REPORT ON BUDGETARY EXECUTION, PUBLIC DEBT AND EXPENDITURE RULE 2022

REPORT 22/22

The mission of the Independent Authority for Fiscal Responsibility, AAI (AIReF) is to ensure strict compliance with the principles of budgetary stability and financial sustainability enshrined in Article 135 of the Spanish Constitution.

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TABLE OF CONTENTS

EXECUTIVE SUMMARY

The Independent Authority for Fiscal Responsibility, AAI (AIReF) has the legal mandate to report on the budgetary execution, public debt and expenditure rule in 2022 of the General Government (GG). Along with this report, AIReF also publishes the individual reports on each Autonomous Region and the supplementary report on the Local Governments (LGs). As the fiscal rules for 2021 are still suspended, the analysis focuses on the General Government's budgetary and sustainability forecasts. AIReF's fiscal supervision also takes on greater importance as a guarantor of the sustainability of the General Government.

In this report, AIReF updates its macroeconomic and fiscal forecasts in a context in which downside risks to economic growth mainly predominate. In its report on the Stability Programme Update published in May, as part of a medium-term analysis, AIReF estimated a GG deficit of 4.2% for 2022, on the basis of GDP growth of 4.3% in real terms and 8.2% in nominal terms. It warned of the existence of downside risks associated with the energy crisis and the persistence of inflation, which raised the likelihood of inflationary spirals and loss of competitiveness, while reducing the purchasing power of households.

Since then, the risks described in the report, far from fading away, seem to have become more pronounced and have crystallised in some cases, particularly those relating to inflation. As a result, AIReF is revising downwards the real growth forecast for 2022, which would stand at 4.2%, while raising its inflation forecast from 6.5% to 7.8%.

With regard to the fiscal scenario, the deficit of the GG as a whole will stand at 4.5% of GDP in 2022. This revision is the result of the new measures approved, the revision of the macroeconomic scenario and the new available information, both on execution published to date and that provided directly by the various public administrations.

How has the macroeconomic scenario evolved?

The macroeconomic scenario underpinning the budgetary projections presented in this report is characterised by a slight decline in expected real growth in 2022 to 4.2%. The revisions relating to inflation are larger, with an expected increase in the CPI of 7.8% on average in 2022, in contrast to the 6.5% expected in May. In the case of growth, the worsening of the energy crisis with successive cuts in the supply of Russian gas to European economies and the lower prospects for global growth have been offset by the positive performance of the service sectors, and in particular tourism, following the removal of mobility restrictions. This has supported employment over the first half of the year, with levels of Social Security affiliation exceeding those observed in 2019.

However, the scenario remains subject to significant downside risks. The main conditioning factor for global growth and growth of the Spanish economy is the threat of a total cut-off of Russian gas supplies to European economies, which could lead to an economic recession in this area given the impossibility of gaining access to alternative energies in such a short period of time. At domestic level, the intensity of inflation is causing a contraction in the long-time purchasing power of households in a context in which savings margins accumulated over the pandemic have disappeared and borrowing conditions are starting to tighten. All these elements, combined with the deterioration in household confidence, could result in lower growth in household spending than that forecast by AIReF. Finally, AIReF maintains the assumption that the Recovery, Transformation and Resilience Plan will contribute to boosting investment and employment, with an impact on the 2022 GDP level of 1.8 pp. However, there is still no information available to assess the rate at which resources are reaching the real economy, namely investment and employment.

For its part, inflation has continued to record unexpected increases and the percentage of products and services in the consumer basket showing high price increases is rising. The intensity and persistence of inflation is having a major impact on the purchasing power of households, particularly those with lower incomes that had already been affected by the pandemic, and raises the risk of loss of competitiveness vis-à-vis the outside world. The ECB has announced increases in official interest rates and net asset purchase programmes have been brought to a close. This institution faces the challenge of preventing inflation expectations from de-anchoring and triggering inflationary spirals, against a backdrop of weak economic growth in which the risk of financial market fragmentation has re-emerged.

How has AIReF modified its budget forecasts?

For its central scenario, AIReF estimates a GG deficit of 4.5% of GDP in 2022, as opposed to the 4.2% in the previous report, and below the 5% of GDP set as the reference rate by the Government. The extension of the measures to address the rise in energy prices and the effects of the war in Ukraine result in an increase in the deficit of 0.6 points of GDP. This increase is partially offset by the effect of the revision of the macroeconomic outlook on the public accounts. Although real growth has slowed, the greater increase in macroeconomic variables in nominal terms due to inflation means an improvement in the 2022 balance of 0.2 points compared with the previous report. Finally, the incorporation of new information reduces the forecast deficit by 0.1 points, as a result of a more positive evolution of tax collection partially offset by expenditure execution above that previously expected.

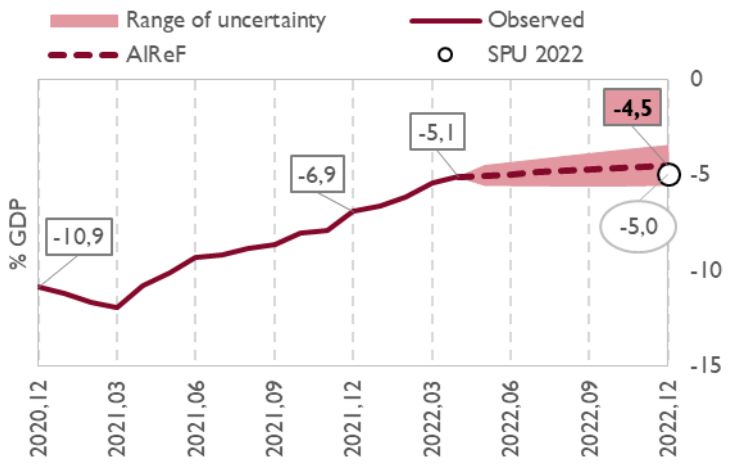
Consequently, the reduction in the deficit in 2022 would be 2.4 points from the 6.9% of GDP recorded in 2021. The main factor for this reduction would be the gradual withdrawal of the measures related to the pandemic, 2.3 points of GDP. Likewise, the structural revenue-increasing measures incorporated in the 2021 and 2022 GSBs contribute to reducing the deficit by 0.2 points, while revenue growth above the baseline evolution of expenditure accounts for a reduction of 0.9 points. In contrast, all the measures adopted to mitigate the effects of the war in Ukraine and the energy crisis result in an increase in the deficit of 1 point of GDP.

Revenue, excluding the Recovery, Transformation and Resilience Plan (RTRP), will amount to 42.4% of GDP, 0.1 points higher than forecast in the previous report. While the extension of the measures to mitigate the rise in electricity prices will lead to lower collection of just under 0.2 points in VAT and Special Taxes, the revision of the macroeconomic scenario and the positive execution data lead to an upward revision of the revenue forecast. On the one hand, higher inflation, the most significant change in the macroeconomic scenario, mainly affects the collection of VAT. On the other hand, the collection data of the first half of the year and especially those of the annual settlement of personal income tax lead to a significant increase in the expected collection of that tax. As a result of the above, AIReF forecasts that revenue, excluding the RTRP, will grow by 5.6% in 2022.

Expenditure, excluding the RTRP, will stand at 46.9% of GDP, 0.4 points higher than forecast in the previous report. On the one hand, the extension of the measures, including the fuel rebate, and the increase in defence spending result in higher expenditure of 0.4 points of GDP. On the other hand, the execution data available to date have led to an increase in expenditure under certain headings, especially in the public consumption of the Autonomous Regions (ARs), of around 0.2 point of GDP, which is partially offset by higher GDP in current terms. In addition, the higher inflation in 2022 is

automatically transferred to pension spending in 2023, which would grow by 10.1% as opposed to the 5% forecast for this year.

NET LENDING/BORROWING OF THE GENERAL GOVERNMENT



Source: AIReF, IGAE and SPU

What changes have taken place at the sub-sector level?

Compared with the previous report, the deficit forecast is somewhat worse for every sub-sector. The Central Government (CG) bears the cost of the extension of the measures, but its forecast revenue is also higher and therefore the deficit forecast only rises by 0.1 points to stand at 3.3% of GDP. In addition, to the extent that this additional revenue is higher than that forecast in the GSB, a portion must be passed onto the ARs and LGs in 2024 as part of the settlement of the financing systems. In the Social Security Funds, both revenue and expenditure forecasts rise slightly and the deficit remains at 0.5% of GDP.

For their part, the forecast of the balance for the ARs worsens to 0.9% of GDP. This deterioration in the balance is the result of higher-than-expected execution of expenditure, mainly due to COVID-related spending higher than initially estimated by AIReF, and to lower forecast revenue from European funds. Finally, the forecast surplus of the LGs falls slightly, although it remains at 0.2%.

NET LENDING/BORROWING BY SUB-SECTOR

		AIReF estimate	
	2022 (Government SPU)	2022 (Rep. SPU)	2022 (Current)
GG	**-5,0**	**-4,2**	**-4,5**
CG	-3,8	-3,2	-3,3
SSFs	-0,5	-0,5	-0,5
ARs	-0,8	-0,7	-0,9
LGs	0,1	0,2	0,2

Source: AIReF, IGAE and SPU

What are the implications from a sustainability point of view?

The increase in public debt that has taken place over recent years makes the sustainability of public finances both for the GG as a whole and for the AR sub-sector a source of vulnerability, especially in a context of tightening financing conditions. Under the medium-term macro-fiscal forecasts prepared by AIReF, the debt-to-GDP ratio of the GG as a whole is expected to fall by 9.6 points over the next four years to stand at 108.8% in 2025. This reduction will be supported mainly by the growth in nominal GDP, with a high contribution from the deflator. However, the debt-to-GDP ratio will return to an upward path in a scenario in which the structural balance remains constant. AIReF performs various simulations which show that maintaining a structural primary deficit of between 1.5% and 2.5% of GDP from 2025 (in line with the latest estimates by the Government and AIReF, respectively) would place the debt ratio between 125% and 140% of GDP in 2040. Higher expected interest rates contribute towards exacerbating the debt trend.

In the case of the ARs, AIReF estimates that, fully applying the accumulated excess financing and under its 2022 forecasts, the debt-to-GDP ratio would stand at 23.9% at the end of the year. Under the assumptions of a regulatory scenario, where it is projected that the primary balance will worsen for 2022 and start to correct following that year, a reduction in the debt-to-GDP ratio of 12.2 points of GDP is calculated for the next 15 years. Under this scenario, it would take over a decade to reach the reference rate of 13% of GDP. Economic growth will be the most decisive factor in the reduction of the ratio, supported by a fiscal balance that will remain at equilibrium in the coming years.

What recommendations does AIReF make in this context?

In this context, AIReF once again insists on the need for a credible and realistic medium-term fiscal strategy. This strategy, integrated with the investments and reforms provided for in the RTRP, is especially relevant in a context in which downside risks predominate and monetary policy becomes progressively more restrictive to limit the growth in inflation. The situation requires the capacity to adapt economic policy to the possible materialisation of risks arising from, *inter alia*, the war in Ukraine, inflation and the pandemic.

Also in the previous report, AIReF warned of the existence of fictitious or apparent margins as a result of various circumstances. On the one hand, the laxity of the reference rates contributes to the idea that there might be room for a more expansive fiscal policy. In addition, inflation generates an automatic increase in revenue in this year, while in expenditure it is transferred

to the following year mainly through the increase in pensions, but also as a result of pressure on other expenditure. Finally, at the sub-sector level, tax collection that is higher than forecast in the GSB distorts the timing of revenue allocation through the settlement of the territorial financing systems. Consequently, the CG has temporary excess revenue this year, while the ARs and LGs will have said temporary excess in 2023 and 2024.

