Lowering Fiscal Vulnerabilities in Spain

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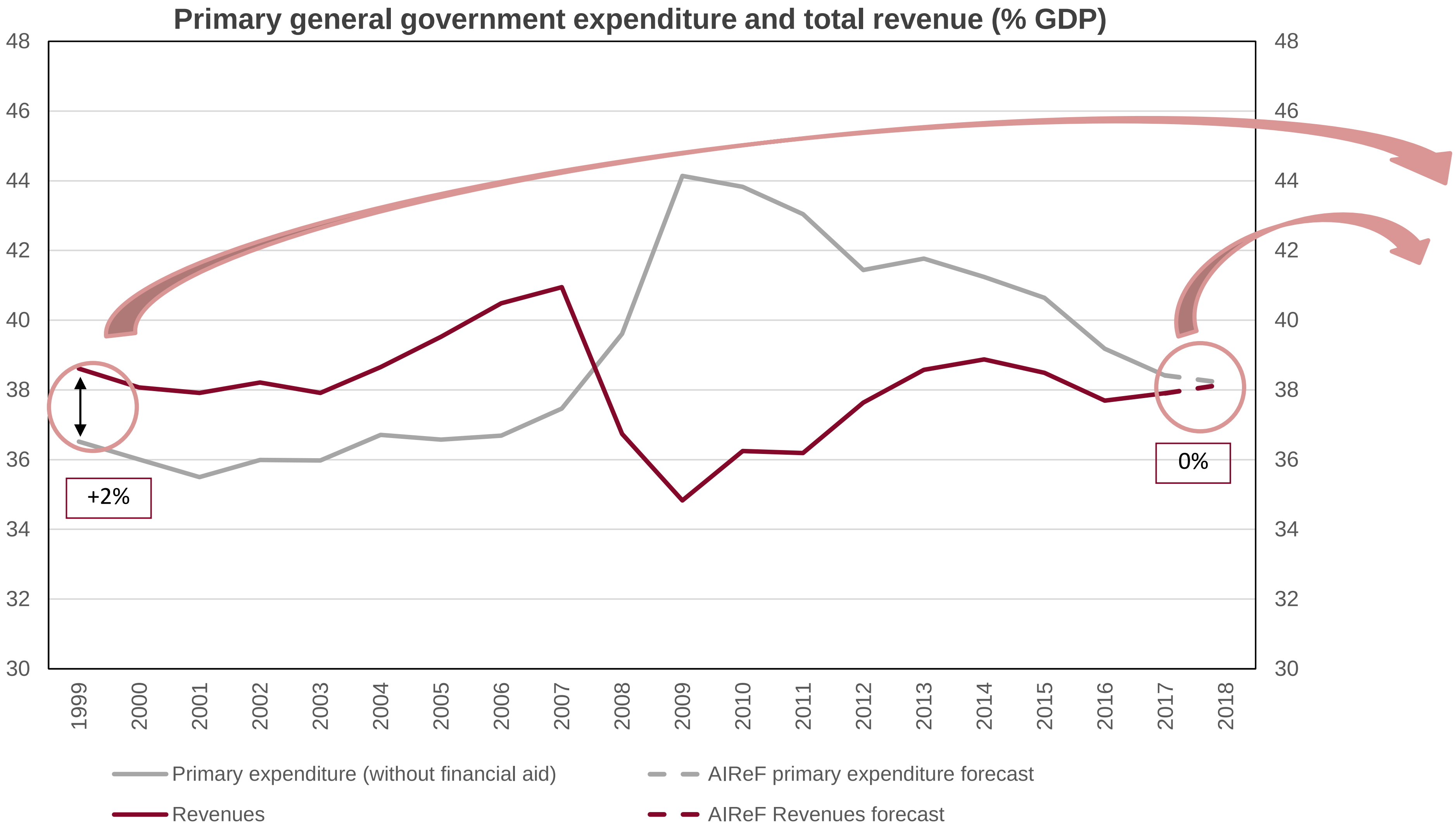
AIReF's President

Where do we stand today?

