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**Testimony of the Governor of the Banco de España before the Senate in
relation to the draft State Budget for 2018**

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Ladies and gentlemen,

I appear before you today as part of the Senate's debate and approval process for the State Budget for 2018.

Allow me to begin by reviewing the current international economic setting of the Spanish economy and its outlook. I shall then refer to the main aspects of this draft Budget. To conclude, I will mention what, in my opinion, are the main challenges for fiscal policy in Spain in the coming years.

The external setting of the Spanish economy

The external setting of the Spanish economy broadly remains favourable, although the global economy is subject to factors of risk that should not be ignored.

Following several quarters of upward surprises, the opening months of this year have – more so in the euro area – seen some moderation in global economic activity whose scope is still uncertain. Notwithstanding, the information available continues to point to the maintenance of the current upturn over the next two or three years, underpinned by the correction of the previous imbalances, agents' confidence, the favourable financing conditions and the boost from the expansionary fiscal policies in the United States.

On the financial markets, despite the bout of marked volatility last February, asset values remain high by historical standards. At the same time, recent weeks have seen an appreciation of the dollar, which would be consistent with the expectations of further US interest rate rises, at a swifter pace than that in other economic areas. However, this appreciation might also be partly in response to a certain safe-haven effect, in a context in which certain risks appear to be rising, in particular in some emerging markets and areas subject to a high degree of political uncertainty. This latter factor is also contributing to heightening the uptrend in oil prices witnessed in recent months.

The decline in activity observed in the euro area during the first three months of 2018, from 0.7% to 0.4% in terms of the GDP growth rate relative to the previous quarter, should be analysed with care. On one hand, it should be borne in mind that last year's growth was particularly sharp (the highest since the start of the crisis, almost a decade ago); accordingly, it is reasonable to expect there should be some moderation. On the other, the as-yet very partial information available does not allow us to specify to what extent the change witnessed may have been due to transitory factors, relating to the weather and the high number of strikes in recent months in certain euro area countries, as opposed to other more durable factors. In any event, forecasts continue to suggest that the sustained rates of increase of euro area activity will continue in the coming months, albeit with a tendency to ease.

As to inflation, the latest data continue to evidence very moderate behaviour, with an increase in April, for the euro area as a whole, of 1.2%. The projected reduction in the degree of slack in the economy should enable inflation rates in the area to draw closer to levels compatible with the Eurosystem's objective of price increases below, but close to, 2%.

Spanish economic developments and outlook

Regarding the Spanish economy, the INE estimate for GDP growth in the first quarter of 2018 shows a rate of increase of 0.7%, in line with the two previous quarters.

That said, there has been a slight decline of 0.2 pp in the year-on-year rate of change from 3.1%, at end-2017, to 2.9% in the first quarter of this year, which is consistent with the continuation of the current upturn, albeit at a somewhat lower rate of increase than that observed in the past three years. On the latest projections published by the Banco de España in late March, output is expected to expand by 2.7% in 2018, 2.3% in 2019 and 2.1% in 2020.

The latest information would broadly confirm this scenario, albeit with a possible slight upward revision this year and next, as a result of the greater fiscal boost built into the draft State Budget for 2018 and in the recently published Stability Programme Update for the period 2018-2021, on which I shall comment later.

It is estimated that the growth of our economy will continue to be underpinned, above all, by national demand, but with a positive – though diminishing – contribution from the external sector. In particular, household consumer spending and residential investment will continue to be assisted by rising employment, the sector's improved financial position, the fiscal impulse and favourable financial conditions. Also, the growth of demand and of corporate earnings, higher capacity utilisation and the aforementioned propitious financial conditions will continue to provide for significant increases in investment in capital goods.

Nonetheless, the tailing off of some of the temporary factors that have supported the increase in activity in Spain in the most recent period would explain the moderation in growth expected in the coming years. This would be the case were there to be a reversal in the trend of oil prices, in the expansionary effect of monetary policy and in the momentum of external markets, following their significant dynamism last year.

