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Testimony of the Governor of the Banco de España before Parliament in relation to the Draft State Budget for 2018

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Ladies and gentlemen,

In my appearance before this Committee, as part of the 2018 State and Social Security Budget discussion and approval process, I shall begin by referring to the current macroeconomic setting. I shall then discuss the main aspects of the draft budget legislation approved by the Government on 27 March, concluding with some thoughts on the challenges which, in the opinion of the Banco de España, the current design of fiscal policy faces.

The external environment of the Spanish economy

The international economic environment has been characterised in recent quarters by the recovery in global economic activity, underpinned by highly favourable financial conditions and the improved confidence of firms and consumers. Although growth has spread to most geographical areas, mention may be made of the spurt in the advanced economies in general, and of the euro area in particular, which saw in 2017 its highest rate of increase in GDP since the start of the crisis in 2008.

This favourable environment has been conducive to the stable performance of international financial markets during the current year; however, this was interrupted in February by a bout of volatility related to the possibility of a swifter normalisation of the Federal Reserve's monetary policy ahead of the prospect of an improvement in economic activity and a rise in US inflation.

Also of relevance, given its potential global impact, is the announced change in the stance of certain economic policies in the United States.

On one hand, the tax reform approved last year and the budgetary agreement reached at the start of this year accentuate the expansionary thrust of fiscal policy. On the other, the announcement of tariff rises is indicative of a change in tack in US trade policy towards protectionist positions, with potentially serious consequences at the global level, for trade and economic activity.

In the euro area, there was a notable improvement in economic activity in 2017 which was extensive to all members. On the latest information, the expansionary stance is estimated to have been maintained in the first quarter of 2018. This growth in the euro area economy was instrumental, on available estimates, in closing the negative output gap that opened up during the crisis. The latest forecasts, set out by the ECB in March, point to the continuation in the medium term of the dynamism observed in the recent period, underpinned both by domestic demand and robust exports.

Despite this dynamism, a relatively moderate inflation scenario persists in the euro area; as a result, the growth of core inflation – which excludes the most volatile elements – stood at 1.2% in February. Moving further into the medium term, the ECB projections exercise, released in March, foresees a very gradual increase in inflation to 1.7% in 2020.

Faced with this contained outlook for inflation in the euro area as a whole, monetary policy in 2017 and at the start of the current year has retained a strongly accommodative stance. The ECB Governing Council decided in March not to alter its benchmark interest rates and reiterated its commitment to maintaining net securities purchases under the asset purchase programme at least until next September.

Developments in and outlook for the Spanish economy

Allow me now to address the developments in, and outlook for, the Spanish economy.

The Spanish economy grew by 0.7% during the fourth quarter of 2017 and the latest information suggests that this growth rate may have continued into the opening months of 2018, thereby enabling current GDP to exceed its pre-crisis level.

For 2018 as a whole, and according to the Banco de España forecasts published on 20 March, GDP is expected to grow by 2.7%. While this figure is somewhat below that for the previous year (3.1%), if this forecast is fulfilled the Spanish economy will, for the fourth year running, show greater dynamism than the euro area as a whole.

Growth over the coming quarters will continue to be underpinned especially by the expansion of national demand, although the external sector is expected to maintain its positive contribution. In particular, favourable employment and household disposable income developments, along with propitious credit access conditions, will continue to boost household consumption and the pick-up in spending on residential investment. Business investment will continue to be assisted by the momentum of demand and by the increase in capacity utilisation, in a very favourable financing setting, both domestically and externally.

According to these projections, the current growth phase in the Spanish economy, dating back to late 2013, is expected to continue over the coming years, supported by a favourable international setting, by easy financial conditions and by the continuing gains in competitiveness. All these factors should allow for further headway in correcting the imbalances built up in the previous expansionary cycle and during the last recession.