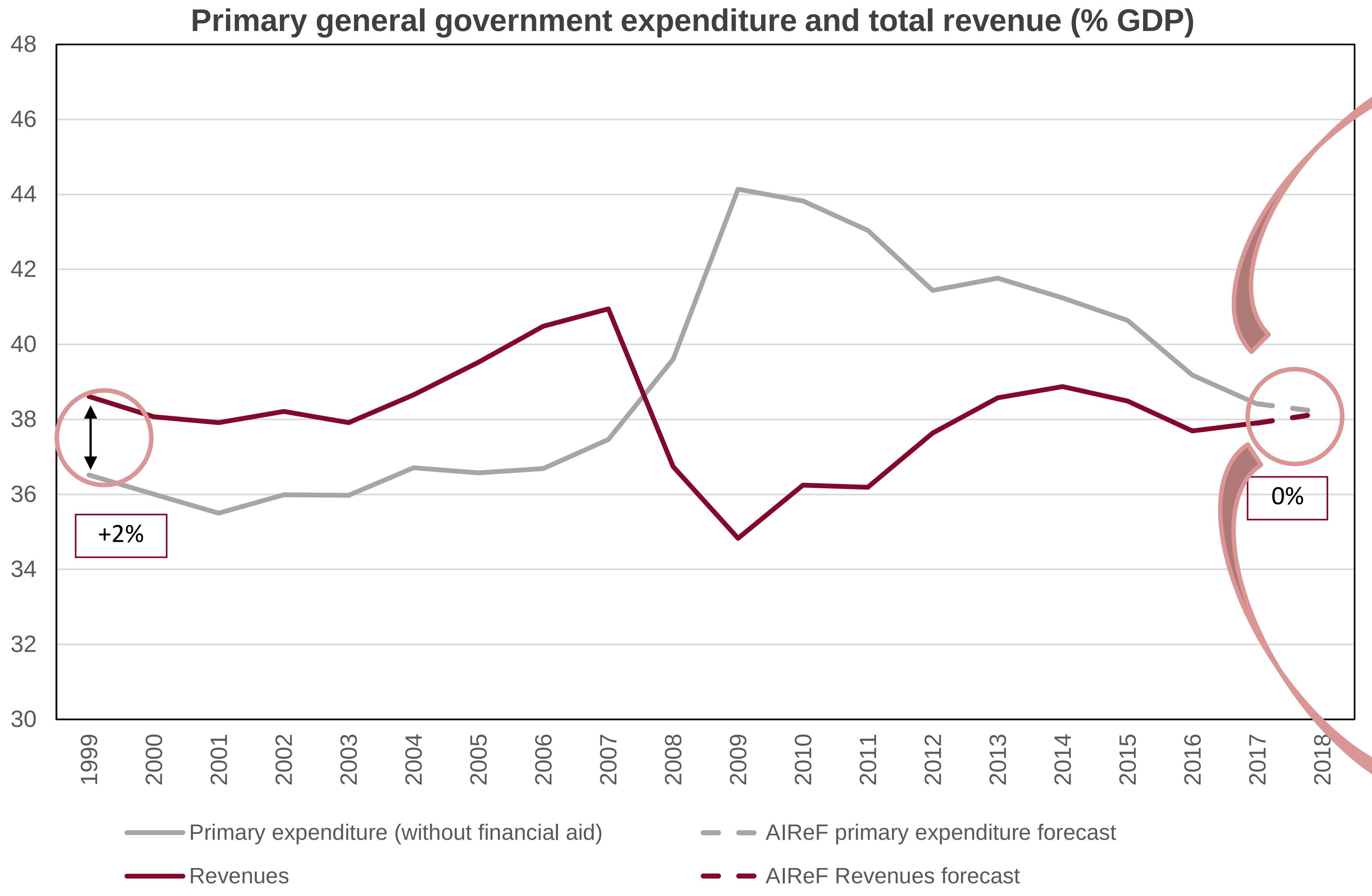


Both years (1999 and 2018) broadly similar neutral cyclical position

2018 overall and structural primary balance in equilibrium vs 2% surplus in 1999

Source: IGAE and AIReF's forecast from 2018

Where do we stand today?



