



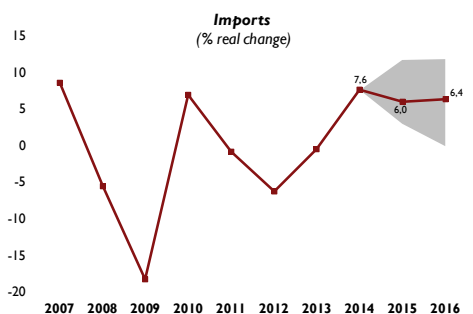
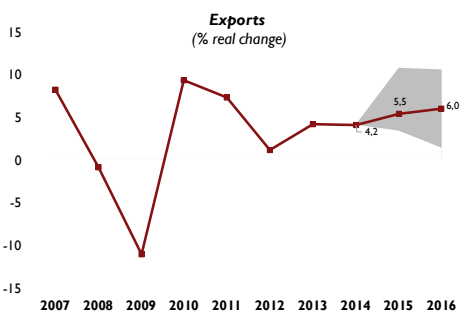
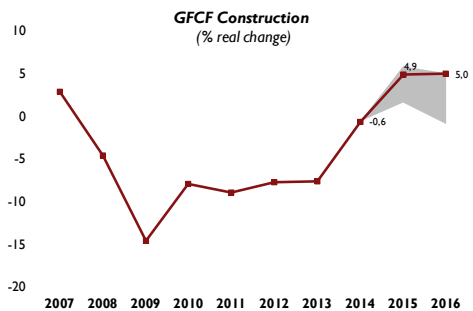
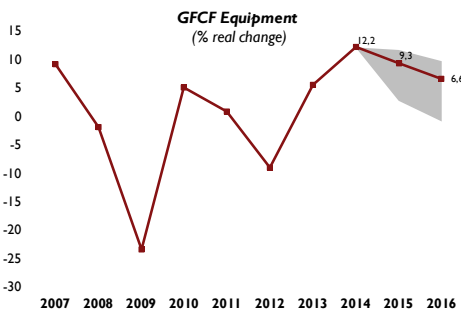
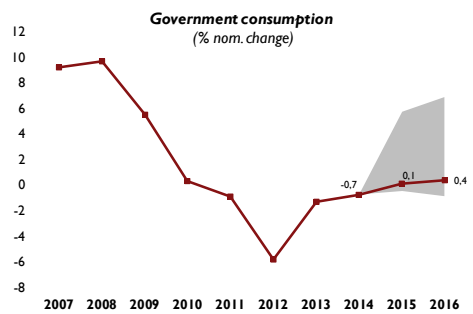
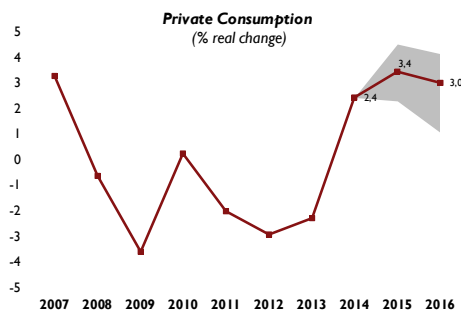
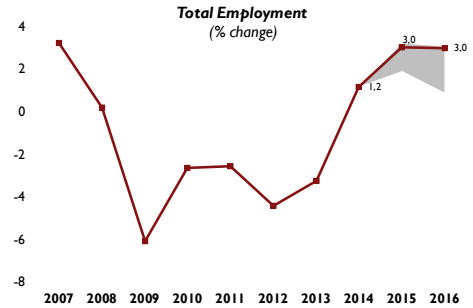
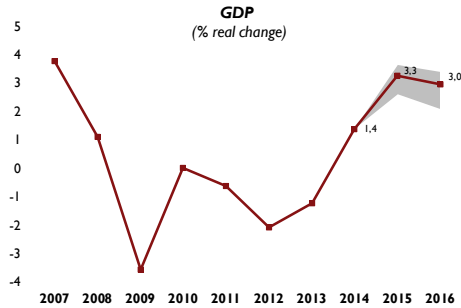
AIReF ENDORSES THE SPANISH GOVERNMENT'S MACROECONOMIC SCENARIO FORECASTS AS LIKELY

- **The scenario is likely overall although the eventual composition of growth may be different from the forecast, with more consumption and less investment**
- **Job creation may be slightly lower than expected by the government according to the report on the government's macroeconomic forecasts**
- **AIReF makes two suggestions of good practices and a recommendation about the information that should be included when preparing macroeconomic scenarios**

The Independent Authority for Fiscal Responsibility (AIReF) in Spain has just published on its website (www.airef.es) its Report on the macroeconomic forecasts in the Spanish government's 2016 Draft State General Budget. In the report the independent fiscal institution endorses the government's forecasts as likely. AIReF is of the view that the government's macroeconomic scenario is likely on the whole. However, the composition of growth may be different from the projection given, with more consumption and less investment and slightly lower job creation than expected.

According to AIReF, the government's forecasts are generally realistic but they are subject to a number of different risks. Firstly, the assumptions for higher interest rates and oil prices than the current ones are prudent, implying that the government's key forecasts may be overshoot in reality. Secondly, there are risks relating to the implementation of the policies designed by the government and to the effects they may have. In particular, those risks concern the effectiveness of the restriction on increasing expenditure on the part of the autonomous regions and the stimulus the new tax cuts will entail for private consumption. Their impact on GDP would be very different depending on the combination of risks that eventually materialises. Overall, however, the report published by AIReF states that the risks surrounding GDP growth are regarded as balanced.