As regards prices, the data available for 2018 continue to show moderate increases, with the CPI's year-on-year growth rate in March at 1.2%. For the coming months a slight pick-up is expected in inflation, which will continue to be influenced by the base effects of energy prices; as a result, for 2018 as a whole, the latest Banco de España projections augur average inflation of 1.2%. For the following years a gradual rise in prices is forecast, as a result of the progressive reduction in the cyclical slack in the Spanish economy.

Main risks and factors of vulnerability

Despite the dynamism of the Spanish economy described, there are factors of vulnerability and potential obstacles to long-term growth.

On the external front, we cannot rule out further bouts of volatility on financial markets during the monetary policy normalisation process in advanced economies. Consideration must also be given to the effects of possible political shocks, such as the potential consequences for trade and global growth of the protectionist slant recently adopted by the US administration. These risks may alter the favourable scenario for the world economy underlying our projections. At home, the political tensions in Catalonia might give rise to episodes of diminished confidence, as occurred in the final quarter of 2017.

The increase in economic activity in recent years has been assisted by the contribution of temporary factors, such as a highly accommodative monetary policy, a clearly expansionary fiscal policy in 2015 and 2016, and favourable oil prices. Conceivably, as these effects fade, their contribution to the growth of the economy will diminish. Accordingly, maintaining sustained growth may require undertaking reforms that replace the temporary momentum recently provided by the above-mentioned temporary factors and monetary and fiscal policies.

The need for reform is all the more pressing in an economy such as Spain's, which evidences low productivity growth, a lack of competitiveness in certain sectors and, still now, significant labour market inefficiencies. These factors, in an environment of marked population ageing, set limits on potential growth in the medium and long term.

I shall now move on to reviewing the main features of the State and Social Security Budget for 2018.

Budgetary policy in 2018

The macroeconomic forecast accompanying the draft Budget point to the extension of the current growth phase. Specifically, they project a 2.7% increase in real GDP in 2018, which would be accompanied by a rise in prices, meaning that the increase in nominal GDP would stand at 4.3%.

The macroeconomic projections underpinning the draft Budget are, generally, consistent with the scenario I have described, which is that framing the latest Banco de España projections. They are also, broadly, consistent with the consensus scenario among analysts from private institutions. Nonetheless, the nominal GDP growth expected for this year in the macroeconomic projections for the Budget is higher than that projected by the Banco de España (4.3% against 3.8%).

The deficit target for the overall general government sector stands for 2018 at 2.2% of GDP, which is compatible with the requirements of the Stability and Growth Pact, and entails a forecast reduction of 0.9 pp of GDP, compared with the previous year. That marks – if we exclude the temporary impact of the financial aid – the ninth consecutive year of improvement in the public finances, from the peak deficit of 11% of GDP recorded in 2009.

The draft Budget places public debt at 97.6% of GDP in 2018, a reduction in this ratio of 0.7 pp of GDP compared with that recorded in 2017, maintaining the marginally declining path of recent years, from the peak of 100.4% reached in 2014.

In the current macroeconomic context, the improvement in the deficit in 2018 will be chiefly due to the sound cyclical behaviour of the economy, and to the reduction in interest payments on public debt. That will be against a background of overall moderation in public spending, determined by the expenditure ceiling, despite certain expenditure-increasing and tax-reduction measures included in the draft Budget. Hence, the fiscal policy stance, measured by the change in the primary structural balance, could be neutral or slightly expansionary, compared with the neutral stance for 2017. Accordingly, it is estimated there will be no headway in 2018 in reducing the still-high Spanish general government structural deficit.

In terms of the different sub-sectors, the draft Budget includes the stability objectives approved by Parliament in July last year. For central government and the Social Security system, the expected budget deficits for 2018 are 0.7% and 1.1% of GDP, respectively, compared with 1.9% and 1.5%, respectively, in 2017. The territorial government objectives are for a deficit of 0.4% for the regional governments (0.3% in 2017) and a balanced budget for local government (compared with the surplus of 0.6 pp of GDP the previous year).