Source: IGAE and AIReF's forecast from 2018

1999 vs 2018

Primary expenditure around 2 pp higher than in 1999:

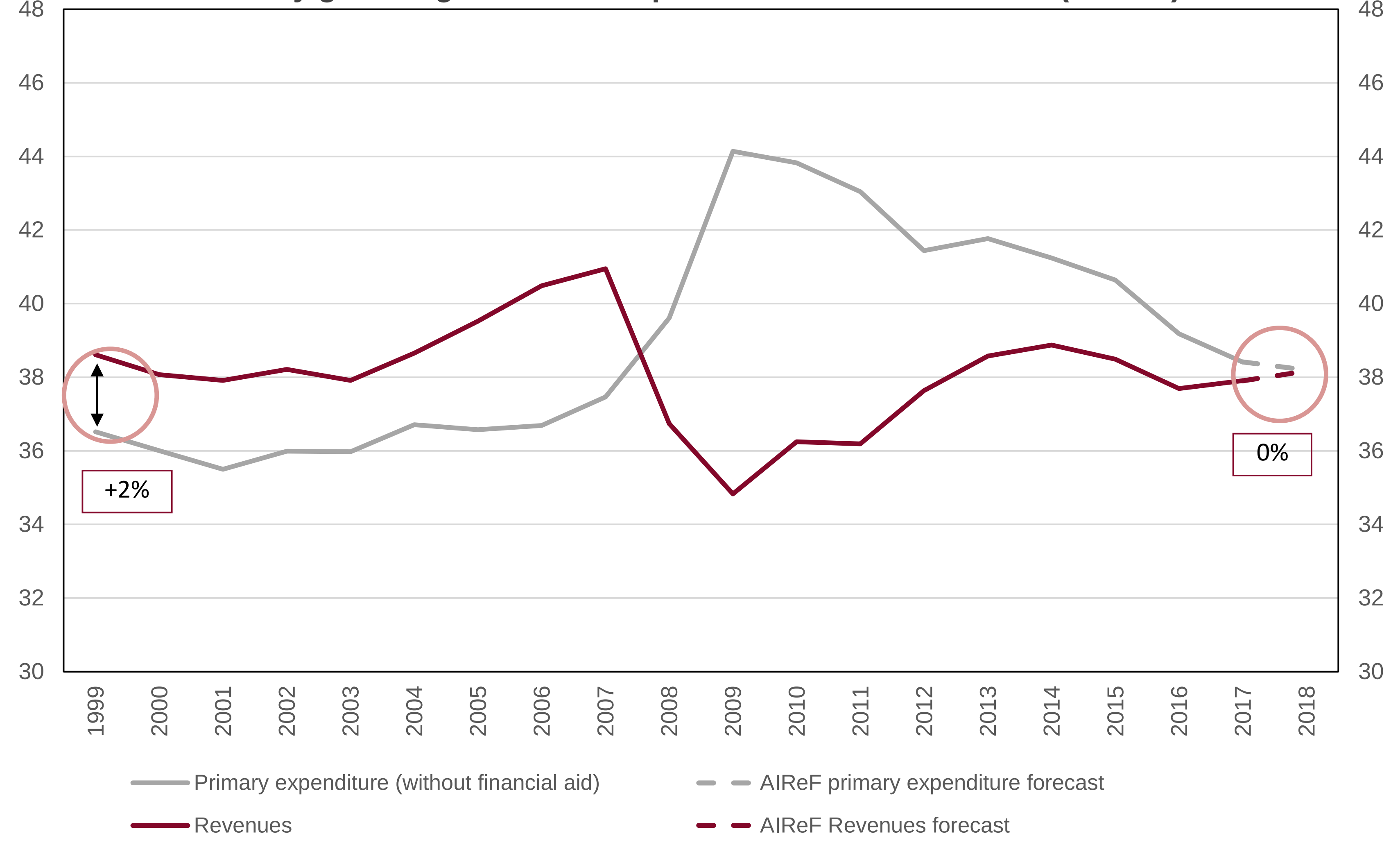
1. Social Security expenditure (mainly pensions) around 2.5 pp GDP higher
2. Health, education and social services around 1 pp higher
3. Offset by the reduction of gross capital formation expenditure by 1.5% pp GDP

