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**Testimony before the Parliamentary Budget Committee in relation to the
draft State Budget for 2016**

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Ladies and gentlemen,

I appear before this Committee at the start of the discussion and approval process for the State Budget for 2016, the draft legislation for which was approved by the Government on 31 July. Let me begin by referring to the current macroeconomic setting and outlook for the Spanish economy, after which I will move on to the core content of the draft Budget and to the relationship between fiscal policy and recovery in our economy.

The external setting of the Spanish economy

The international financial setting is marked by a degree of volatility. The ups and downs of the negotiations between the Greek authorities and European institutions and the IMF, doubts over the economic situation in China and expectations about the normalisation of US monetary policy have given rise to uncertainty in the principal markets, leading to movements in share prices, long-term interest rates and exchange rates.

The agreement reached by the euro area Heads of State and of Government on 13 July paved the way for a third financial assistance programme for Greece. This agreement has reaffirmed the commitment to monetary union, patent both in the supportive efforts of its members and in the observance of the common stability rules governing the functioning of the Monetary Union.

The negotiations for the Third Bailout Programme for Greece unfolded as scheduled, and there is every indication the Programme will be launched immediately and that the day after tomorrow, on 20 August, the Greek authorities will be able to meet their ECB payments, thereby avoiding a default with dire consequences.

This third bailout is, perhaps, the most complex and demanding of those so far agreed between Greece and the European authorities and the IMF. This is so, among other things, because it will include measures to reinforce the Greek banking system, which has been greatly affected by events in recent months. Evidently, it is in the interest of all euro area members that the new Programme should be properly adhered to, and follow schedule, so that assessments of its implementation before year-end may be positive and provide for its full effectiveness and continuity. Needless to say, the fulfilment of this third programme will boost the growth of the Greek economy – the central and fundamental objective of this third assistance programme – and will strengthen the euro area and its stability as a whole.

Recent developments on the international economic front are positive in terms of growth. While growth in both the Asian and Latin American emerging economies remains below par, the latest indicators show that the United States and the United Kingdom appear to have picked up speed, following the weak first-quarter results this year.

Economic recovery is also holding up in the euro area. GDP grew by 0.4% in the first quarter of this year and, on the latest preliminary estimate released last Friday, by 0.3% in the second quarter. For the year as a whole, projections envisage figures of around 1.5%, considerably up on end-2014 estimates. Private consumption continues to be the driving force here, while the contribution of private investment remains moderate.

Turning to inflation, both actual and projected euro area rates have now turned around from the declining trajectory marking their path throughout 2014, but inflation is still some way off the ECB's reference level of 2% for the euro area.

The favourable performance of euro area economic activity and prices is underpinned by certain external factors, such as the pick-up in the global economy and lower oil prices, but also by other factors whose origin lies in the economic policy decisions adopted by the national governments and the European authorities. These include most notably the reforms undertaken in different countries and the more neutral stance of fiscal policies.

In any event, mention should be made of the contribution of monetary policy and the significance of the decision adopted in January this year to enlarge the securities purchase programme with the inclusion of government debt securities. Since then, we have witnessed not only further monetary easing and the depreciation of the euro, but also a more uniform transmission of expansionary impulses to the various countries in the area and, in particular, to those such as Spain which were comparatively more affected by the fragmentation of European financial markets.

The latest monetary policy measures have translated into a significant improvement in the Spanish economy's financing conditions. This improvement is visible not only in the lower cost of new funds, but also in a progressive – but slow – normalisation of credit in Spain. Aggregate balances continue to post negative rates of change, reflecting the headway in the deleveraging of our households and firms; however, these rates are increasingly less negative and are compatible with the growth of new financing flows.

Performance of and outlook for the Spanish economy

On preliminary estimates in late July, the Spanish economy is expected to have grown by 1% in the second quarter of this year. This growth rate highlights the dynamism of the current recovery phase, now under way for two years.

Recent indicators suggest this expansionary trajectory will hold in the second half of the year. On the latest Banco de España estimates, GDP growth should be slightly over 3% this year and somewhat below that figure in 2016, meaning that growth in our economy will continue to outpace the euro area average.

In terms of composition, national demand has continued to expand strongly. After several years of containment in household spending plans, the favourable course of their disposable income coupled with brighter job prospects and readier access to credit have been conducive to the growth of consumption. Real estate market indicators show a recovery in the sector which, while moderate and uneven across market segments and regions, is also contributing to rekindling household spending. The buoyancy of final demand and the progressive normalisation of financial conditions have continued exerting a positive effect on business investment.