For this reason, the advantages of having a medium-term fiscal strategy at national level are fully applicable to the specific scope of action of each public administration. At regional level, revenue volatility coupled with the specific impact of the health crisis on the spending managed by the regions make it advisable to draw up a medium-term scenario that is effectively incorporated into the annual budgetary process, taking into account the cyclical and structural nature of their revenue and expenditure.

AIReF has therefore recommended that the Ministry of Finance and Civil Service and each Autonomous Region should:

- Frame the preparation of budgets for 2023 within a medium-term fiscal strategy that considers the structural or cyclical nature of expenditure and revenue.

Furthermore, as a specific version for the Regions of the recommendation submitted to the Ministry of Finance and Civil Service as a result of the Report on the SPU, AIReF recommends that each of the ARs should:

- Avoid increases in expenditure or reductions in revenue of a structural nature whose permanent funding is not ensured once the extraordinary revenue flows expected in these coming years disappear.

Finally, the laxity in the reference rates also has an impact on the debt authorisations for the ARs. Therefore, AIReF incorporates several recommendations to the Ministry of Finance and Civil Service so that borrowing is adapted to actual financing needs and the excess borrowing observed in 2021 is avoided.

1. INTRODUCTION

AIReF has the legal mandate to report on budgetary execution, public debt and the expenditure rule for 2022 by July 15th. In accordance with Article 17 of Law 6/2013 of November 14th, on the establishment of AIReF, and Article 19 of Royal Decree 215/2014 approving its Organic Statute. AIReF has the obligation to issue an opinion on compliance with budgetary stability and public debt targets and the expenditure rule prior to July 15th each year. On September 13th, 2021, the Congress, following a report from AIReF, considered that the extraordinary emergency situation provided for in Article 11.3 of the Organic Law on Budgetary Stability and Financial Sustainability still persisted. Therefore, the public deficit and debt targets, as well as the expenditure rule, continue to be suspended for 2022.

In the current context of suspended fiscal rules as a result of the pandemic, AIReF's fiscal supervision takes on greater importance as a guarantor of the sustainability of the General Government. The suspension of fiscal rules in 2020, 2021 and 2022 as a result of the pandemic and its foreseeable extension until 2023 due to the uncertainty caused by the energy crisis and the war in Ukraine, reinforces the need for AIReF to monitor the fiscal situation of the GG in order to guarantee the sustainability of public finances. Although the growth in expenditure, deficit and debt do not entail any corrective measures, it is important to bear in mind that, once the crisis caused by the pandemic and the current economic and geopolitical context has ended, it will be necessary to return to a path of fiscal discipline. Therefore, the ongoing monitoring of these fiscal indicators, regardless of the revisions that take place at the time

of their reactivation, provides valuable information on the fiscal position and evolution of each public administration.

In this report, AIReF updates its macroeconomic and fiscal forecasts for 2022 in accordance with the latest available information. AIReF has already pronounced on the macroeconomic and fiscal forecasts for 2022 on three occasions. Firstly, in the report on the main lines of the 2022 budgets[1], published in 2021. Secondly, in the report on initial budgets for 2022[2], published in April. Subsequently, in May, AIReF published its report on the 2022-2025 Stability Programme Update (SPU)[3] which contained a medium-term analysis focused on the General Government as a whole. In this report, AIReF updates the forecasts since the publication of the report on the SPU, incorporating into the analysis the measures taken by the Government, all the new information published and provided by the GG on the execution of its budgets in this year and year-end forecasts, as well as the evolution of the macroeconomic environment.

The macroeconomic and budgetary assessment for 2022 presented in this report is divided into six sections. Following this introduction, Section 2 sets out the purpose and scope of the report. Section 3 updates the macroeconomic scenario that underpins the fiscal projections, stating the reasons why it has changed. Section 4 refers to the budgetary scenario, analysing in detail the changes that have taken place in the estimate of revenue and expenditure for 2022 for the GG as a whole and for each one of the sub-sectors in relation to the forecasts in the report on the SPU. That is followed by an update on the impact of fiscal policy measures and an analysis of the main contingent liabilities and fiscal risks for this year. Section 5, after analysing recent developments in public debt and medium-term projections, assesses the challenges for the sustainability of public finances. Finally, Section 6 presents the recommendations stemming from the analysis conducted.

[1] AIReF-Report on the Main Budgetary Lines and Draft Budget of the General Government for 2022

[2] AIReF-Report on the Initial Budgets of the General Government for 2022

[3] AIReF Report on the 2022-2025 Stability Programme Update

2. PURPOSE AND SCOPE

The purpose of this report is to analyse the stability and debt forecasts of the GG for 2022, updating the pronouncement made in the report on the SPU. AIReF has updated the macroeconomic and fiscal forecasts of the GG for 2022 contained in the report on the SPU issued in May. For this purpose, it incorporates into its assessment the latest published data on budgetary execution, the measures approved by the Government, the new information available to date on both the macroeconomic and fiscal environment and other additional information received. In particular, this report includes: the latest data published by the General State Comptroller (IGAE) in national accounting terms (month of May for the State, month of April for CG, SSFs and ARs and first quarter for LGs), the budgetary execution of the different sub-sectors (Central State Administration, Social Security System, SEPE, FOGASA and month of April for the ARs), monthly information on tax collection from the State Tax Administration Agency (AEAT) also for the month of May, and pensions paid out (eSTADISS database) and unemployment benefits statistics. In addition, the information on the annual Personal Income Tax campaign is included, as published in the press release of the State Tax Administration Agency.

This analysis is carried out for all the sub-sectors, including the individual analysis by AR and the main LGs, and is completed with the overall vision for the GG as a whole. In particular, AIReF has analysed:

- The Central Government sub-sector.
- The Social Security Funds sub-sector.
- The Autonomous Regions sub-sector and each of them.

- The Local Government sub-sector and an individual evaluation of the 24 large local governments (the 16 municipalities with more than 250,000 inhabitants, the Provincial Councils of Barcelona, Valencia and Seville, the Island Council of Tenerife and the Island Council of Majorca and the Provincial Councils of Gipuzkoa, Biscay and Araba/Álava). In addition, the Local Governments with significant risks in terms of sustainability, according to AIReF's selection and rating methodology, have been individually evaluated.

The analysis by sub-sector is completed with the overview of the situation for the GG as a whole.

The subject of the report continues to be conditioned by the uncertainty resulting, in addition to the pandemic, from the energy crisis and the war in Ukraine. Two years after the outbreak of the pandemic in March 2020, the Spanish economy has been hit by a succession of global supply shocks that have shifted the focus of uncertainty from the health sector to the supply side of the economy. The development and economic implications of these shocks are difficult to predict. The tensions in global value chains and in commodities markets that had emerged previously have intensified following Russia's invasion of Ukraine in February 2022, setting up a less favourable scenario for global growth. In addition, after several years at moderate levels, inflation has emerged with unexpected intensity, which has also led to a tightening of the economy's financing conditions. In addition, the pandemic remains a key determining factor for the economic situation. Therefore, AIReF's opinion remains conditioned by uncertainty and the estimates made should be treated with greater caution than usual.

In addition, other limitations common to previous reports are maintained. These include the lack of budgets in national accounting terms or complete and updated information on the impact of the main contingent liabilities that might have an impact on the deficit for the year. Another limitation that is of particular importance since the approval of the RTRP in July 2021 is the lack of transparency on its degree of execution in national accounting terms. From a macroeconomic point of view, this lack of information is a limitation in terms of knowing which funds are reaching the final recipient and, therefore, which are having an effect on the economy. In addition, from a fiscal point of view, it limits the analysis of the evolution of the revenue and expenditure headings that are not related to the RTRP and that constitute the ordinary activity of the GG.

3. MACROECONOMIC SCENARIO

Growth prospects continue to deteriorate as inflationary tensions intensify. The global economic scenario continues to be affected by an array of shocks that interact with each other, restricting the supply capacity of the economy: the energy crisis and the bottlenecks in supply chains of agricultural and industrial raw materials, which emerged in 2021, have significantly accentuated in the first few months of 2022 with the war in Ukraine and China's zero-covid policy. The lack of supply-side response capacity has led to a rapid rise in inflationary tensions, which has triggered a tightening of monetary conditions and a fall in the confidence and purchasing power of households. In contrast to these factors, a greater dynamism than expected in April was observed in services, particularly tourism.

In this context, AIReF revises the growth forecasts of the Spanish economy for 2022 downwards by 0.1 points to 4.2%, while increasing the expected growth in prices to 7.8%. The revision of the growth scenario reflects conflicting factors. On the one hand, the deterioration in global growth prospects and the intensity of inflation, together with the deterioration in household confidence, are causing less dynamism in private consumption and the exports of goods. On the other hand, the dynamism shown by service activities and, in particular, the positive performance of tourism, contributes to sustaining the growth in employment and economic activity in the short term. In addition, AIReF maintains the assumption that the Recovery, Transformation and Resilience Plan (RTRP) will begin to gain material momentum in the second half of the year, although sufficient information is not yet available to assess the degree of compliance with this assumption.

The downside risks to growth remain high and even external risks of a geopolitical nature are accentuated. In the domestic sphere, there is a sharp deterioration in household confidence, real income and savings, which projects downside risks to economic growth in the coming quarters. On the external front, the risks of a possible cut in the supply of natural gas to Europe by Russia, which could trigger a drastic stoppage in the activity of our main trading partners and in Spain, are accentuated.

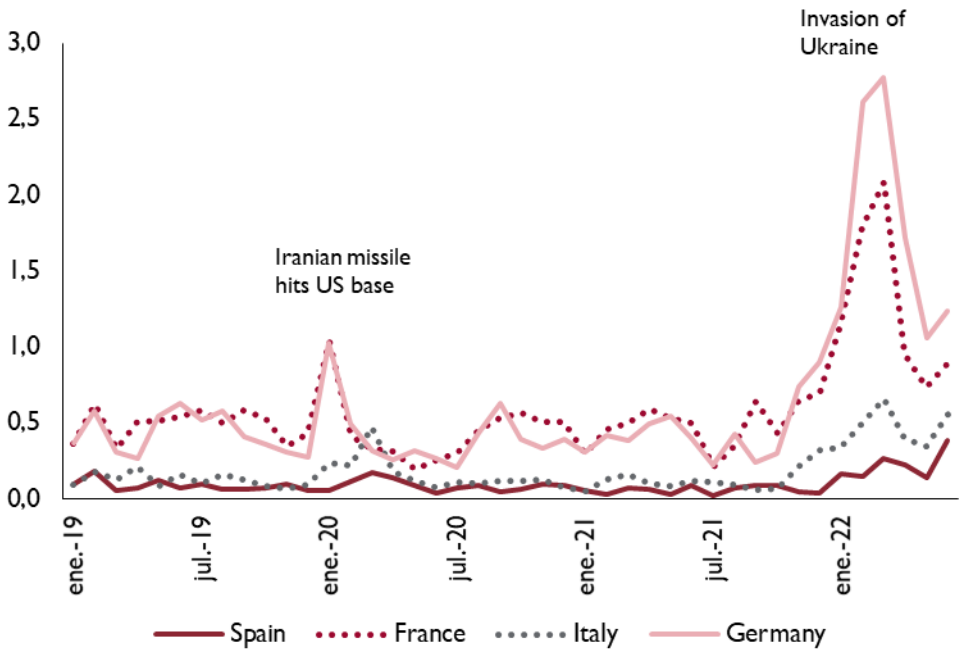
In the case of inflation, the upward revision mainly reflects the upward trend observed in the Consumer Price Index and, in particular, in the price of gas, which has been intensified by the depreciation of the euro. The introduction of the gas price cap coincided with Russia partially cutting off the supply of this raw material to some European countries, which accentuated the upward path in the price of gas and energy that are now substitutes, like coal (see Box 1). This was compounded by the depreciation of the euro, which has largely offset the recent fall in the prices of certain raw materials and oil in international markets.