The fulfilment of the budget deficit target rests on two fundamental factors.

Firstly, on expenditure holding in line with the limit set by the State expenditure ceiling approved by Parliament in July last year; secondly, on the significant increase in public revenues assumed.

Among the most notable spending measures are the 1.75% increase in 2018 in the fixed remuneration of public-sector employees (plus 0.2% of additional funds in respect of total gross wages), in line with the agreement reached by the Government and the main trade union organisations. With regard to public-sector employment, the draft Budget provides continuity and expands the hiring policy of the past two years in 2018. Specifically, the 100% replacement rate for general government staff is extended across the board, allowing in some cases increases above this figure, and additional measures relating to the working day and temporary employment are included.

For 2018 as a whole, these measures would lead to growth of 5.4% in State Budget wage expenses, compared with the decline of 2.3% observed in 2017. On a separate note, the restrictions on current expenditure on goods and services are maintained, with this item falling by 4.1%.

As regards public investment, an increase of around 15% (when compared with last year's initial budget) is projected in 2018 in investment in the consolidated State, Social Security and corporate public sector budget. In 2017 the related figure was a reduction of 3.3%.

Notable among the measures under the Social Security budget are the 3% and 2% increases in minimum and widows' pensions, respectively, and the rise in the lowest contributory pensions, ranging from 1-1.5%, which, overall, will mean that contributory pensions increase by 1%, compared with the figure of 0.25% set in the revaluation formula.

These measures, along with the demographic determinants, relating to changes in the number of pensioners and to the substitution effect arising from the new pensions that replace those that are terminated, will see contributory pension expenditure increase this year by 3.5%. Accordingly, the weight of expenditure on pensions in total consolidated State and Social Security expenditure will increase to 40.9% (compared with 40.5% in 2017). It is also worth noting the 10% reduction in expenditure on unemployment benefits in the draft Budget, which should be consistent with the declines assumed for the unemployment rate and for the coverage rate of the unemployed.

On the revenue side, the main measures included in the budget are concentrated in the personal income tax area, and comprise the rise in the minimum amount exempt from taxation under this tax from an annual gross figure of €12,000 to €14,000, and other measures that reduce the taxation of net salary income, create childbirth and nursery care cheques, and extend the already existing family cheques.

Overall, tax revenues, before the transfer to local and regional governments, are projected to increase by 6.0% in 2018, and social contributions by 5.1%. Given the macroeconomic forecasts and the impact of the aforementioned regulatory changes, that would entail a greater response by revenues to growth in activity than has been historically observed. This will call for ongoing monitoring of the pattern of revenues during the year, so that timely reaction is possible both on the expenditure and on the revenue sides, should the risks to fulfilment of the deficit targets materialise.

It is worth recalling that Spain is a country that is highly decentralised in terms of public spending powers, where more than 40% of such spending is carried out by regional and local governments. Hence, the budget affecting the State and Social Security system offers only a partial view of overall general government budgetary policy.

Against this backdrop, the Updated Stability Programme to be published in the coming days is important, since it consolidates the budgets of central government agencies with those of regional government and local government. This Programme should provide for a complete analysis of budgetary forecasts.

The importance of budgetary consolidation

Before concluding I should like to mention some of the challenges facing public finances in Spain.

First I should like to highlight what is most immediate. The Spanish general government sector is subject to an "Excessive Deficit Procedure", initiated in April 2009 under the so-called corrective arm of the Stability and Growth Pact.

At present we are, along with France, one of the two EU countries under this procedure. The term set by the Council of the European Union Council for overcoming this situation is this year, 2018. Let us not forget, however, that once this objective has been fulfilled, consolidation should proceed until a balanced budget in structural terms is achieved, this being fundamental in order to restore fiscal policy's room for manoeuvre in the face of potentially adverse growth scenarios. Bearing in mind that, according to European Commission estimates, the Spanish general government structural deficit was still standing at around 3% of GDP in 2017, the budgetary adjustment still to be made remains significant.