1 and 2: structural
3: doubtful

Revenue similar to 1999 but with higher taxes: direct and indirect taxes around 1pp GDP higher offset by lower EU funds and seigniorage

Where do we stand today?

Primary general government expenditure and total revenue (% GDP)

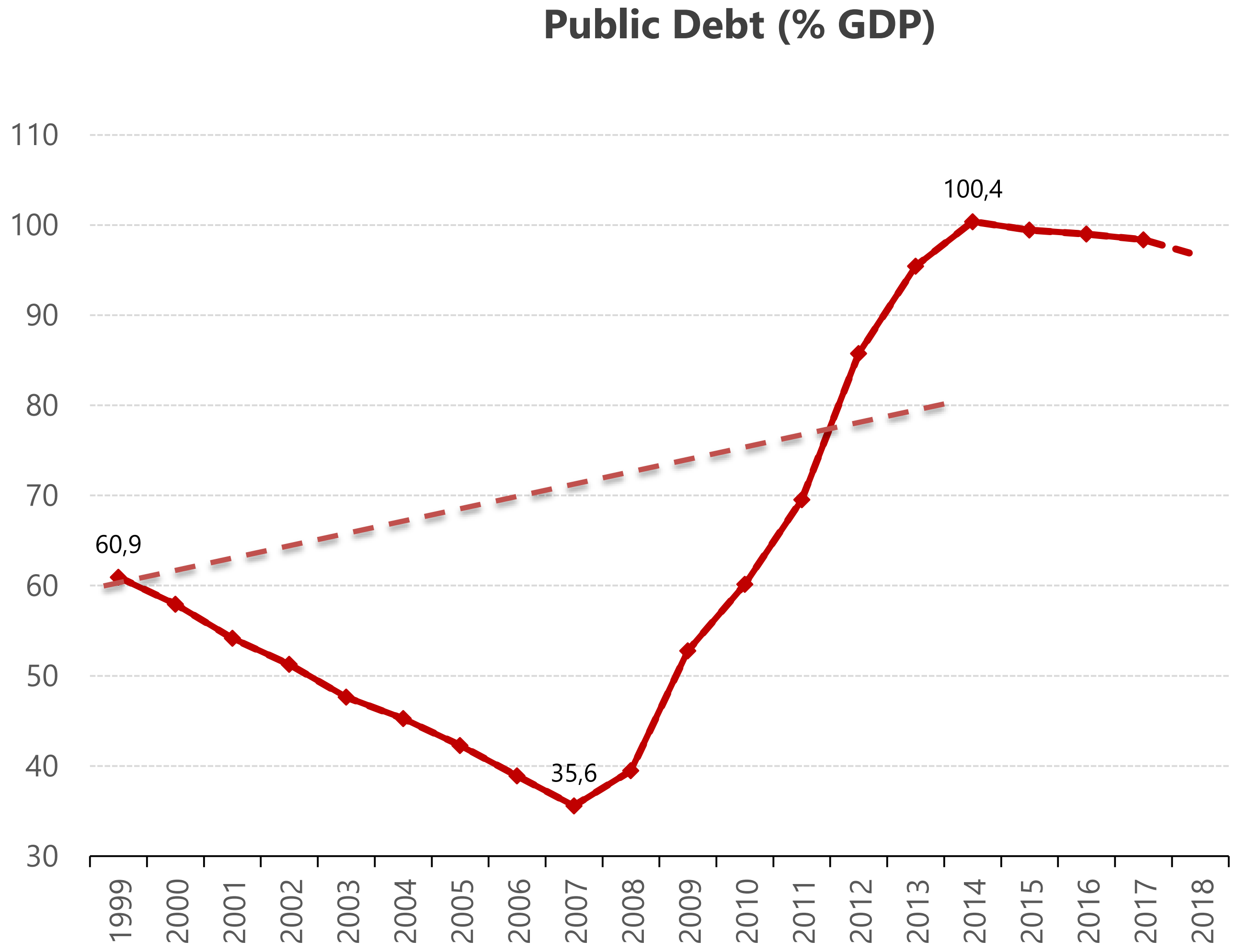


Source: IGAE and AIReF's forecast from 2018

Today's structural primary balance in equilibrium but with a significant social security imbalance:

- **Primary deficit of Social Security (-1.4%)**
- **Offset by similar primary surpluses in central and subnational (regions and local) governments (0.7% each)**

Public debt legacy unveils structural fiscal weaknesses