After the summer, and in view of the preparation of the report on the General State Budget for 2023, all the conditions of growth and inflation will be reassessed. These forecasts do not include the impact of the measures announced by the Government on Tuesday, July 12th.

3.1. Recent developments in the external environment

The predominance of geopolitical risks continues to condition the outlook for global growth and inflation. The war in Ukraine and China's zero-COVID policy have intensified supply problems in global value chains and the energy crisis. But there is no doubt that the gradual cut in the supply of Russian natural gas to Europe and the threat of a total cut-off is the main determinant of growth in the short and medium term.

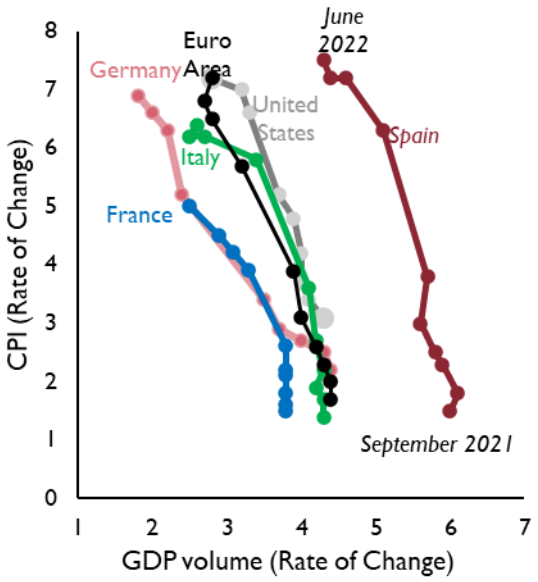
FIGURE 1. GEOPOLITICAL RISK INDEX



Source: Dario and Matteo Iacoviello (2022), "Measuring Geopolitical Risk," AER

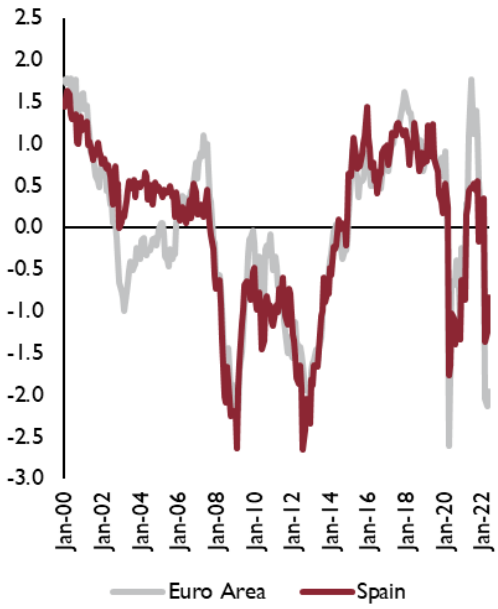
The combination of the energy crisis and bottlenecks in global value chains has led to further downward revisions of global growth forecasts, as inflationary pressures intensify and become more persistent. In the United States, the risk of economic recession is accentuated in a context of strong inflationary tensions, labour shortages and a notable tightening of financial conditions - the Atlanta Fed projects a contraction in GDP in the second quarter of 2022, following the fall recorded in the first three months of the year. In Europe, the most recent forecasts by private analysts and the EC (which published its summer forecast on July 14th, with estimated growth for the euro area of 2.6% in 2022 and 1.4% in 2023) continue to revise economic growth in 2022 and particularly in 2023 downwards, while inflation is revised upwards for both years. Consumer confidence has deteriorated significantly in most countries and there is an increased risk that cuts in gas supplies from Russia could plunge the euro area as a whole into recession. Only in China do recent indicators show some improvement after the easing of mobility restrictions imposed in many cities, although strict lockdowns persist in some of them.

FIGURE 2. GROWTH-INFLATION PAIRING FOR 2022



Source: Consensus

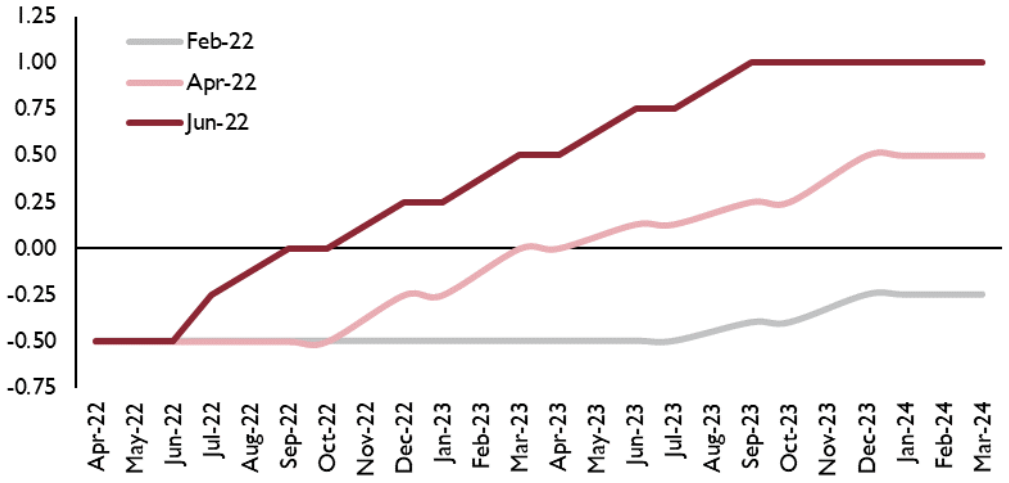
FIGURE 3. STANDARDISED CONSUMER CONFIDENCE INDEX



Source: European Commission.

The confirmation that inflation is proving to be stronger and more persistent than anticipated a few months ago is causing a tightening of financing conditions globally. There have been unexpected rises in inflation in the euro area over recent months, to stand at 8.6% in June - an all-time high since the creation of the euro. In this context, the ECB has ended its net purchase programmes and has already announced interest rate hikes, despite the difficulty in containing price pressures stemming from supply factors. Markets anticipate a greater tightening of financing conditions than previously announced. In recent weeks, however, the lower growth outlook for the euro area has led to a slight easing of interest rate hike expectations.

FIGURE 4. EXPECTED DEPOSIT FACILITY RATE (%)



Source: European Central Bank

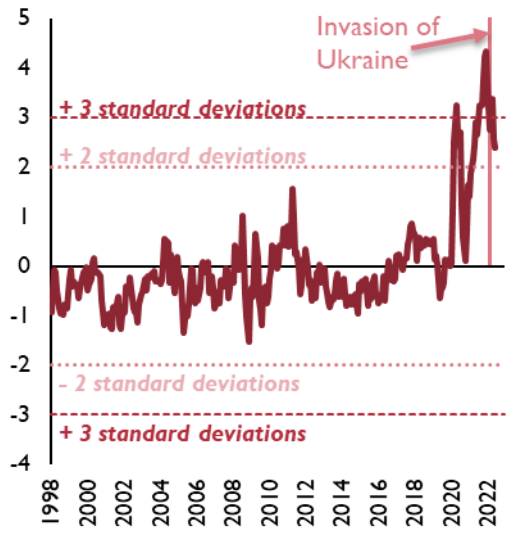
Volatility in financial markets has increased, with corrections in financial asset markets and a depreciation of the euro. For the first time since the euro came into circulation (January 1st, 2002), the currency is close to parity against the dollar, i.e. EUR 1 is exchanged for USD 1. This milestone represents a depreciation of 18% of the euro against the dollar since June 2021 - when EUR 1 was exchanged for USD 1.22 - and it amplifies the impact on inflation of the rise in the price of imported raw materials, most of which are traded and denominated in dollars. In the opposite direction, it contributes to mitigating the losses of competitiveness against dollarised economies resulting from high inflation levels in the euro area.

In a context of slowing global activity, signs have emerged that supply constraints may have begun to ease, although they still remain at very high levels. In particular, shortages of supplies continue to be identified, but not as acute as those observed in the early months of the year. The easing of the lockdown measures implemented in China might help explain this result. Raw material prices have turned downwards in recent months: in the crude oil market, expectations of lower global demand have led to a fall in the price of Brent to close to $100 per barrel, after reaching levels of around $120 per barrel in early 2022. In the case of industrial raw materials, the prices of certain metals such as copper, aluminium and nickel fell significantly in June, after the record highs reached in recent months. Finally, prices of agricultural raw materials, such as wheat and corn, have also fallen considerably, although they remain at much higher levels than those recorded before the pandemic.

The exception to this downward trend is natural gas, whose prices have continued to rise as a result of supply cuts by Russia. In this regard, on June 15th Russia cut gas supplies to Europe through the Nord Stream 1 pipeline and

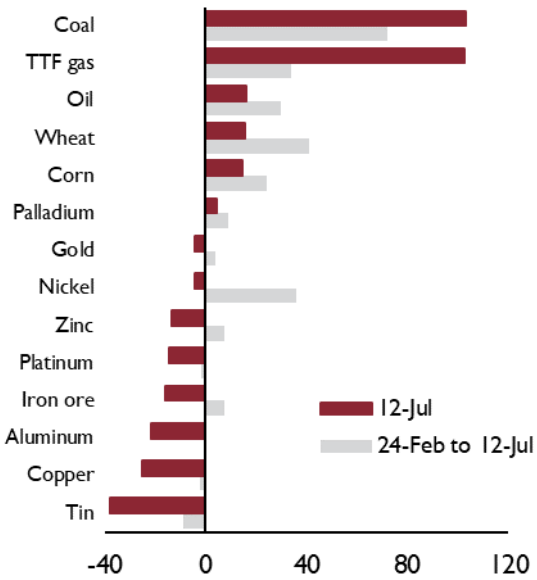
on July 11th shut it down, in theory until July 21st, citing facility maintenance needs. It is not known at this time whether the supply will be restored. This situation has led many countries to adopt national contingency plans for possible shortages in the coming winter, and the European Commission plans to present a European emergency plan this July. Coal prices are also on an upward trend in view of the growing demand in some European countries.

FIGURE 5. INDICATOR OF GLOBAL PRESSURES IN VALUE CHAINS



Source: NY FED

FIGURE 6. CHANGE IN RAW MATERIAL PRICES SINCE JANUARY 2022 FOLLOWING THE INVASION OF UKRAINE



Source: Refinitiv

3.2. AIReF's economic forecasts for the Spanish economy in 2022

AIReF estimates that Spanish GDP will grow by 4.2% in 2022, while inflation will rise to 7.8% on average for the year. Compared with the scenario used in May to assess the 2022-2025 Stability Programme, these figures represent a slight downward revision in expected growth for 2022, from 4.3% to 4.2%, while inflation is revised upwards significantly, to 7.8% from the 6.5% projected previously. In comparative terms, the European Commission's most recent forecasts predict real GDP growth of 4% in 2022 and 2.1% in 2023, while projected inflation would reach 8.1% in 2022 and 3.4% in 2023.