Government forecasts and AIReF uncertainty ranges





In its report AIReF makes the following two suggestions of good practices to the Spanish government:

1. In order to improve the forecasting process in the future, it would be advisable for the government to make its forecasts using the assumption of unchanged policies. The forecasts should be accompanied by a separate quantification of the impact of any new measures planned and how they would affect the macroeconomic aggregates.
2. With respect to the minimum information to be provided in the forecasts, AIReF reiterates its earlier recommendation to include the key elements in the forecasts in a simplified national accounting framework. This would make it possible to understand the connections between economic activity, demand and employment on the one hand, and income flows and borrowing requirements on the other, and so identify the impact of the policy measures adopted by the government.

Furthermore, AIReF recommends that the work should be completed so that the published macroeconomic forecasts include all the relevant methodologies, assumptions and parameters underpinning them, so making them compliant with Directive 2011/85 on budget frameworks and with article 29 of the LOEPSF, which defines the content of the medium-term budgetary plans of the General Government sector. This recommendation is in the process of being complied with by the Ministry of Economy and Competitiveness. AIReF considers that the Stability Programme Update in Spring 2016 should include these aspects.

Risk analysis

The risks stemming from the external environment are approximately balanced. On the one hand, uncertainty about the situation in the euro area persists. Furthermore, geopolitical tensions whose impact may be to push up the oil price could hold back world growth. In the financial sphere, the lack of any synchronisation of monetary policy in the advanced economies might end up triggering a change in the configuration of exchange rates and an unexpected increase in volatility and sovereign risk premiums. On the upside, there are other risks that could also be mentioned stemming from the positive momentum triggered by cheaper oil prices, the depreciation of the euro, lower interest rates and improved financing conditions that might last longer or have a greater than expected impact on economic activity.

Although the assumption about long-term interest rates is prudent, given that the trend forecast is above the path stemming from market expectations, this interest rate trend is subject to upside risks —stemming from the foreseeable normalisation of monetary policy in USA and the still uncertain situation in Greece— and downward risks if governance in the euro area manages to gain greater credibility. This assumption is very important because of its impact both on GDP growth (essentially through investment) and on the interest burden on the public administrations in Spain and consequently on their deficit target.



There is also a risk that oil prices will rise more quickly than expected although the impact of this hypothesis would not be substantial in the short term. The reduction in supply in response to lower prices could be particularly intense. Additionally, although Iran's return to the crude oil markets could give rise to expectations of more output, any escalation in the existing tensions with Russia or in the Middle East could end up strangling supply. In the opposite direction a bigger impact of real income gains from the fall in oil prices on economic activity cannot be ruled out either.

There are significant risks of insufficient implementation of the stringent government expenditure restriction policy included in the government consumption forecasts. Although there is uncertainty about the accuracy of the different forecasting instruments used, the models developed by AIReF suggest that the simultaneous rises in interest rates and oil prices contained in the government's hypotheses together with the maintenance of the notable government expenditure restrictions included in the forecasts for 2015 and 2016 could entail a slowdown in economic activity of one percentage point compared to the government's scenario, and lower growth in employment of the same size. There is an additional uncertainty related to the difficulties of implementing the forecast expenditure policy. If sufficient expenditure restraint measures —affecting the expenditure implemented by the autonomous regions above all— were to be applied in order to meet the government consumption target proposed by the government, as well as to comply with the expenditure rule in the whole General Government sector, the deficit target for the whole sector envisaged by the government in its macroeconomic scenario would be achievable. This countercyclical budget constraint policy, which is linked to the requirement for compliance with the expenditure rule laid down in the Organic Law on Budgetary Stability and Financial Sustainability, would have a moderating effect on the financial imbalances that a swift expansion of private demand generates and would contribute to making the growth in real GDP more stable in the medium term.

Any relaxation of government expenditure control discipline would have negative consequences for budget stability and contrasting effects on growth in the short and medium term. If, as seems likely to judge from past experience, the risk of significantly higher government expenditure than the figure included in the forecasts materialises, less fiscal policy restraint on the spending side would fuel growth in domestic demand, increasing inflationary tension and undermining the competitiveness gains that wage moderation, structural reforms and price stability have brought. Additionally, the reduction in the government deficit forecast in the budgetary scenario would not be the scheduled figure in nominal terms because the side-effects of the greater expansion of economic activity and higher prices on revenue and expenditure with cyclical sensitivity would not be enough to offset the higher government expenditure on goods and services. If that happened there would definitely be a lesser degree of fiscal consolidation in structural terms and impairment of medium-term growth.

In summary, the risks for the key macroeconomic variables in 2015 and 2016 seem broadly balanced. There are factors that would boost growth in the short term, such as the persistence of an expansionary outlook in monetary policy which is committed at least until September 2016 and might maintain more comfortable financing conditions than those assumed in the government's scenario. This favourable financial environment might be combined with a relaxation of fiscal policy both on the expenditure side and the revenue side that would



exacerbate the procyclical momentum of economic policies, with negative results for the sustainability of growth in the medium term. Other factors, in contrast, might moderate the economic expansion. On the international front, growth in the world economy might slow down because of the weakness in the emerging economies and so negatively affect the growth of Spanish markets abroad and exports. In the euro area, the uncertain situation in Greece might deteriorate further. This would undermine confidence and lead to a new tightening of the conditions to obtain financing that our economy relies so heavily on with negative consequences for investment. In Spain, job creation might be lower than the figure expected by the government and this would affect the forecasted strength of private consumption. The risks concerning external demand are judged to be balanced, although the forecasts for the current account balance to remain above 1% of GDP are optimistic. The government deficit targets that have been met in recent years are deemed difficult to achieve in 2015 and 2016.