The firming of the recovery in the euro area economy has helped compensate for the recent loss of momentum in some non-Community markets, meaning that exports maintain high growth rates. Ongoing contributing factors are the gains in competitiveness in our economy, which reflect the containment of costs in recent years by Spanish firms and, more recently, the depreciation of the euro. Nonetheless, imports have responded

forcefully to the pick-up in domestic spending (we should remember that gains and losses in competitiveness are felt abroad but also at home, in respect of imports), which has led, in net terms, to external demand generally not contributing to the increase in activity.

The recovery in output has come in step with a more expansionary behaviour of employment than might have been foreseen on past patterns. According to official Spanish labour force data, from the second quarter of 2014 to the same period this year numbers employed are estimated to have increased by more than half a million, making for an appreciable reduction in the unemployment rate.

The greater flexibility enjoyed by firms, following the reforms approved in 2012, in adjusting their working conditions to the macroeconomic and competitive setting has no doubt provided for the creation of new jobs and, therefore, for the expansion of economic activity. If the dynamics of the past 18 months hold, the increase in employment might place the unemployment rate at around 20% in the fourth quarter of 2016.

As to prices, the increases in activity and employment have been accompanied by very low inflation rates. The fall in oil prices has prompted declines in the general level of prices over much of the past year. Yet core inflation, the indicator that excludes energy and fresh food prices, has moved on a rising course over the year. And while still at moderate levels, this indicator's recent trajectory suggests the risks of entering an overly prolonged period of very low inflation have progressively been dispelled.

While in July the overall price index posted growth of 0.1%, influenced by fuel prices, inflation at the end of the year is expected to be around 1%. In any event, the still-high spare capacity in the economy presages a gradual recovery in inflation over the next two years.

The factors underpinning the recovery

The path of recovery of growth and employment has essentially been underpinned by the restoring of macroeconomic and financial equilibria, which were severely eroded in the crisis. Progress has been visible in the correction of the external imbalance, the deleveraging of households and firms, the redressing of fiscal balances towards levels more compatible with the sustainability of public finances and the restructuring and consolidation of the banking sector. Unemployment, too, is showing clear signs of a correction.

The reforms undertaken within Spain, along with the headway in economic and monetary union and the application of the highly expansionary monetary policy by the ECB, have proven key to restoring confidence and providing for the progressive absorption of the imbalances. By way of illustration, the proportion of Spanish public debt held by non-residents has risen from 30% in 2012 to 44% at present, an increase indicative of the improved confidence in our economy, but also of its dependence on the perception abroad of the soundness and continuity of our recovery. Despite what has been achieved in growth, employment and restoring equilibria, we are far from having overcome all the factors of vulnerability. Doubts over the continuity of the macroeconomic, fiscal and financial re-balancing drive might curtail and lead to backtracking from these achievements.

We must not forget that the legacy of the crisis is still burdensome. Our unemployment rate remains above 22%; households and firms are speedily reducing their high debt, but public debt as a proportion of GDP has increased by over 60 pp since 2007; and the economy's financial dependence on the external sector remains high, with a net debtor position of close to 100% of GDP, far higher than in the other major euro area economies. Admittedly, though, a portion of the recent increase in this latter ratio is due to the recovery in the relative value of Spanish assets.

It is thus essential to persevere with the policies that strengthen confidence in our economy. In particular, a swifter reduction in unemployment and ensuring that the correction of the external imbalance continues calls for maintaining and, where possible, deepening gains in competitiveness. Budgetary policy, for its part, should provide for the stabilisation, first, and the reduction, subsequently, of the public debt/GDP ratio. I shall now turn to budgetary policy.

Budgetary policy in 2016

The macroeconomic forecasts accompanying the draft State and Social Security Budget for 2016 entail the prolongation of the current expansionary phase. They estimate a 3.0% increase in GDP in 2016, after a projected 3.3% increase for this year, rates that are slightly up on the latest Banco de España forecast but that are of course feasible in the current setting. Based on these forecasts, growth will be accompanied by a mild pick-up in inflation, whose rate could average close to 1.1%, measured by the private consumption deflator. As a result, the increase in nominal GDP would be around 4%.

At end-2015 the overall general government deficit target (4.2% of GDP) is expected to be met. For 2016, a deficit of 2.8% of GDP is targeted, which would involve attaining – for the first time since 2007 – a figure close to the 3% ceiling established in the Stability and Growth Pact. In turn, the public debt/GDP ratio would stand at 98.2% in 2016, having posted a figure of 98.7% at end-2015, which would mean a decline in this ratio for the first time since 2007.

The macroeconomic scenario used to devise the Draft Budget is, as I earlier stated, and with slight upward differences, similar in terms of rates and composition to that I described when referring to the Banco de España forecasts and, more generally, to the consensus of analysts.