TABLE 1. AIREF'S MACROECONOMIC OUTLOOK FOR 2022

Year-on-Year Rates of Change	*2021*	*2022*	*Revision Compared With 2022-2025 SPU*
Private Domestic Final Consumption Expenditure	4,6	3,6	-0,5
General Government Final Consumption Expenditure	3,1	1,0	-0,3
GFCF	4,3	7,0	0,3
GFCF Equipment and Cultivated Assets	*15,7*	*11,0*	*3,4*
GFCF Construction and Intellectual Property	*-0,7*	*4,9*	*-1,2*
Domestic Demand*	*4,7*	3,6	-0,3
Exports of Goods and Services	14,7	8,5	0,9
Imports of Goods and Services	13,9	7,1	0,4
External Balance*	*0,5*	0,6	0,2
Gross Domestic Product	**5,1**	**4,2**	**-0,1**
Nominal Gross Domestic Product	**7,4**	**8,5**	**0,3**
Gross Domestic Product Deflator	2,2	4,1	0,4
CPI	3,1	7,8	1,3
Full-Time Equivalent Employment	6,6	3,0	0,0
Unit Labour Cost	0,7	2,1	0,2
Productivity per Full-Time Employee	-1,5	1,2	-0,1
Unemployment Rate (% of Active Population)	14,8	13,2	0,0
Household and NPISH Savings Rate (% Gross Disposable Income)	11,4	7,1	-1,6

* Contribution to GDP growth
Source: INE and AIReF forecasts

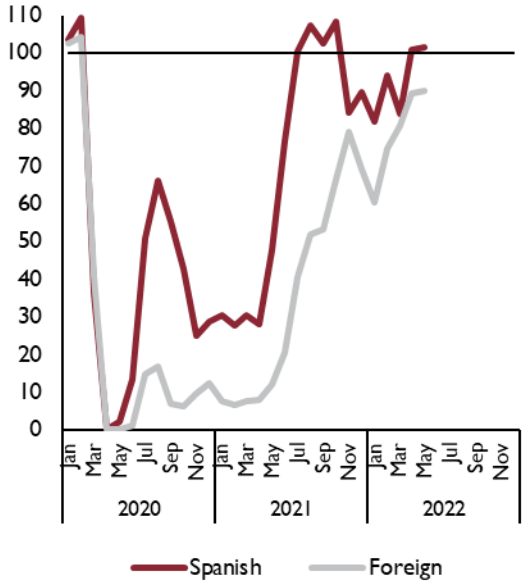
The moderate revision in economic growth reflects competing factors. Thus, the 0.2% quarter-on-quarter GDP growth rate in the first quarter was lower than expected as a result of the negative impact on services due to the outbreak of the Omicron variant in Europe and Spain, supply-side tensions caused by bottlenecks in supply chains and the energy crisis, which worsened in February following the invasion of Ukraine and the transport strike that led to disruptions in the production and distribution of some products.

In contrast, the estimates available for the second quarter point to greater dynamism compared with AIReF's expectations in the Report on the 2022-2025 Stability Programme Update. Particularly noteworthy is the dynamism of service activities and the positive performance of domestic and foreign tourism following the withdrawal of COVID-19 mobility restrictions, which have contributed to sustain employment growth in recent months. At the report date, the MIPred model estimates quarter-on-quarter growth of 1% for the second quarter, while the OECD real-time model predicts even higher growth of 1.5%. At the same time, some alternative high-frequency indicators

available for June, such as BBVA card expenditure, have begun to show signs of weakness.

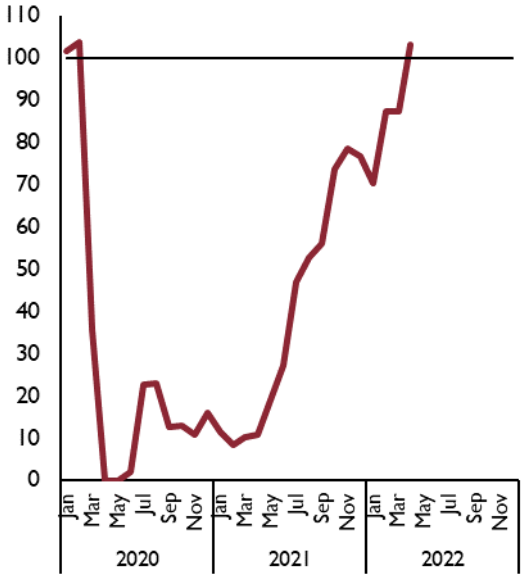
In the summer months, tourism demand is expected to contribute to sustaining economic growth, despite the complexity of the geopolitical environment and the rise in the cost of transport and tourism services. The estimates of tourism GDP made by Exceltur place it at levels slightly higher than those recorded in 2019 (1.1% higher) in the second quarter. In addition, the expectations of Spanish tourism businesses are favourable since more than half (54.6%) declare that they have already reached pre-pandemic turnover levels, or expect to do so in the remainder of 2022. In the same vein, the UN World Tourism Organization has improved its outlook for 2022 due to stronger than expected results in the first quarter of 2022 and a significant increase in flight bookings. However, this scenario is conditional on the absence of new outbreaks or new variants of the coronavirus that would make it necessary to reintroduce global mobility restrictions.

FIGURE 7. OVERNIGHT STAYS AT HOTELS (COMPARED WITH THE SAME MONTH OF 2019)



Source: National Statistics Institute (INE)

FIGURE 8. REVENUE FROM TOURISM (COMPARED WITH THE SAME MONTH OF 2019)

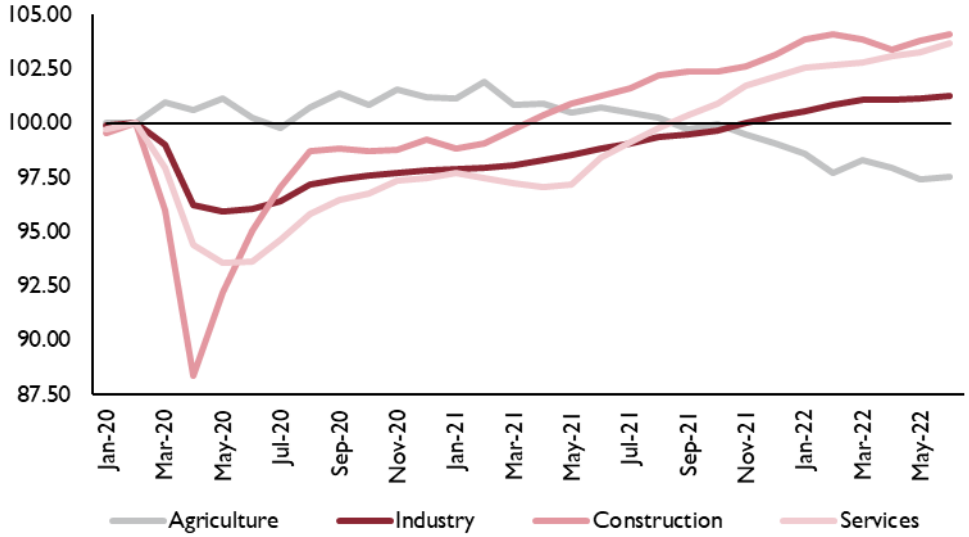


Source: Bank of Spain

For its part, employment ended the first half of the year with a total number of average Social Security affiliations of 20,102,040 people, seasonally-adjusted and corrected for the calendar effect, 675,140 average affiliations more than in December 2019. Affiliation has increased across all sectors, but particularly in construction and services - where 10% of companies reveal difficulties hiring staff - and, in particular, in activities related to tourism and restaurants, where

the number of people in job-retention schemes (ERTEs) has fallen significantly. Public employment was very important in the phases of greatest restrictions on activity, although in recent months job creation has been concentrated in private employment, with the number of public sector affiliations stabilising. The percentage of permanent contracts and, in particular, of permanent seasonal contracts has risen significantly since January. Along the same lines, the Labour Force Survey also reflects the good performance of the labour market: the number of employed people reached 20,084,700 in the first quarter of 2022, 117,800 more than in the fourth quarter of 2019, with year-on-year growth compared with 2021 of 4.6%. For its part, the unemployment rate stood at 13.6% in the first quarter, significantly below the peaks reached in 2020 (16.3% in the third quarter of 2020).

FIGURE 9. EVOLUTION OF AFFILIATION BY SECTOR (SWDA, FEB2020 INDEX=100)



Source: Ministry of Inclusion, Social Security and Migration

Despite the favourable performance of the labour market, private consumption is the component of demand that shows the greatest signs of weakness. In fact, it is the component that accumulates the greatest downward revisions in AIReF's macroeconomic scenario. On the one hand, consumer confidence has returned to negative figures in the second quarter, which have not been recorded since the summer of 2020 and are reflected in greater caution in consumer decisions, especially regarding purchases of durable goods. Added to this is the decline in the purchasing power of households caused by inflation: in the first quarter of the year, real disposable income contracted by 4.4% in year-on-year terms. It should also be noted that the effects of inflation on the purchasing power of households are uneven at an individual level. They have a greater impact on the most vulnerable households that devote a greater percentage of their income to food and

energy consumption, categories which have recorded the highest price increases, and which had already suffered the adverse effects of the pandemic to a greater extent. Finally, the household savings rate stood at 7.5% of gross disposable income in the same period, a level similar to those observed before the pandemic. This would indicate that accumulated forced savings over the periods of mobility restrictions have already run out. All this information as a whole points to a very moderate consumption behaviour in the remainder of the year.

FIGURE 10. GROSS DISPOSABLE INCOME AND PRIVATE CONSUMPTION (INDEX 2019Q4=100)

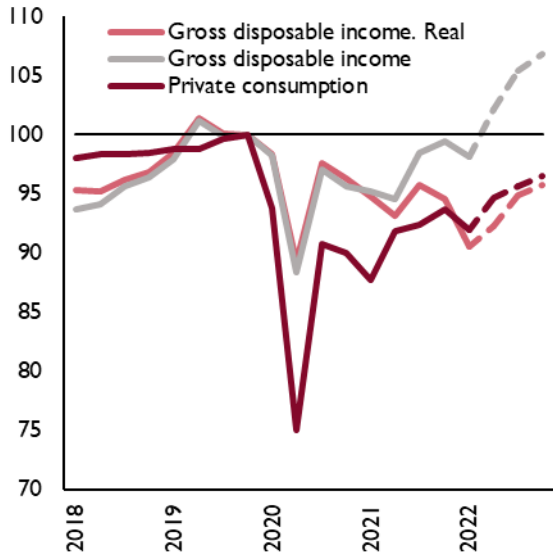
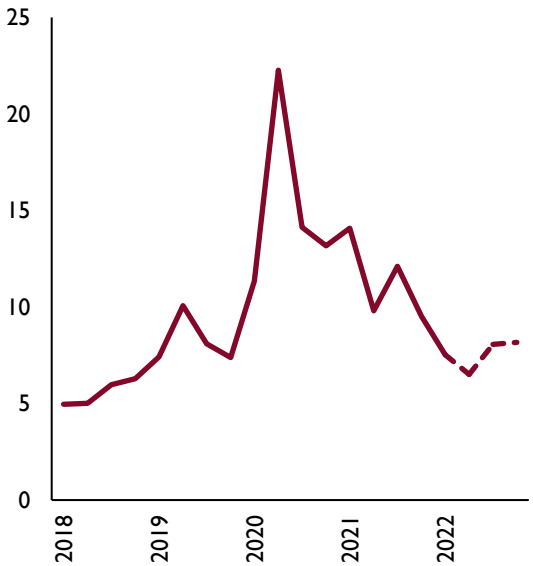


FIGURE 11. HOUSEHOLD AND NPISH SAVINGS RATE (% GROSS DISPOSABLE INCOME)



Source: National Statistics Institute and AIReF forecasts

Finally, the contribution that the RTRP is making to economic growth remains unknown. The information available on budget execution suggests that around 10% of the projects budgeted for this year would have been executed by the end of June 2022. Other sources of information[4] point to a similar percentage (10%) of tender offers that would be left un-awarded in the environment of high inflation and bottlenecks in the production that persists. Beyond these figures, there is still no information available to assess the rate at which resources are reaching real activity and employment. The European Commission authorised the second disbursement of the NGEU funds allocated to Spain (€12bn) after positively evaluating compliance with the milestones of reforms carried out in the second half of 2021. The final amount allocated to

[4] Government, design and technology for public administration

Spain through the Recovery and Resilience Facility - calculated on the basis of the 2020 and 2021 GDP figures of the EU countries - will finally be €77.23bn, instead of the €69.53bn euros initially allocated. In addition, the Government has announced its intention to apply for the €70bn in loans in the near future. In the coming months, it will be necessary to negotiate with the EC an addendum to the plan specifying new investment objectives and milestones associated with these resources.

