

AIREF LOWERS THE FORECAST FOR 2022 GDP BY TWO POINTS, TO 4.3%, AND REDUCES THE DEFICIT ESTIMATE BY 0.6 POINTS, TO 4.2% OF GDP

- The Independent Authority for Fiscal Responsibility updates its forecasts to take into account the impact of the energy crisis and production supply problems, which have been amplified by the war in Ukraine
- The institution reduces growth by two points compared with the last report due to the succession of supply shocks
- Expected inflation for 2022 rises by almost five points, to 6.2%, and the impact on growth associated with the RTRP is lowered from 2.5% of GDP to 1.8%.
- AIReF reduces its deficit forecast by 0.6 points due to the more favourable than expected evolution of revenue in 2021 and early 2022, which exceeds the cost of the measures to mitigate the effects of the war and the deterioration of the macroeconomic scenario
- By sub-sector, AIReF estimates a deficit of 3.3% of GDP in the Central Government; of 0.4% of GDP in the Social Security Funds; of 0.7% of GDP in the Autonomous Regions and a surplus of 0.3% of GDP in the Local Governments
- AIReF forecasts a debt ratio of 113.9% of GDP in 2022
- AIReF recommends including in the Stability Programme Update a medium-term fiscal strategy that will realistically and credibly ensure the financial sustainability of the General Government.

The Independent Authority for Fiscal Responsibility (AIReF) today published the Report on the Initial Budgets of the General Government (GG) for 2022. This report contains updates of its macroeconomic and fiscal forecasts in line with the new geopolitical situation, which has led to inflationary tensions that have not been seen since the 1970s, and the latest available information. Within the difficulty of assessing the economic consequences of this conflict, AIReF presents a new macroeconomic scenario in which it lowers forecasts for real GDP growth to 4.3%. In fiscal terms, AIReF revises the General Government deficit forecast in its central scenario to 4.2% of GDP from the 4.8% forecast in the previous report.

In the report, AIReF points out that the environment in which the Spanish economy operates remains characterised by extreme uncertainty, although the epicentre has shifted from the health sector to the economy's supply capacity and, in particular, to energy markets. The disruptions in production chains and energy markets that emerged

over 2021 have been heavily amplified by the invasion of Ukraine by the Russian army in February 2022, generating inflationary tensions not seen since the 1970s.

The Spanish economy has been affected to a greater extent than other neighbouring economies by this succession of supply shocks given its high energy dependence and the quick transmission of price increases in energy raw materials to electricity costs. AIReF highlights that price tensions are causing a reduction in households' purchasing power and in competitiveness with other countries, while they have led to a change in the monetary policy stance and greater volatility in financial markets.

In this context, AIReF's forecasts lower real GDP growth for 2022 from the 6.3% that served as the basis for preparing the report on the macroeconomic forecasts of the 2022 General State Budget (GSB) to 4.3%, while nominal GDP growth, which is particularly relevant for fiscal forecasts, stands at 8%. At the same time, expected inflation for 2022 is revised from the 1.8% forecast in October to the 6.2% currently expected. The Government's forecasts used to prepare the Budget projected real growth of 7% for this year and expected inflation of 1.3%.

Revision of impact of the RTRP

In addition to the impact of all the aforementioned shocks, these forecasts also incorporate a downward revision of the impact on growth associated with the Recovery, Transformation and Resilience Plan (RTRP) in 2022 from 2.5% of GDP to 1.8%. This is due to the fact that the revenue will reach the economy in a more adverse environment, characterised by bottlenecks and inflationary pressures and associated with a lower multiplier, which is revised from 1.2 to 0.9.

In addition, AIReF notes that the balance of risks is clearly on the downside for growth and on the upside for inflation. The persistence of the pandemic may cause supply shortages to last longer than projected in this scenario. In addition, the roots of the energy crisis go beyond the war in Ukraine, given the limited progress in renewable energy production, while the energy transition in Europe and, more recently, in China may lead to greater demand shifted towards less polluting fossil fuels, such as natural gas.

Budgetary scenario of the General Government

For its central scenario, AIReF estimates a General Government deficit of 4.2% of GDP in 2022, thus lowering its forecast by 0.6 points compared with the October report. These 0.6 points are explained by the incorporation of the latest available information, which leads to a reduction in the forecast of the deficit of 1.3 points of GDP compared with October; the effect of the deterioration of the macroeconomic scenario on the fiscal forecasts, with contrasting effects that together cause an increase in the forecast of the deficit of 0.1 points; and the new measures adopted since the previous report, which result in a higher deficit in 2022 of 0.6 points of GDP.

Firstly, the improvement due to the incorporation of the latest available information is mainly due to the year-end figure for the 2021 public deficit of 6.9% of GDP, one point

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less than in the October report. At the end of 2021, the evolution of revenue was significantly more positive than expected and what might be inferred from the expected evolution of macroeconomic variables. Consequently, revenue ended the year 1.3 points above the forecast, which also made it possible to absorb some unforeseen expenditure, such as deferred tax credits or the allocation of bad debts due to COVID guarantees in 2021.

Secondly, the worsening macroeconomic scenario also affects fiscal forecasts through various channels with opposing effects. This produces a combined result of an increase in the deficit of under 0.1 points of GDP.