In this setting of consolidation, it is also vital to achieve sustainable consensus over time concerning the reform of regional government financing. Our administrative structure is a highly decentralised one, meaning that the involvement of regional and local government is essential for ensuring budgetary stability.

There is broad consensus in the sense that the current regional and local government financing arrangements should be reformed in order to improve their transparency, to adapt their funds to spending needs and to increase the degree of fiscal co-responsibility. In addition, the regional governments should seek to regain access to capital markets as a fundamental means of financing their budgetary shortfalls, leaving the various State funds, developed during the crisis, as an emergency vehicle for exceptional circumstances. In any event, while these mechanisms remain operational, the factors of conditionality available should be applied.

In the medium term, the main challenge in terms of public finances is that posed by the persistence of a high level of public debt, whose ratio to GDP stood at 98.3% in 2017. While the high nominal growth of output has enabled this ratio to be reduced slightly from its 2014 peak, running such a high level of public debt may affect the functioning of the economy; examples here include the absorption of resources that could be put to more productive use, a greater dependence on external financial conditions, and the reduction in fiscal policy's room for manoeuvre in the face of adverse shocks. If we add to these factors the normalisation of financial conditions foreseen for the coming years and, even more importantly, the impact of demographic trends on expenditure in the medium term, it is all the more evident that ongoing public deleveraging should be a priority.

Given its significance in several key respects, I should like to insist on the impact of population ageing on public spending in the medium and long term, which is a primordial challenge to the sustainability of public finances.

If the latest estimates in this connection should hold, public spending on pensions, health and long-term care will increase by between 1.5 and 2 percentage points of GDP per annum over the next three decades, peaking at over 21% of GDP around 2050.

In the case of the pension system, the application of the sustainability factor – which links the initial pension to the increase in life expectancy – and, above all, of the annual pension revaluation index – which links increases therein to balance between the system's revenues and expenditure – could bring about a gradual reduction in the current deficit, which reached 1.5% of GDP at end-2017, and counter the effect of the expected increase in the dependency ratio in the long term. That said, in the absence of additional increases in revenues, the adjustment would be made mainly through a reduction in the public pension replacement rate. With a view to the future, the key is to strike a balance between the replacement rates for our pension system that it is sought to ensure and the revenues needed to safeguard the system's sustainability.

Drawing on the analyses available it can be concluded that the maintenance of the current replacement rates, which are high on international comparisons, would require most significant increases in the system's revenues. In any event, it is desirable that any reform strategy chosen should increase the systems transparency, strengthen the relationship between contributions and benefits, and maintain an adjustment mechanism that ensures financial equilibrium.

For the reasons set out, it should be stressed that fiscal consolidation be anchored in a medium-term programme that details the measures that enable budgetary targets to be achieved, and in prudent forecasts of macroeconomic developments and public revenues.

Of particular importance in the current setting is the composition of the adjustment, so that it may be conducive to a greater contribution by public finances to the economy's potential growth. In this respect, headway should continue to be made in rationalising public spending and making it more efficient, and in considering a revision and definition of the tax basket so that the revenues needed to finance the desired level of public spending may be obtained in a stable manner.

Conclusions

I will now conclude.

The Spanish economy continues to evidence sound growth in output and employment, rooted in the strength of the foreign sector. This economic robustness is expected to continue over the coming years, although it is likely to do so at a somewhat lesser pace, in a setting in which non-negligible factors of risk persist.

Despite this favourable interpretation and the recent progress, the Spanish economy has significant imbalances, such as high public debt, external net borrowing requirements and the persistence of still-high unemployment levels.

For this reason, fiscal consolidation policies and reforms aimed at shoring up the confidence of the economy's various agents and at increasing growth potential are essential conditions for correcting these imbalances and enabling the continuing growth of economic activity and employment generation.

Thank you for your attention.