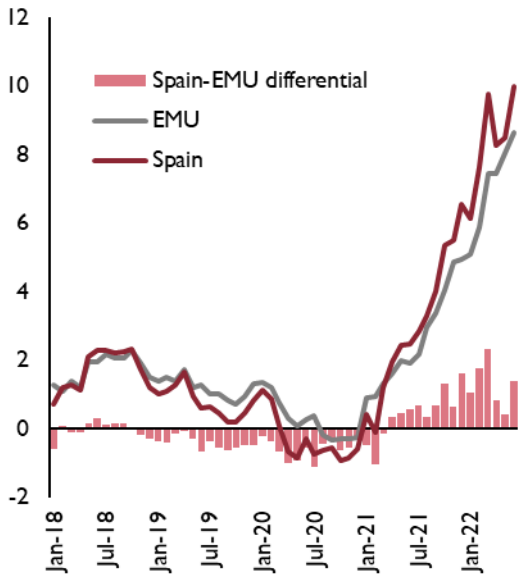
In relation to prices, expected inflation for 2022 as a whole currently stands at 7.8%, as opposed to the 6.5% projected in the Report on the Stability Programme. Inflation continued recording unexpected increases to stand at 10.2% in June, according to the CPI published by the INE. The monthly increase in prices was 1.9%, the largest increase recorded in a month of June since 1977. For its part, core inflation (excluding energy and unprocessed food components) rose to 5.5%, the highest rate since August 1993 (4.9% in May). This unexpected increase reflects further increases in energy and food prices, although the rise in the prices of accommodation and hospitality services linked to tourism was also noteworthy.

Energy prices have continued to rise despite the introduction of measures to mitigate the impact of the energy crisis on inflation. Among them, on Wednesday June 15th, the Iberian mechanism to limit the price of gas to €40/MWh entered into force. This measure is intended to lower the price of electricity in the wholesale market and thus decouple the gas and electricity markets. The impact on inflation estimated by some institutions is in a range between -0.4 and -0.8 percentage points (see Box 1), in line with AIReF's estimated impact of -0.8 percentage points on average in 2022 compared with a no-measure scenario. Nevertheless, electricity prices have continued to rise as the entry into force of this measure coincided with a further rise in the price of gas on international markets, associated with a nearly two-thirds reduction in the supply to the EU of Russian natural gas through the Nord Stream 1 gas pipeline.

Inflation has spread to most of the consumer basket and could lead to a loss of competitiveness *vis-à-vis* the outside world. Thus, in May, 66% of products and services had inflation rates above 3%. Following the data for June, Spain, together with the Netherlands, is one of the countries with the highest inflationary pressures among the large economies with which it has greater trade links, exceeding the annual change in the euro area CPI of 8.6% by 1.6 percentage points. However, there are still no second round effects on wages. Wages negotiated under collective bargaining agreements have maintained moderate growth rates, averaging 2.45% to June. While it is true that most of the agreements recorded up to June were signed in previous years (although

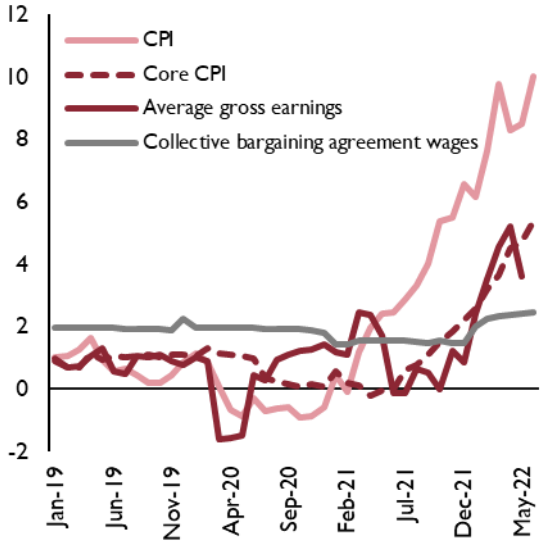
they have effects in 2022), the newly signed agreements also show moderate increases, with an average salary increase of 2.58%.

FIGURE 12. HARMONISED INDEX OF CONSUMER PRICES (ANNUAL % CHANGE)



Source: Eurostat

FIGURE 13. CHANGES IN PRICES AND WAGES (% CHANGE PER YEAR)



Source: INE and Ministry of Labour and Social Economy

3.3. Risks

The main risk in this scenario is geopolitical in nature and is related to a possible cut-off or rationing of Russian gas to Europe. Although the Spanish economy's direct dependence on Russian gas is low, the EU's inability to find alternative energy sources in such a short period of time might lead to a contraction in the GDP of some of our major trading partners. This would ultimately weigh down on Spain's growth scenario. The estimates made by the European Central Bank for a scenario marked by a cut in energy supplies from Russia suggest that the euro area would enter recession at the end of 2022. According to the ECB, in this scenario EMU growth could slow to 1.3% in 2022 and GDP could fall by 1.7% in 2023 (compared with the 2.8% and 2.1% gains, respectively, projected in the baseline scenario). In the case of inflation, the forecasts rise to 8% in 2022 and 6.4% in 2023 (compared with 6.8% and 3.5%, respectively, forecast in the baseline scenario). The threat from Russia has led some countries to adopt national contingency plans for possible shortages for the coming winter, while the European Commission plans to present a European emergency plan in mid-July.

The persistence and intensity of inflation is a source of risk in several areas:

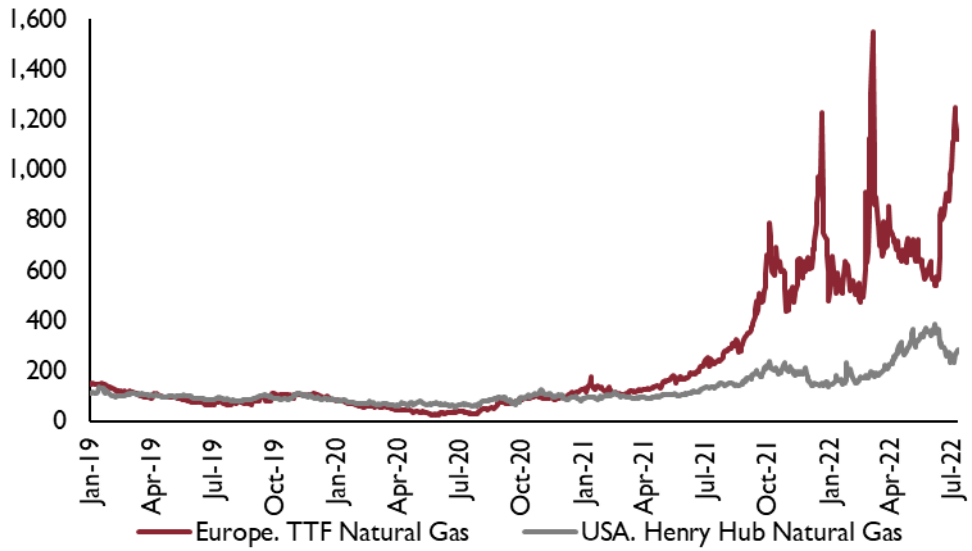
- High and lasting inflation has a direct impact on the purchasing power of households while increasing uncertainty. This could lead households to maintain a more cautious attitude in their spending decisions.
- At the same time, the risk of de-anchoring expectations and unleashing inflationary spirals is heightened. Therefore, despite signs of a slowdown in consumption in Europe, the ECB has announced a tightening of its monetary policy. It also raises the risk of loss of competitiveness *vis-à-vis* trading partners that maintain lower price growth (Germany, France and Italy).
- The complexity for economic policy resulting from a scenario of lower growth and high inflation has led to greater volatility in financial markets and a widening of risk premiums. In the euro area, the risk of financial market fragmentation has re-emerged. The details on the anti-fragmentation instrument prepared by the ECB will be key to contain this risk.

Furthermore, in the business sector, the end of the bankruptcy moratorium and the grace period for ICO loans could mean an increase in bankruptcies and non-performing loans. On June 30th, two support measures for companies that were implemented at the beginning of the health crisis ended: the bankruptcy moratorium, which had been repeatedly extended since it was first approved in March 2020, and the grace period negotiated with banks for companies that have applied for loans guaranteed by the ICO. In this regard, there is a risk of an increase in bankruptcies. In addition, although the Government has asked the EC to extend the repayment term of these loans, according to the Bank of Spain, there has been a deterioration in the credit quality of the ICO loans over the last few quarters. The lending guaranteed through the ICO classified in special surveillance reached 22.7% in March 2022, an increase of 6.4 percentage points on June 2021. For its part, the proportion of non-performing loans reached 4.1% (2 percentage points more than in June 2021). This implies loans amounting to €19.5bn under special surveillance and €3.5bn as non-performing loans.

BOX 1. THE IBERIAN GAS MECHANISM

Since the first quarter of 2021, the price of natural gas in the main international markets has followed an upward path, with greater intensity in the case of European countries. This upward path has been exacerbated by the invasion of Ukraine.

PRICE OF GAS. INDEX 100 = AVERAGE 2019



Source: Refinitiv

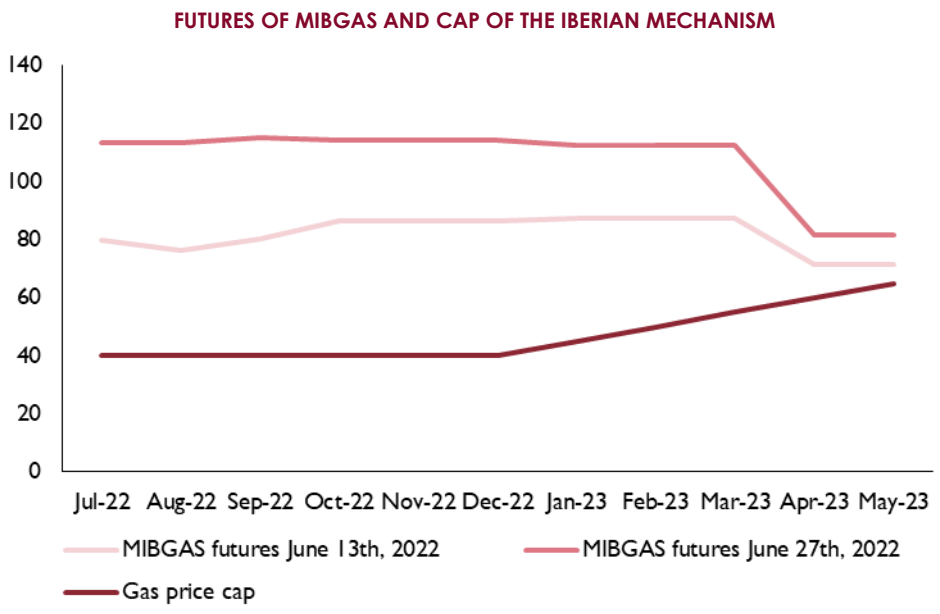
This behaviour is proving decisive in determining energy costs for households and businesses. This is because the price in the wholesale market is determined by the cost of the technology that enters the market last, which allows supply and demand to be matched and which is more expensive than the energy sources that have entered before. The marginal technology is usually hydroelectric (54.9% in 2021)[5]. However, the decision whether or not to produce in hydroelectric power plants depends on the opportunity cost of using water as opposed to the possibility of doing so at another time, which, in turn, is mainly determined by the cost of combined cycle power plants that use natural gas and whose production cost is higher than that of other technologies such as nuclear, hydraulic or renewable. Therefore, the price of natural gas ends up determining the price of electricity in the pool

[5] European Commission (2022). State Aid SA. 102454 (2022/N) – Spain and SA.102569 (2022/N) - Portugal – Production cost adjustment mechanism for the reduction of the electricity wholesale price in the Iberian market

and, ultimately, the Voluntary Price for the Small Consumer (Spanish acronym: PVPC), a regulated tariff linked to the pool price.