As regards prices, the latest data continue to show, as in the euro area as a whole, very moderate behaviour, with the year-on-year growth of the CPI standing at 1.1% in April. The Banco de España projections published in March augured an increase of 1.2% for the year as a whole; however, it might ultimately be higher owing to the impact of the recent rises in oil prices. In this respect, the current volatility on the oil markets adds further uncertainty to the evolution of prices in the short term. In any event, for the more stable components of inflation (excluding energy), a gradual rise is forecast, in line with the expected increase in the degree of use of productive resources.

The main risks and factors of vulnerability

In this scenario, a series of risks should be highlighted.

Globally, behind the recent increase in economic activity, an expansionary stance has underlain demand-side policies in most geographical areas, in particular in the case of the monetary policy still maintained by the main advanced economies. By their very nature, it is to be expected that these measures will be reversed in the future, which might affect agents' expectations. While the various economic authorities are committed to a process of

monetary normalisation, in as gradual and orderly a way as possible, specific bouts of tightening on financial markets, as seen in the early months of this year, should not be ruled out.

Against this backdrop, the US Administration's recent measures also contain elements of uncertainty or risk.

First, US fiscal policy has adopted a clearly expansionary stance, in a context of maintaining GDP growth rates clearly above potential over a prolonged period. Further, the decisions announced in respect of tariffs, mainly – but not only – vis-à-vis China, might, although they still affect only a limited group of sectors, trigger retaliation, with clearly negative effects on activity and global trade. This adverse circumstance would, within the EU, be combined with the still-uncertain impact of Brexit on the UK economy and its trading partners. Finally, as the United States has broken the nuclear agreement with Iran, there might be further tensions on the oil market, with adverse effects on world growth.

In the current setting these risks are relevant to the Spanish economy, given that it still has high levels of public and external debt, which make it particularly vulnerable to negative developments on the international capital markets. At the same time, further increases in oil prices might particularly affect our economy in view of its high foreign energy dependence.

Elsewhere, the political situation in Catalonia does not appear to have stabilised, thereby posing a further factor of uncertainty, with potentially adverse consequences for the Spanish economy as a whole.

In the medium term, the expansion of our economy should cease to rest on the expansionary impulses of demand-side policies and come to depend on more durable factors. The estimates available on potential growth are relatively modest, meaning it is crucial to attempt to address some of the problems restricting it. These include most notably high structural unemployment, population ageing, a poor productivity trend and the technological capital deficit.

Budgetary policy in 2018

I shall now discuss the main items of the draft State Budget for 2018 approved by the Government on 27 March, and complemented by the Stability Programme Update for the period 2018-2021, submitted to the European authorities on 30 April.

This second document already includes some of the measures added to the draft Budget in its passage through Parliament. It is particularly useful in that it offers an overview of overall Spanish general (central, regional and local, including the Social Security system) government budgetary policy, providing a broader time perspective of four years. In a country as decentralised as Spain, it is impossible to properly assess public spending and revenue policies without this overview. At the same time, an effective fiscal policy, particularly when the starting point is a budgetary imbalance like ours, should be part of a consistent multi-year plan with specific measures.

The Budget and the Stability Programme include macroeconomic projections that point to increases in real GDP in Spain of 2.7% in 2018, and slightly lower levels in the following

years: 2.4% in 2019, and 2.3% both in 2020 and in 2021. Nominal GDP is expected to increase by around 4.3% over the entire forecasting horizon. The growth forecast and its composition are broadly consistent with the baseline scenario of the Banco de España's macroeconomic projections I outlined earlier.

The Stability Programme envisages an overall general government deficit of 2.2% in 2018, in line with the requirements of the Stability and Growth Pact. That should be conducive to Spain exiting the "excessive deficit" situation still prevailing. For the following years, further declines in the budgetary imbalance are envisaged, until resuming a slightly positive balance in 2021, for the first time since 2007. All tiers of government, including Social Security funds, should attain budgetary equilibrium in this horizon, according to the Programme.