On the revenue side, inflationary pressures generate in the very short term a positive and automatic effect of increased revenue, especially in VAT. Approximately, each additional point of inflation results in just over €2bn of additional revenue. However, this shock also implies a reduction in real growth forecasts, which will in turn reduce public sector revenue. Once the effect of all the shocks mentioned in the previous section has been incorporated, the macroeconomic scenario will contribute to increase revenue by 0.3 points.

On the expenditure side, inflation has a direct and automatic impact on the interest rates of inflation-indexed bonds. In the longer term, it will also affect the goods and services purchased by the GG as the contracts are tendered or renewed. However, this effect will be limited in 2022 due to the existence of the already approved budget with limitations in the appropriations. In addition, interest expenditure will grow with new debt issues as inflation expectations and monetary policy normalisation feed through to interest rates. For 2022, the impact of inflation on expenditure would be around 0.4 points of GDP. In addition, inflationary tensions in 2022 will also affect the evolution of expenditure in 2023. This impact is direct and automatic in the case of pensions, which will be increased in 2023 in line with the 2022 CPI, in accordance with the pension reform. This means that each additional point of inflation in 2022 will raise spending by around €1.5bn in 2023.

Thirdly, the new geopolitical situation and its effect on the macroeconomic scenario affects fiscal forecasts through the action of governments to mitigate its effects. As of the issue date of this report, the new measures adopted since the previous report imply a higher deficit in 2022 of 0.6 points of GDP.

Reduction of the deficit in 2022

As a result of the above, the deficit in 2022 will be reduced by 2.7 points of GDP compared with 2021. The progressive withdrawal of the measures implemented to mitigate the effects of the COVID-19 crisis is the main factor, contributing 2.4 points to the reduction in the deficit compared with 2021. In addition, the evolution of revenue associated with the economic cycle and expenditure not linked to COVID or the new measures result in a further reduction of the deficit of 0.5 points in 2022. In addition, the measures put in place to mitigate the effects of the war exceed the effect of the tax measures incorporated in the GSB, jointly raising the deficit by 0.2 points in 2022

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compared with 2021. Finally, AIReF assumes a neutral effect on the deficit of the implementation of the Recovery and Resilience Plan and the REACT-EU funds.

AIReF forecasts that revenue will grow by 4.2% without including the RTRP in 2022, to stand at 42% of GDP, 44% if RTRP revenue is included. Expenditure, excluding the RTRP, will stand at 46.2% in 2022, according to AIReF's estimates, compared with 45.5% in the previous report.

By sub-sector, AIReF estimates a deficit of 3.3% of GDP for the Central Government in 2021, a reduction of 0.5 points on the previous forecast. In addition, it reduces the estimated deficit of the Social Security Funds by 0.1 points to 0.4% of GDP, after ending 2021 with a deficit of 1% of GDP. The deficit of the Autonomous Regions, meanwhile, will grow in 2022 to 0.7%, after ending 2021 almost with a balanced budget, while Local Governments will maintain in 2022 the surplus of 0.3% of GDP in AIReF's central scenario, 0.1 points higher than in the previous report.

Sustainability

In this complex context, AIReF notes that the Spanish debt-to-GDP ratio stood at 118.4% at the end of 2021, a reduction of 1.5 points over the year. Although this year-end 2021 level is an improvement compared with all the forecasts, both from national and international organisations, it is 22.9 points higher than the pre-pandemic level. This year, AIReF's macroeconomic and fiscal forecasts project a reduction in the debt-to-GDP ratio of 4.5 points on the level recorded in 2021, placing the ratio at 113.9% in 2022.

AIReF points out that the risks and challenges for the medium- and long-term sustainability of the public accounts are high. The new crisis scenario that has emerged following the invasion of Ukraine may alter the process of normalisation of monetary conditions that was expected over 2022 as a result of the sharp increase in inflation worldwide, accelerating the process of stimulus withdrawal and deteriorating financing conditions. In addition, the war in Ukraine generates new investment needs in the short and medium term associated with both defence spending and the greater urgency to increase renewable energy production capacity and reduce dependence on Russian energy. This is compounded by the well-known challenge of an ageing population and higher pension expenditure, which, if not financed with additional revenue, will lead to a very significant increase in debt from levels that are already historically very high.

Recommendations

AIReF has been making recommendations for the Government to set out a medium-term fiscal strategy that will act as fiscal guidance and will realistically and credibly ensure the financial sustainability of the General Government since the activation of the escape clause in 2020. In addition, if the current geopolitical and economic context requires fiscal policy action, the institution believes it is essential that, while the necessary short-term

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measures are taken, a medium-term strategy be set out to achieve a realistic and credible path of debt reduction once the measures are withdrawn.

According to AIReF, this planning must include the means for a gradual consolidation, where medium-term targets and goals should be set and, at the same time, provide for actions and fiscal margins to achieve them. Moreover, this strategy must be designed in such a way as not to harm the country's economic growth. The current uncertain environment means that this strategy will inevitably be adapted flexibly to the changes that arise in the economic situation. In this regard, AIReF considers that the Stability Programme Update would be a good opportunity to fully and adequately reflect all these elements.

In addition, in order to have complete information on the implementation of the RTRP, AIReF recommends that the Ministry of Finance and Civil Service publish separately the amounts corresponding to the revenue and expenditure of the RTRP in national accounting headings. It should also publish a breakdown in national accounting terms of the amount transferred and the recipient sub-sector of the current and capital transfers between GG sub-sectors corresponding to the RTRP.