In this regard, Royal Decree-law 10/2022, of May 13th, introduced a production cost adjustment mechanism to reduce the electricity wholesale price based on a limitation on the price of gas used for electricity generation. Following the adoption of the measure by the European Commission on June 8th, as it was considered compatible with the rules on State aid, the limit on the price of natural gas for electricity generation entered into force on June 15th. The adjustment mechanism or "*Iberian mechanism*" establishes a cap on the price of gas used for electricity generation in Spain and Portugal - which form a single integrated electricity market, but with very limited interconnections with the rest of the EU electricity market. The *Iberian mechanism* sets the cap for the price of natural gas used for electricity generation at €40/MWh from June to December 2022, with a monthly increase of €5 to reach €65/MWh in May 2023, the date on which it will no longer be applied. The objective of this measure is to lower the price of electricity in the wholesale market or "pool" and, therefore, the price that consumers pay with a regulated tariff (PVPC), which is directly linked to the price of the pool.

Under the "*Iberian mechanism*", the gas price cap acts as a reference for the cost of electricity that enters the market last after the daily matching of electricity supply and demand. As shown in the graph, the cap established through the mechanism is well below the prices of gas futures immediately prior to the entry into force of the measure and even more so in relation to those in force at the end of June. This will mean a reduction in the price of electricity produced with technologies other than combined cycles and, therefore, of the PVPC.



Source: Prepared by AIReF based on MIBGAS

In the case of electricity produced through a combined cycle, producers will need to be compensated for the difference between the market price of natural gas and the cap of the *Iberian mechanism*. This compensation will be financed by consumers with regulated tariffs, beneficiaries of the measure, and consumers with free market tariffs who have revised their prices after April 2022 and who, therefore, will also be able to benefit from the measure. This compensation limits the effect of reducing the final price of electricity. The calculation of the unit adjustment cost, according to Royal Decree Law 10/2022, is performed using the following formula:

$$Adjustment\ cost\ = \frac{MIBGAS\ Price - Reference\ Price}{0.55}.$$

Where $MIBGAS\ price$ is the price of natural gas, in €/MWh, of the Iberian Gas Market (MIBGAS), $Reference\ Price$ is the gas price for electricity generation (40€/MWh in 2022) and 0.55 is a factor that reflects the average efficiency of combined cycle power plants.

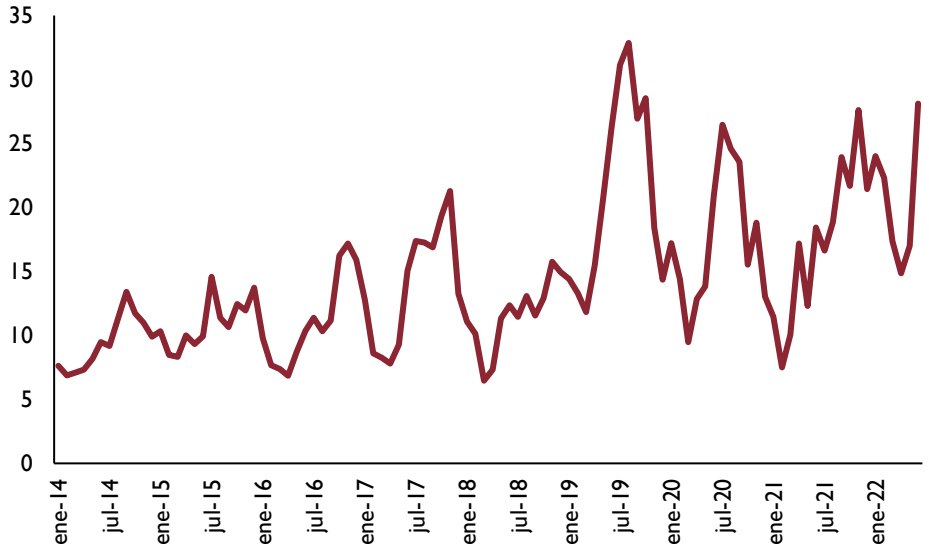
In general, the effect of reducing electricity prices of the Iberian mechanism will be[6]:

[6] There are other factors such as the volume of electricity exports to France. Given that under the Iberian mechanism the price of electricity is lower in Spain, there are greater exports to France, up to the available interconnection capacity. This means an implicit subsidy from Spanish consumers to the French, which is partly offset by the fact that

- Greater the more gas prices grow, as has been the case in recent weeks due to tensions on international markets, the war in Ukraine and the restrictions that Russia is imposing on gas exports, as well as the accident at the gas plant in Freeport, one of the main points for exporting liquefied natural gas from the United States to Europe.

- Lower the greater the importance of the combined cycle in generation. In this case, a greater part of the energy produced will be subject to compensation and, therefore, the final price for the consumer will be reduced less. This is what happened in the second half of June, when abnormally high temperatures were recorded in relation to the historical average which, in addition to raising electricity consumption, limited production capacity through renewable sources, in particular wind energy.

PERCENTAGE OF GENERATION BY COMBINED CYCLE OVER THE TOTAL. MONTHLY AVERAGES

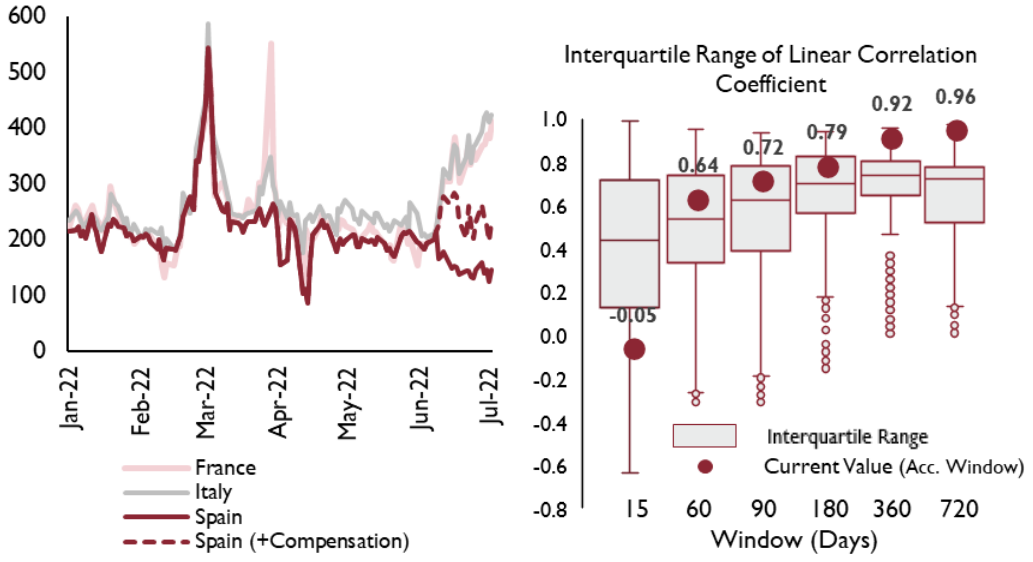


Source: Prepared by AIReF based on Red Electrica

Since the introduction of this measure, the spot price of the wholesale electricity market in Spain, after including the adjustment cost and other factors, seems to have been decoupled from that of France, Italy and Germany. In fact, during almost the entire first month of the entry into force of the *Iberian mechanism*, the simple linear correlation between the daily variations in the gas price in France and Spain taking 15-day moving windows is approximately at -0.1, while for higher windows a very high correlation was observed.

France has to pay a fee to Spain for the saturation of the electricity grid, called congestion income.

ELECTRICITY PRICE ON THE WHOLESALE MARKET (€/MWh) AND SIMPLE LINEAR CORRELATION COEFFICIENT BETWEEN THE DAILY DIFFERENCES OF THE SPANISH AND FRENCH MARKET



Source: Refinitiv and AIReF

To approximate the impact of *the Iberian mechanism* on inflation, a relationship between the pool price and the MIBGAS price has been estimated. This relationship is used to predict the pool price under a baseline scenario in which it is assumed that the *Iberian mechanism* is not applied and gas prices evolve in line with MIBGAS futures, and another scenario with the measure, in which the gas cap is applied. In the scenario with the measure, the adjustment cost that the consumers benefiting from the cap have to pay to compensate the combined cycle plants that generate electricity using gas is incorporated. From the projection of the pool price, the PVPC is calculated under the following additional assumptions:

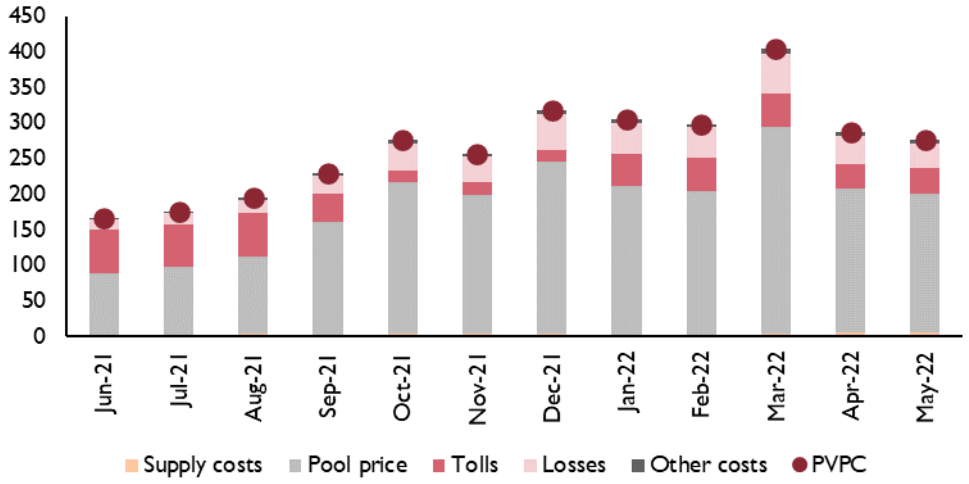
- The structure of electricity generation by technology and the relative weight of the combined cycle are identical to those of 2021.

- The percentage of electricity consumption that benefits from the measure is 46%, according to the Bank of Spain's assumptions.

- The impact of congestion income is not estimated.

- The costs corresponding to the adjustment services of the system associated with supply and other supply-related costs evolved in a similar manner to last year.