Source: Banco de España and AIReF estimates

65 pp increase in 6 years: 2008-2014

Impact of the crisis 2008-2014 (protracted cyclical weakness in a low inflation environment) …………….. 38 pp

- Economic cycle………………………..21 pp
- Crisis level interest rates…….................6 pp
- Financial assistance to private sector...7 pp
- Contribution EFSF/ESM..………………4 pp

Structural budgetary factors ....21 pp
(Cumulated structural primary balance)

Debt dynamics effect.………………..…. 6 pp

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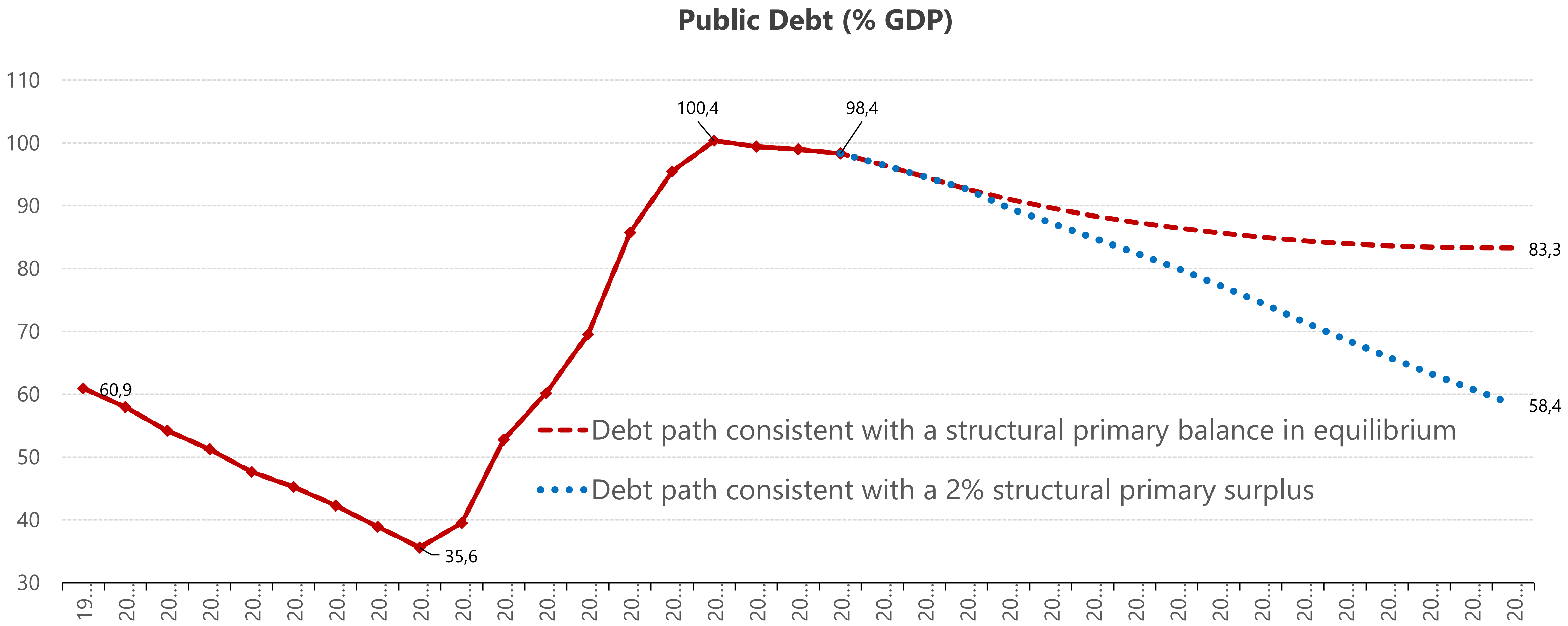
Sustainability will ultimately depend on fiscal discipline