For 2018, the drive to correct the budgetary imbalance is totally concentrated in central government and in Social Security funds, which should reduce their respective deficits by 1.2 pp and 0.4 pp of GDP to 0.7% and 1.1%. Conversely, the targets for regional and local government for 2018 are less demanding than last year and stand at -0.4% and 0% of GDP, respectively, compared with -0.3% and a surplus of 0.6% posted by these administrations in 2017.

The fulfilment of these targets and the macroeconomic projections should lead to a decline in overall general government debt to 97% of GDP in 2018, and 89.1% in 2021, down 1.3 pp and 9.2 pp, respectively, on 2017.

Significantly, practically the entire adjustment in 2018, and somewhat more than two-thirds of that in the period 2018-2021, would be due to the cyclical effect, whereby the structural budgetary effort would be relatively modest.

In terms of its composition, the Stability Programme envisages an increase in revenue somewhat outpacing that in GDP, in line with what occurred in 2017. Expenditure, meantime, after having posted very low growth in the past four years, is expected to increase by 2.7% on average over the 2018-2021 period, although its weight in GDP will continue to diminish.

On the revenue side, the Stability Programme includes the personal income tax cuts included in the draft Budget for 2018, which mainly affect the lowest-earning taxpayers, and which are expected to reduce the revenues relating to this tax in 2018 and 2019. This would be partly offset by the introduction of a new tax on certain digital services, which might contribute to raising resources by around €600 million in 2018 and by €1.5 billion in 2019, according to the Programme. However, this new instrument is still relatively undefined, meaning it is difficult to judge its tax-raising potential. Overall, and as stated in my last appearance before Parliament in relation to the Budget, achieving the public revenue targets for the current year, 2018, will entail a greater response by tax revenues to growth in economic activity than has been historically observed.

As regards the expenditure forecast for 2018, its more expansionary trend relative to previous years is mainly due to the agreements reached on employment and compensation of public-sector employees, on one hand, and on the revaluation of pensions, on the other.

The agreement reached by the Government with the main trade union organisations includes an increase in public-sector employees' remuneration of 1.75% in 2018, plus additional funds for targets and specific bodies that might entail a further 0.4 pp increase in total gross wages. In the following years, to 2020, there would be even higher increases than these. The budgetary plan also includes an extension to the hiring policy of the last two years, raising replacement rates in some sectors and enacting additional measures affecting working hours and temporary employment. Against this background, the estimated 2% increase in public-sector employees' remuneration in the Stability Programme for 2018 will probably be surpassed.

With respect to welfare benefits, the Stability Programme reflects the 1.6% settlement for the revaluation of public pensions, both in 2018 and 2019. This increase will be 3% this year, 2018, in the case of minimum and non-contributory pensions. I shall later return to this. In any event, given the trend growth in the number of pensions and the substitution effect arising from the new pensions replacing those that are terminated, which are generally higher than was earlier the case, the forecast growth in the budget earmarked for welfare benefits in 2018 (3.7%) may also be surpassed.

Among the remaining expenditure items for this year, goods and services purchases will notably continue to be contained, and interest payments to decline, while there will be a significant increase in public investment. This latter development is partly in response to the inclusion in 2018 of the expenditure associated with amounts for which the government may be liable under the insolvency-related legal proceedings currently affecting certain toll motorways. But even after adjusting for this effect, public investment is expected to be more expansionary than other items, as was the case in 2017. All told, public investment is expected to stand at 2.1% of GDP in 2018, excluding the temporary effect arising from the above-mentioning legal proceedings, a level far below the average for the previous two decades, which was 3.6%.