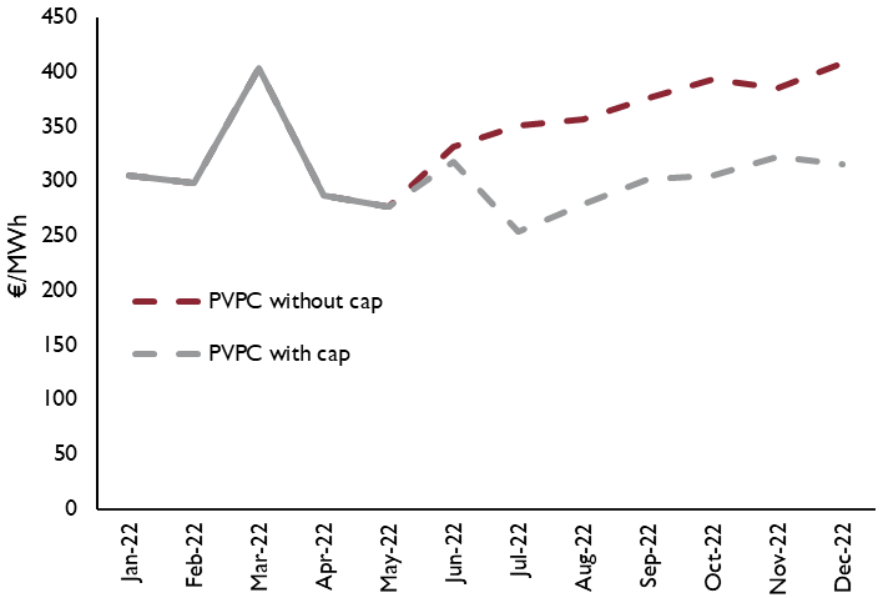
PVPC COMPONENTS (€/MWh)



Source: Prepared by AIReF based on Red Electrica. Weekends are excluded

Considering the MIBGAS gas prices observed in the whole of June and futures up to December 2022, which have increased sharply throughout June, the reduction in the PVPC in 2022 in the scenario with the gas cap would be 19.5%, which would translate into a reduction in the inflation rate of 0.8 percentage points in 2022 compared with a no-measure scenario.

EVOLUTION OF THE PVPC IN THE BASELINE NO-MEASURE SCENARIO (€/MWh)

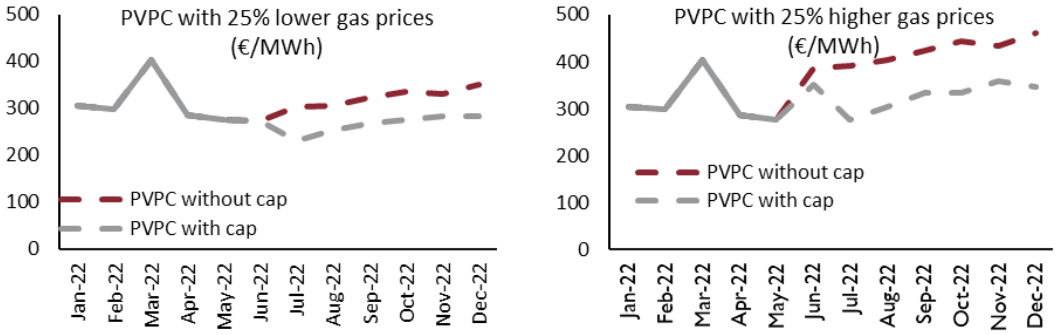


Source: Prepared by AIReF.

These estimates are similar to those made by the Bank of Spain[7]. This institution estimates that the Iberian mechanism might reduce the price of the pool on average by 30% between June 2022 and May 2023 and the PVPC by 17%. In terms of inflation, this impact would translate into a reduction of 0.5 percentage points in 2022 compared with a scenario without the *Iberian mechanism* and an increase of 0.1 percentage points in 2023. In a scenario of higher gas price growth, the impact on inflation would be -0.7 percentage points in 2022 compared with a no-measure scenario.

If alternative scenarios for the evolution of the price of gas are considered, it can be seen that, *a priori*, the relative impact of the measure is greater the higher the price of gas. Thus, for example, if the gas price were 25% higher than that indicated by MIBGAS futures for the Spanish market, the reduction in inflation would be 0.9 percentage points (on higher inflation). Similarly, if the price of gas were 25% lower than that of MIBGAS futures, the impact of the measure on inflation would be reduced to 0.65 percentage points.

GAS PRICE EVOLUTION SCENARIOS (€/MWh)



Source: Prepared by AIReF.

[7] Quarterly Report on the Spanish Economy. June 2022. The impact on inflation of the mechanism to cap gas prices in the Iberian market.

4. ANALYSIS OF BUDGETARY STABILITY AND THE EXPENDITURE RULE

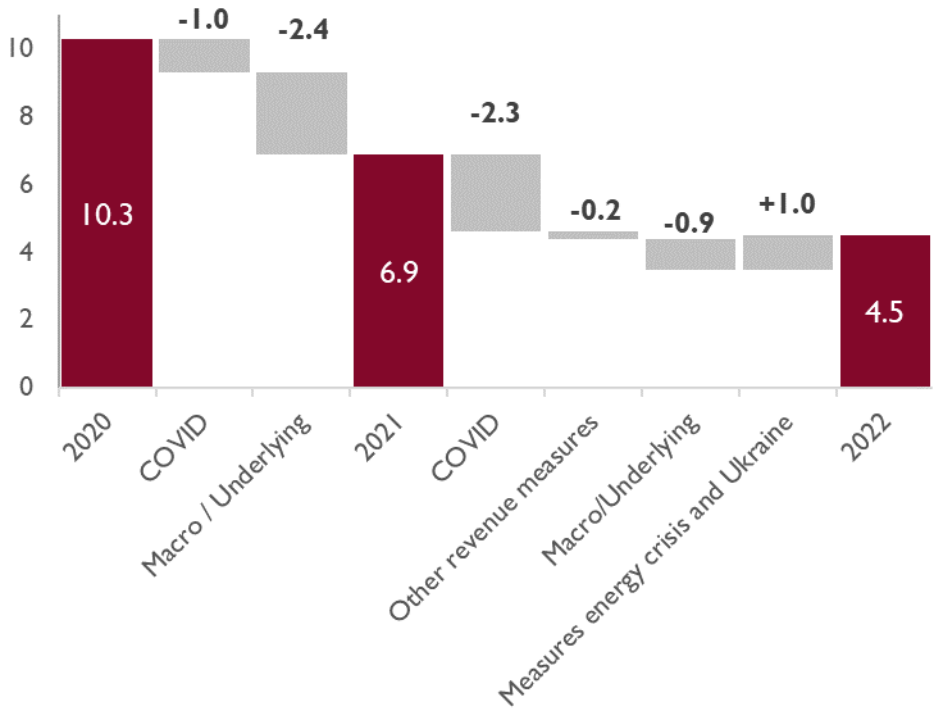
4.1. General Government

AIReF estimates that the GG deficit will stand at 4.5% of GDP, 0.3 points above the estimate in the previous report. At any event, AIReF's forecast is below the reference rate set by the Government of 5% of GDP. Two months have passed since the publication of the Report on the 2022 SPU and during this time deviations have been detected with respect to the fiscal scenario outlined in May, which are updated in this report. Firstly, the effect known to date of the measures already assessed in the previous report and the estimate of the new measures approved in the last two months raises the deficit by 0.6 points. Secondly, the update of the macroeconomic scenario is included with a deficit reduction impact of 0.2 points. This is because the real growth that is somewhat lower than the previous forecast corresponds in nominal terms to higher growth as a result of the increase in the forecast of the GDP deflator for 2022. Finally, the incorporation of the latest published data reduces the forecast deficit by 0.1 points, as the more positive evolution of tax collection is partially offset by expenditure execution above that previously expected.

Since 2020, the deficit will be reduced by almost 6 points, 3.4 points in 2021 and an additional 2.4 points in 2022 compared with 2021. This reduction is mainly explained by the phasing out of most of the COVID-19 measures, which

is more accentuated between 2021 and 2022. Another major factor, especially in 2021, is the dynamism of revenue associated with the economic recovery, which exceeds the baseline evolution of expenditure. Finally, in 2022, albeit to a lesser extent, measures to increase structural revenue also contribute to the reduction in the deficit. In contrast, the cost of the new measures adopted to mitigate the energy crisis and the consequences of the war in Ukraine push the deficit up by one point in the current year.

FIGURE 14. EVOLUTION OF DEFICIT BY COMPONENTS, AIREF (% GDP)



Source: AIReF and IGAE

AIReF estimates that revenue excluding the RTRP will stand at 42.4% of GDP in 2022 and 44.3% if the plan is included. Revenue, without the RTRP, will grow by 5.6% compared with 2021, with its proportion over GDP 0.1 points up on the forecast included in the previous report. Both the macroeconomic scenario and the evolution of tax collection in the early part of the year have led to an increase in Personal Income Tax and Corporate Income Tax revenue forecasts. In the opposite direction, the impact of the new package of measures approved to mitigate the energy crisis has been incorporated, which pushes down the expected collection of both VAT and STs. With regard to the Tax on the Value of Electricity Production, its suspension would be offset by a lower transfer to the electricity system, so it would have a neutral effect on the deficit and reduce the forecast of both revenue and expenditure. The estimate of the amount of property income and other revenue is reduced as a result of the downward revision of AR revenue from traditional EU funds.

Expenditure, excluding the RTRP, will stand at 46.9% of GDP, 0.4 points higher than that forecast in the previous report. Including the RTRP, the figure would stand at 48.8%. The execution data available to date have led to an increase in expenditure under certain headings, such as compensation of employees, intermediate consumption and temporary incapacity for work. However, the increase in expenditure is mainly due to the expansion of measures to mitigate the energy crisis approved in Royal Decree-Law 11/2022, the increase in defence spending of €1bn approved after the NATO summit and greater execution observed at a regional level.

TABLE 2. AIREF FISCAL SCENARIO WITHOUT RTRP IN % GDP

	2022 (Rep. SPU)	2022 (Current)
REVENUE	42.2	42.4
EXPENDITURE	46.4	46.9
NET LENDING/BORROWING	-4.2	-4.5

Source: AIReF and IGAE

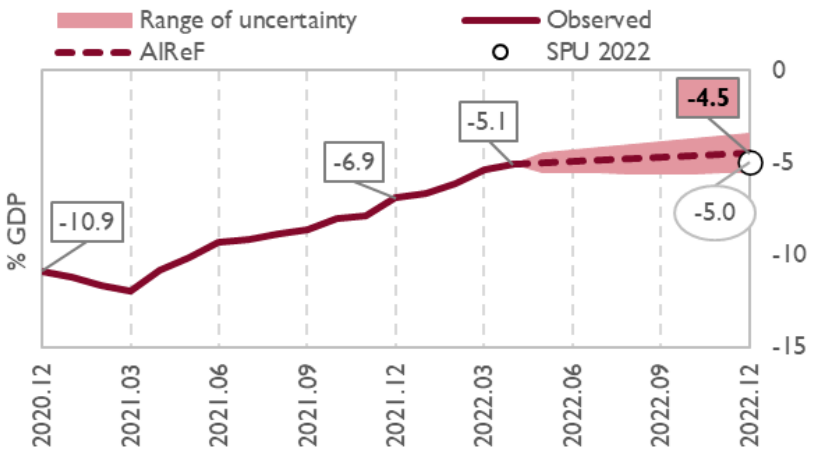
TABLE 3. AIREF FISCAL SCENARIO WITH RTRP IN % GDP

	2022 (Rep. SPU)	2022 (Current)
REVENUE	44.2	44.3
EXPENDITURE	48.4	48.8
NET LENDING/BORROWING	-4.2	-4.5

Source: AIReF and IGAE

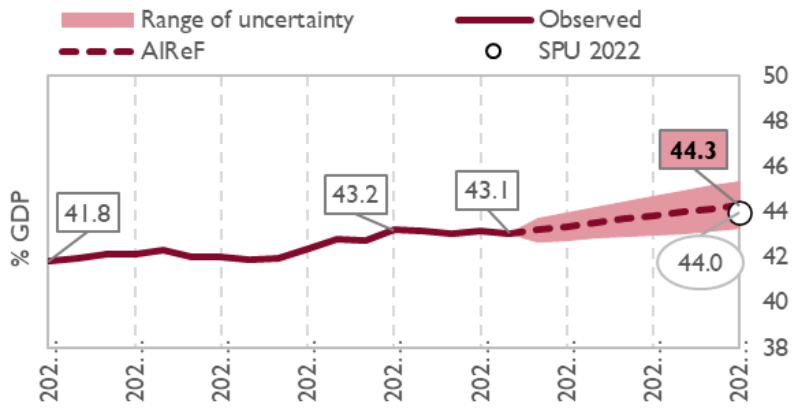
FIGURE 15. TOTAL GENERAL GOVERNMENT

FIGURE 15.A NET LENDING/BORROWING WITH RTRP (% GDP)