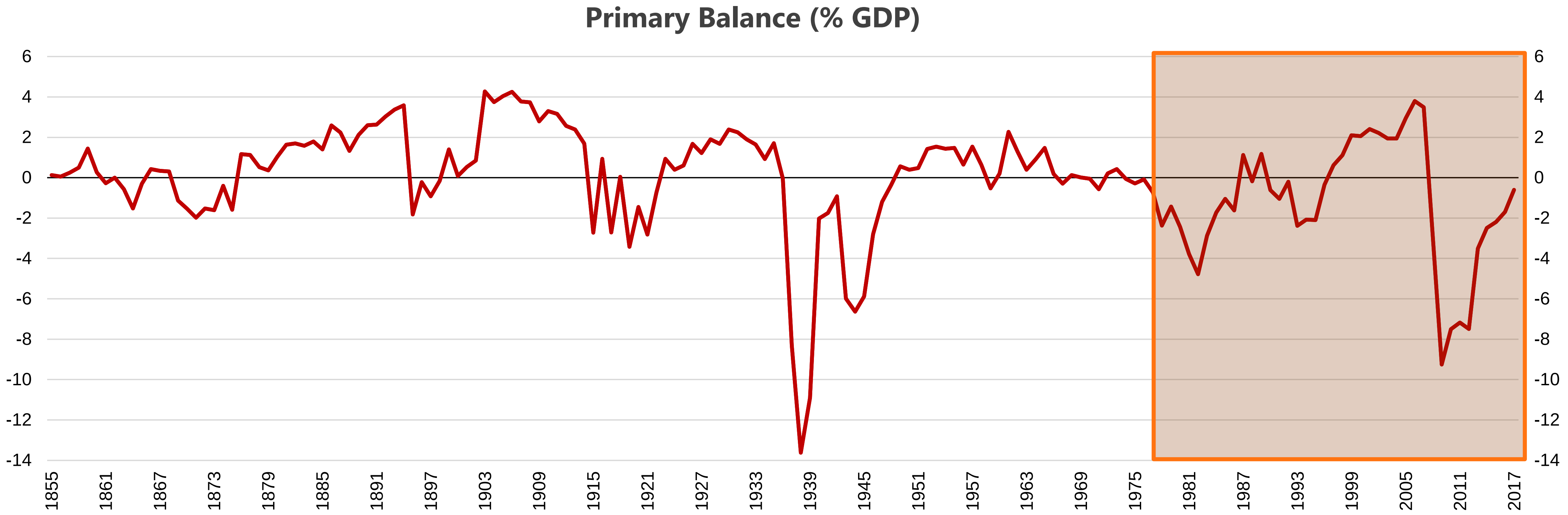


Source: Banco de España & AIReF estimates

Macro assumptions common to both scenarios (average 2018-2035):

- Inflation: 1.8%
- Output Gap closes in 2019
- Implicit interest rate: 2.9%
- Potential growth rate: 1.5%

What does Spanish track-record show? 2% primary surplus is not the norm



Source: AIReF

	Average PB (%GDP)	Number of years in surplus	Number of years with surplus >2%
1850-2017	**-0.1**	**99** (59% of total observations)	**29** (17% of total observations)
1978-2017	**-1.2**	**13** (33% of total observations)	**7** (18% of total observations)