Overall, it may be concluded that the attainment of the budget deficit target for this year, namely 2.2% of GDP, is subject to significant risks. If they are not to materialise, potential slippage from the projections must be monitored so that there is time to react and the objectives pursued are not compromised. In this respect, the forecasts published by the European Commission several weeks ago should be taken as a warning sign, given that a deficit almost 0.5 pp of GDP higher than this target is estimated. Should this failure to hit the target be confirmed, the structural deficit would also be impaired, making fiscal policy in 2017 procyclical, given the estimation that the output gap would have already moved into positive territory.

The importance of budgetary consolidation

I should now like to move on to the importance of budgetary consolidation.

Since 2009 Spain has embarked on an intense process of public finances consolidation, which has entailed a reduction in the overall general government deficit of 8 pp of GDP. Achieving such an adjustment proved very difficult, given the prevailing circumstances.

Yet even if the budgetary targets for 2018 are met, public finances, as projected in the draft Budget, will still be in deficit to the tune of 2.2% of GDP, while public debt will be standing

at around 97% of GDP. Given that the Spanish economy is regaining, according to most analysts, a neutral or slightly positive cyclical position, this will entail, for 2018, a structural deficit – i.e. the cyclically adjusted total deficit – higher than the budgeted figure of 2.2%.

Against this background, the Stability Programme Update considers a continuation of the fiscal adjustment which, in any event, would still entail in 2021, eight years after the start of the economic expansion, a structural deficit of over 1 pp of GDP and public debt of almost 90% of output.

Maintaining levels of public debt around those currently prevailing in the Spanish economy involves significant costs that need to be taken into account. It entails the deviation of major resources for interest payments and, above all, vulnerability in the face of episodes of tightening financing conditions on international markets, restricting the possibilities of pursuing a countercyclical fiscal policy at times of economic recession.

In sum, it is most important to harness the current favourable circumstances of the Spanish economy to redress, as soon as possible, our structural deficit and public debt levels, bringing them in line with the standards set by our legislation and European regulations.

I would underscore, too, the challenge posed by the ageing of our population, in particular for our pension system. This is essentially a medium and long-term challenge; but for that very reason, tackling it appropriately is more difficult than other, shorter-term challenges.

The latest Social Security reform, in 2013, introduced two automatic adjustment mechanisms (the Sustainability Factor and the Revaluation Index) which sought to ensure a balance between the system's revenue and expenditure. The draft Budget and the Stability Programme Update have introduced measures to increase pensions above the level established by the Revaluation Index, in 2018 and 2019, and to delay the entry into force of the Sustainability Factor, from 2019 to 2023.

Allow me to reiterate what I have said in various addresses regarding this matter: it is a priority that we define, in accordance with social preferences, the substitution rates for the pension system that it is sought to ensure; and then, that we adjust revenue accordingly, so that sustainability is ensured. I believe this is a structural issue, requiring a debate not confined to the habitual discussions of an annual budget.

Conclusions

To conclude, I wish to highlight the fact that the Spanish economy is in its fifth consecutive year of growth, with the prospect that this trend will continue in the coming years, albeit at progressively more moderate rates. Set against this baseline scenario are a series of risks, which might shorten or moderate the current upturn. Accordingly, efforts to continue improving the Spanish general government budgetary position should not be delayed, so as to be able to effectively withstand potentially negative future developments. In this respect, fulfilment of the objectives set in the draft State Budget for 2018 and in the recent Stability Programme Update is crucial. Success will require strict implementation of spending policies and the continuous monitoring of revenue.

As this is my last appearance before the Senate as Governor of the Banco de España, and to conclude, I should like to express my gratitude for the consideration that has always been extended to the Bank and to me in this chamber, and for the quality of the interventions and questions raised on which I have had to comment. I have always thought, and have said so on different occasions, that the lower and upper houses are the “natural fora” in which an institution such as the Banco de España should preferentially express itself, cooperating and contributing, as best it can, to parliamentary functions.

Thank you for your attention.