It is reasonable to expect the improved cyclical position and the reduction in public debt yields to have a positive direct effect on public finances. In this respect, the upward revision of the Spanish economy's growth prospects means that the budgetary drive required to further the fiscal consolidation process, measured by the change in the primary structural balance, will be very limited, in line with the latest Updated Stability Programme, which anticipated that the fiscal policy stance would be essentially neutral in the 2015-2018 period. Naturally, any slippage in growth or rise in financing costs would hamper fiscal consolidation, making the process more demanding.

In 2016, according to the draft State Budget, the planned reduction in the deficit will stem firstly from lower public spending, whose ceiling for the year as a whole, excluding that

derived from local and regional government financing arrangements, will entail a reduction of 4.4% in relation to that set for 2015.

The key expenditure-side measures are the 1% increase in the remuneration of public sector employees and the refund in 2016 of the remaining 50% of the extra salary payment eliminated in 2012. With regard to public employment, a standard 50% replacement rate has been established for public-sector vacancies, rising to 100% in priority sectors. Overall, these measures would lead to growth of 2.7% in wage expenses in the State Budget relative to the 2015 Budget outturn projection. The restrictions on current expenditure on goods and services are maintained, with a 14% reduction.

Notable with regard to the Social Security system is the 0.25% revaluation of pensions, in keeping with the provisions of the 2013 reform. The projected growth in spending on contributory pensions in relation to the initial 2015 budget is rather higher, at 2.8%. This is as a result of the foreseeable increase in the number of pensions and of the substitution effect in terms of new pension claimants as opposed to deregistered pensioners, meaning that the weight of pensions spending relative to total consolidated spending of the State and Social Security system rises to 38.5% (37.8% in 2015). Mention should also be made of the reduction in spending on unemployment benefits, by 21.9% relative to the initial 2015 Budget. This is due to the fall in unemployment and in the coverage rate of the contributory benefit, which is partly offset by a shift in beneficiaries to non-contributory benefits, such as reinsertion scheme income and economic assistance under the activation programme for the unemployed.

Finally, a further decline in the interest burden on government debt is foreseen as a result of the reduction in interest rates.

On the revenue side, the main measures include the application of the second phase of the corporate income tax reform, and the impact over a full year of the related personal income tax reform. It is estimated the budgetary cost of these measures will be offset by the increase in revenue attributable to greater economic activity. Specifically, tax revenue before assignment to local and regional governments is expected to increase by 6.2% relative to the 2015 budget outturn projection, and Social Security contributions by 6.6% compared with the initial budget for 2015, which, given the macroeconomic forecast and the impact of the aforementioned tax reforms, would signify a greater response by revenue to the pattern of economic activity than that historically observed.

The uncertainty habitually surrounding estimates of the impact of tax changes, which peaks at times of marked cyclical swings, will call over the rest of 2015 and in 2016 for a monitoring of revenue that enables risks of slippage to be identified and pre-emptive action to prevent such risks materialising.

Notably, in a country as decentralised as Spain where more than 40% of public spending is by local and regional government, the Budget affecting central government and the Social Security system offers a partial view of the budgetary policy for next year. We must wait until October for the 2016 budgetary plan for the overall general government sector, including the regional and local governments. It is that document which will allow a full analysis of the budgetary forecasts for next year and which is, indeed, the draft on which basis the European Commission will deliver judgement in autumn, under the new European governance arrangements.

Meeting our fiscal consolidation commitments remains the best anchor for preserving credibility and for ensuring, first, the stabilisation of the level of public debt and, subsequently, its reduction. In this respect, the different tiers of government (central, regional and local) must fulfil these commitments to the same degree of stringency. The Budgetary Stability Law has instruments at its disposal to achieve this aim.

Conclusions

I shall now sum up. Compared with past experience in Spain, we are currently in a fairly exceptional situation: GDP and employment are growing at over 3%, and the economy is maintaining its gains in competitiveness vis-à-vis the external sector, whereby our exports continue to increase their market share and we continue to run a substantial external surplus. This combination, which has arisen solely over very short periods in Spain's economic history in recent decades, obviously does not in itself guarantee any continuation, nor does it mean that Spain has managed to sufficiently overcome the consequences of the crisis that broke in 2007, as indeed the unemployment and foreign debt figures, among others, testify.

Continuing to pursue fiscal consolidation policies – the only means of containing the increase in public debt relative to GDP and bringing about its subsequent reduction – and the policies that have brought about our gains in competitiveness will prove pivotal to controlling our financing costs, our balance of payments and, of course, the capacity of our economy to generate employment.

Thank you.