Projected debt levels not sustainable: need for fiscal buffers

- In a monetary union, fiscal policy overburdened
- Significant risks looming

	SOEs, PPPs	Ageing related	Financial crises	Geopolitical risks
Probability	Very high	Almost certain	High	Non-linear and sudden
Horizon	Medium-term	Long-term	On average once very 15 years	Uncertain
Size	Medium: at most 3.5% GDP	Medium: between 2% and 4% of GDP	Larger over time due to no inflationary financing and sizeable more financial sector	Very large

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Strengthening the fiscal framework is the only way forward

	Significant progress	But still lot of room for improvement
Transparency	➢ **Information requirements become mandatory:** Oct 2012 Ministerial Order. ➢ **Extremely detailed regulation on:** o Who provides what and how (electronic means) o Economic and Financial Information Center	➢ Information **on methodologies and accounting criteria:** very scare and incomplete ➢ **Technical Committee of National Accounts** still to be established after more than 4 years of mandate by organic law
Normative framework	➢ Budgetary stability principle at the **highest normative level:** Constitution + Organic Act ➢ **All subsectors** subject to fiscal rules ➢ **Commercial debt and late payments** included under the fiscal sustainability principle ➢ **Subnational enforcement mechanisms reinforced**	➢ **A. Weak enforcement** A.1 Rule implementation problematic A.2 Subsector and intra sector mismatches ➢ **B. Design deficiencies:** B.1 No sound medium-term approach B.2 Adequate to build up fiscal buffers?

A. Weak enforcement

A1. Fiscal rules implementation problematic

- Unrealistic and too demanding targets (no technical criteria)
- Complicated rules (no hierarchy; no consistency)
- Corrective measures not viable. EFP mere pro-forma documents
- No correction plan for central government
- Wide room for discretionary decisions (no automatism)
- CPFF working methods do not foster fiscal co-responsibility

A2, Subsector mismatches and deficiencies of regional financing system

- Recurrent local surplus vs underlying deficit of social security and central government
- Widely recognized financing inequalities across regions
- Unclear definition of competences and unclear division of responsibilities
- Insufficient role of spending needs as anchor of the system
- Bilateral negotiations dominance

a) No moral authority to enforce compliance

b) Weak fiscal rules ownership

➢ Mechanisms to face liquidity restrictions (FLA): true driver of fiscal discipline

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B. Design weaknesses

B1. No sound medium-term approach

- Stability Programs (SP) not a good substitute for medium-term approach
- SP: delinked from the budgetary process
- SP: no info by subsectors
- SP and annual budgets: different accounting criteria
- Annual revisions: moving targets
- Deficient ex ante and ex post impact assessment of measures

B2. Is the current fiscal rules setting design adequate to build up fiscal buffers?

- Spanish rules not fully aligned with EU ones: less stringent expenditure benchmark
- Fiscal requirements based on structural indicators: not adequate fiscal guidance tool
- Insufficient attention to debt: consensus on main anchor for long-term
- Contingent labilities to be factored in
- Towards a broader analysis and management of fiscal risks

EU reforms (2011 Directive assessment and 6 pack and 2 pack reviews) as an opportunity to trigger changes

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Conclusions

- **Spain has exited the crisis with significant fiscal vulnerabilities**
- This requires a **credible and realistic medium-term fiscal plan** where long-term pressures of public spending must also be properly factored in.
- **The quality of public finances merits special attention in this medium-term strategy**. Spending review is an opportunity and a step in the right direction.
- **The fiscal governance framework needs to be strengthened and transparency to be improved**.
- **Fiscal rules to be simplified**, be based on observable variables, aligned with EU standards and provide the right incentives to keep consolidating (and mainly) in good times.
- **Compliance with fiscal rules very much depends on its ownership by different levels of public administration:** a more transparent, objective and cooperative system for setting fiscal targets (based on objective input) and a more balanced regional financing system free from financing bias.

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