULTIPLIER WITH AND WITHOUT REFORMS



SOURCE: Own calculations. Banco de España.

First, the transformative potential of the programme would be boosted if it was accompanied by structural measures enabling the reallocation of resources between firms and sectors. According to a recent analysis published by the Banco de España, a very significant degree of complementarity exists between such reforms and the expansionary effect of the European funds in the medium and long term.

Second, the success of the NGEU programme crucially depends on a careful and rigorous selection of projects that are aligned with the goals to structurally transform the Spanish economy in the medium and long term. To this end, this selection should be based on thorough pre-assessment and real-time monitoring, so that any possible deviations from the goals established can be corrected swiftly. In line with best practice, an ex post impact assessment should then be provided by the research community and independent bodies.

Third and last, from a European perspective, this programme could be the seed for a permanent macroeconomic stabilisation initiative. In this respect, the reputational effect of the correct execution of the NGEU funds could help create a climate in Europe that paves the way for establishing such a mechanism in the EU's fiscal governance framework.

3.3 Reform of the Stability and Growth Pact

To conclude my analysis of the challenges facing fiscal policy, allow me some brief reflections on the reform of the Stability and Growth Pact that is currently under debate.[28]

REFLECTIONS ON THE REFORM OF THE STABILITY AND GROWTH PACT

1. **A framework of fiscal rules to ensure the sustainability of public finances is absolutely essential for the smooth functioning of the monetary union.**
2. **The euro area must be provided with a permanent macroeconomic stabilisation mechanism that complements monetary policy action.**
3. **The EU's fiscal rules should be better aligned with the structural economic transformations that have come about since they were formulated, including the secular decline in interest rates and changes in economies' growth potential.**
4. **There is a need to simplify the current framework, improving its hitherto scant capacity to ensure that countries build up fiscal buffers in good times for use in future crises.**
5. **Lastly, with a view to the significant investments needed to address climate-related challenges, a European financing mechanism that does not rely on the fiscal space of each country would be desirable.**

First, a framework of fiscal rules that ensures the sustainability of public finances is absolutely necessary for the proper functioning of the euro area. Beyond the necessary separation of monetary and fiscal policy to guarantee the ECB's independence in pursuing its price stability mandate, the absence of a common budget for euro area Member States means that each country's fiscal policy is responsible for stabilising the national economy. However, these fiscal policy measures could have a negative impact on the euro area as a whole if they are not compatible with the sustainability of government debt. This could arise from the possible increase in the financing costs of the other member countries if, contrary to the no bail-out clause established in the Maastricht Treaty, they were obliged to take on part of the government debt of another country which had failed to guarantee its solvency. It is in this setting that having discipline based on a credible framework of rules becomes indispensable.

My second observation refers to the absence of a permanent macroeconomic stabilisation mechanism in the euro area that complements monetary policy action. While, as I mentioned earlier, the implementation of the NGEU programme is a significant step forward in this direction, at present it cannot be deemed the supranational stabilisation tool that the euro area needs, since it is a temporary measure and lacks sufficient funding and taxation powers. A true macroeconomic stabilisation mechanism should be permanent and should have sufficient funding and also revenue-raising and borrowing capacity.

[28] 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.

Thirdly, I would like to highlight the need to reform the fiscal rules determining EU governance, to better align them with the structural economic transformations that have come about since they were formulated. On one hand, the secular decline in long-term interest rates means that higher debt levels can be maintained without compromising the public finances in the long run, provided that potential growth has not fallen in parallel. On the other, the past decade has shown that it might not be possible to manage tail risks on a purely domestic front. Thus, a new framework is in order in which the national and supranational fiscal authorities complement one another, with the former ensuring the sustainability of domestic debt in the medium term and the latter responding to extreme shocks, while supporting monetary policy action by defining the aggregate euro area fiscal stance.

My fourth thought focuses on the need to simplify the current framework and enhance its hitherto scant capacity to ensure that countries build up fiscal buffers in good times for use in crises. This requires improving the design of the system of incentives governing compliance with fiscal rules and possibly strengthening the role of independent fiscal institutions such as AIReF.

Lastly, I also wish to highlight the recent debate on the possibility of excluding government spending to tackle climate change when assessing compliance with fiscal rules. While this proposal is conceptually attractive, given its possible positive impact in terms of achieving Spain's climate goals, it does have some drawbacks. Notably the difficulty of defining spending that could be excluded on climate-change grounds, and the fact that a supranational approach, not an exclusively national one, should be adopted when tackling a universal problem like climate change.

4 Conclusions

In my testimony before this House, I have tried to highlight the importance of adapting each draft Budget to the particular economic circumstances of each financial year. It seems reasonable to assume that faced with a recovery that is still partial and marked by considerable uncertainty, fiscal policy will continue to selectively support the areas where fiscal policy measures are warranted.

CONCLUSION

1. **In the current circumstances, with the economy gradually recovering from the profound economic crisis caused by the pandemic, albeit still partially, unevenly and subject to many uncertainties, the support provided by monetary and fiscal policy needs to be maintained.**

2. **The stimulus measures of budgetary policy should be very selective and focused, and avoid further increasing the structural budget deficit and the possible "overheating" of the hardest-hit sectors.**

3. **In parallel, a fiscal consolidation strategy should be designed to reduce, once the crisis is over, the vulnerability of public finances and to build up fiscal buffers. If this strategy is designed thoroughly, announced promptly and enjoys broad consensus, its effectiveness will be significantly enhanced.**

4. **There is also a need for a comprehensive review of spending and the tax system to improve its contribution to economic growth.**

5. **Lastly, the transformative impact of the NGEU funds must be maximised. This requires a careful selection and ongoing assessment of projects, complemented by the implementation of a raft of ambitious structural reforms that reduce the obstacles limiting the Spanish economy's capacity for growth.**

Yet at the same time, considering a longer time frame, I have pointed out the need to acknowledge the still fragile situation of Spain's public finances. This dates back from before the crisis and has been compounded by the necessary response to the pandemic, resulting in very high structural deficit and public debt levels.

This source of vulnerability requires a firm fiscal policy response on three fronts. First, by pursing a strict fiscal policy which, while maintaining the expansionary stance required by the economic circumstances, is effective and selective in the use of public resources, thoroughly assessing any permanent increases in public spending.

Second, with the early and gradual implementation of a public finances restructuring process once the recovery has taken hold, to give the necessary fiscal space to respond to possible future crises.

Lastly, I wish to stress that it would be desirable for the structure of government receipts and spending in Spain to be redesigned to foster the economic growth and structural transformation that our country needs. The NGEU funds offer a unique opportunity to improve the Spanish economy's growth potential in the medium and long term, through the careful selection of projects accompanied by ambitious structural reforms.

To satisfactorily address these challenges, a concerted and sustained effort is required. If we succeed, the potential benefits would have a positive and lasting impact on our economy and our personal well-being.