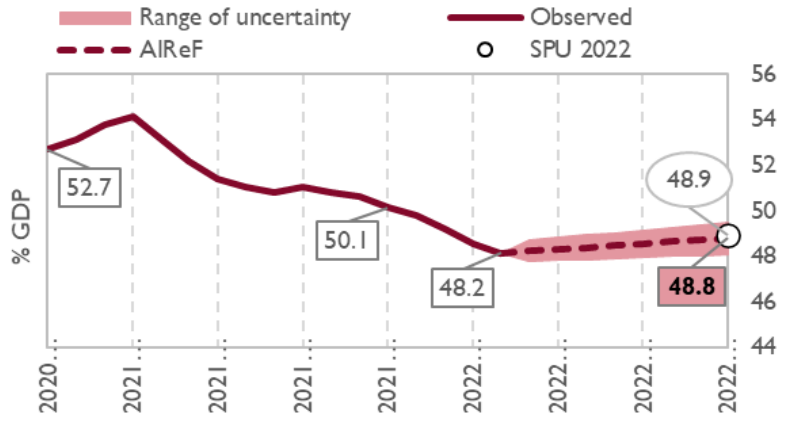
Source: AIReF and IGAE

FIGURE 15.B REVENUE WITH RTRP (% PIB)



Source: AIReF and IGAE

FIGURE 15.C EXPENDITURE WITH RTRP (% PIB)



Source: AIReF and IGAE

4.2. Evolution of General Government revenue

AIReF estimates that in 2022 revenue without the RTRP will stand at 42.4% of GDP, 0.1 points higher than forecast in the previous report. This revision is due to a combination of factors. On the one hand, taxes increase their weight by 0.2 points compared with the previous estimate due to the dynamism of the collection data and the revision of the macroeconomic scenario, which is partially offset by the expansion of the package of measures to mitigate the energy crisis. Contributions remain unchanged from the previous report, while the weight of other revenue falls by 0.1 points.

By heading, the increase is concentrated in taxes on income, which increase their weight over GDP by 0.4 points, while the package of measures mainly affects taxes on production, which reduce their weight by 0.1 points. Tax revenue will stand at 24.5% of GDP, while contributions maintain their weight

of 13.7%. Other revenue will stand at 4.2%, 0.1 points less than in the previous forecast due to the downward revision of revenue from traditional EU funds to the ARs.

TABLE 4. COMPARISON OF AIREF SCENARIOS: REVENUE WITHOUT RTRP % GDP

	2022 (Rep. SPU)	2022 (Current)	Current-SPU Difference
REVENUE	**42.2**	**42.4**	**0.1**
TAXES	24.2	24.5	0.3
On production	12.1	11.9	-0.1
On income	11.7	12.2	0.4
Capital	0.4	0.4	0.0
CONTRIBUTIONS:	13.7	13.7	0.0
Other revenue	4.3	4.2	-0.1

Source: AIReF and IGAE

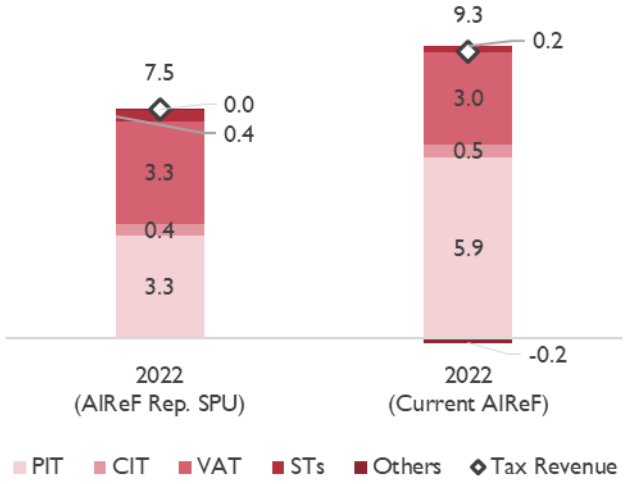
TABLE 5. COMPARISON OF AIREF SCENARIOS: REVENUE WITH RTRP % GDP

	2022 (Rep. SPU)	2022 (Current)	Current-SPU Difference
REVENUE	**44.2**	**44.3**	**0.1**
TAXES	24.2	24.5	0.3
On production	12.1	11.9	-0.1
On income	11.7	12.2	0.4
Capital	0.4	0.4	0.0
CONTRIBUTIONS:	13.7	13.7	0.0
Other revenue	6.2	6.1	-0.1

Source: AIReF and IGAE

AIReF raises the rate of change of tax revenue in national accounting terms by 1.9 points compared with the May report. For taxes under the ordinary regime, prior to their transfer to the Autonomous Regions and Local Governments, the growth in the rate of change at the end of the period increases to 9.3%. This is despite the extension of the measures to combat the rise in electricity prices approved on June 25th (RDL 11/2022), which reduces the forecasts for VAT and Special Taxes. On the other hand, the update of the tax bases for the first quarter of 2022, the collection of the months of April and May and the information for the end of the 2021 income tax return campaign, provide higher results than estimated and generate an upward revision of the forecast for Personal Income Tax revenue.

FIGURE 16. EVOLUTION OF TAX REVENUE UNDER THE ORDINARY TAX REGIME IN NATIONAL ACCOUNTING. CONTRIBUTION OF THE MAIN TAX CATEGORIES TO THE CHANGE (% CHANGE YEAR-ON-YEAR)

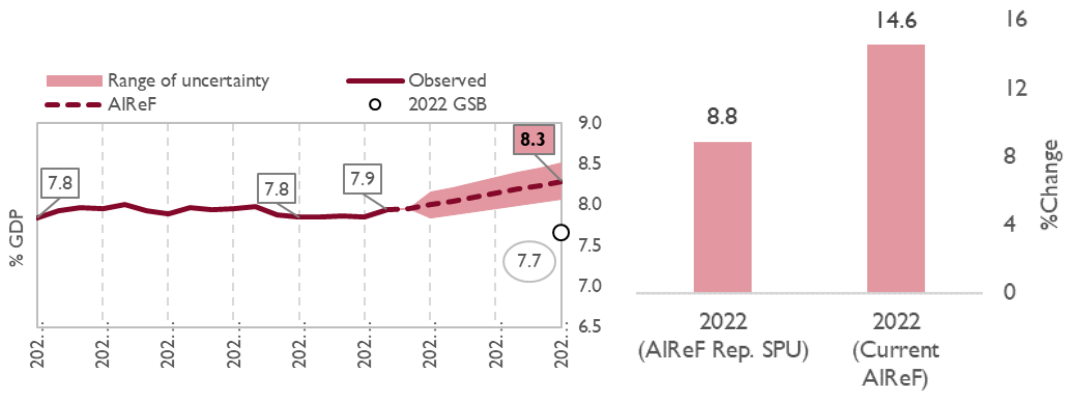


Source: AIReF and IGAE

4.2.1 Personal Income Tax

AIReF raises the weight of Personal Income Tax cash revenue as a percentage of GDP to 8.3%, 0.4 points more than in the previous report. Year-to-date results exceed AIReF's projections, leading it to revise its forecasts upwards. This new forecast is supported by the incorporation of the information provided by the tax bases for the first quarter, the collection up to May and the data for the end of the 2021 income tax campaign. The slight update of the macroeconomic scenario, which revises the increase in the variable of compensation of employees by a fraction of a percentage point, also makes a minor contribution to this revision.

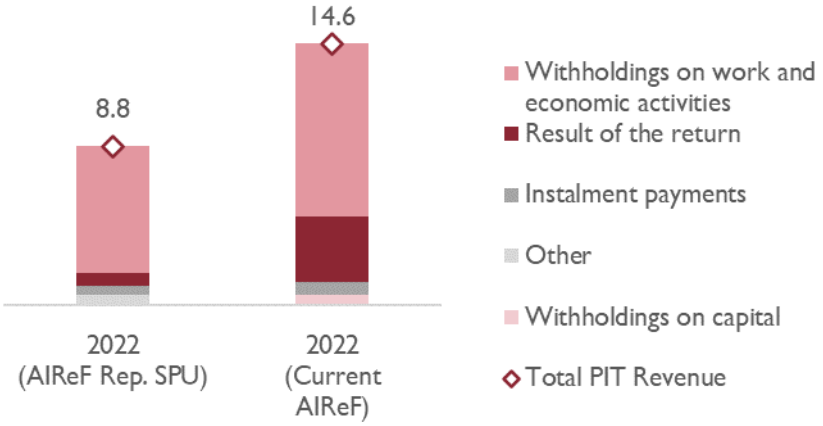
FIGURE 17. EVOLUTION OF PIT IN CASH (% GDP AND % CHANGE YEAR-ON-YEAR)



Source: AIReF and IGAE

The growth in PIT revenue stands at 14.6%, over 0.5 points above the figure in the previous report. This increase fundamentally affects tax due minus tax credits, tax withheld and prepayments, which adds an additional three points of growth compared with the previous estimate, as the preliminary results of the 2021 income tax campaign show the highest tax payable on record, 28% above that of the previous year. Also significant is the revision of the most important component of Personal Income Tax - withholdings on work - which add an extra 2.6 points of growth, mainly due to the strong boost from withholdings on private wages. According to data from the first quarter, this increase was mainly due to the growth in the number of private wage earners.

FIGURE 18. CONTRIBUTION BY COMPONENT TO THE GROWTH OF CASH PIT (% CHANGE YEAR-ON-YEAR)



Source: AEAT, AIReF

The weight of Personal Income Tax in national accounting terms will be 8.6%, 0.4 points more than in the previous estimate. The revision comes as a result of the increase in revenue in cash terms, given that the updating of the estimates and their effect on the collection mechanism generates a proportional revision in the national accounting adjustment.

BOX 2. Evolution of PIT revenue 2020-2022

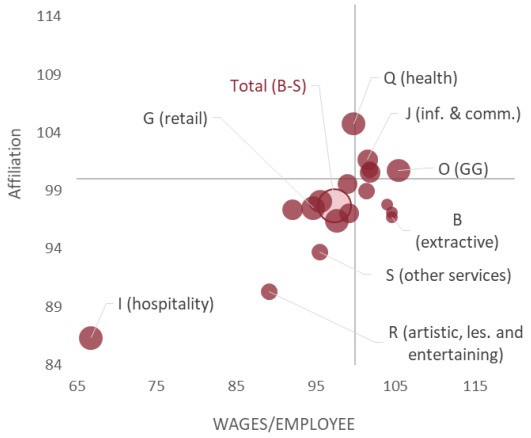
The growth in tax revenue intensified up to May 2022, placing it at 23.3% above the figure for the same period of 2019. The main increases are in PIT, which provides 10.2 points of this increase, and in VAT, which contributes an additional 6.9 points. In this context, the available information yields some results on the causes that drive this growth.

PIT has been highly buoyant since 2021, in line with the job market. In 2020, there was growth in employment in the public sector, while in the private sector it fell in the contribution groups that include the lower-paid professional categories. In addition, there was a higher incidence of ERTEs in the sections of activity with low wages, most notably the hospitality and retail sectors. Combined with these employment movements, there was a wage increase in health, public administration, information and telecommunications, all of which are sections of activity with a significant volume of employment and above-average wages. However, private employment took over at the end of 2021, with a further increase in the contribution groups with higher wages. During the first quarter of 2022, the bulk of the activities of industry, construction and services recorded employment growth, both in large companies and in SMEs, which was also accompanied by wage increases in most of the activity sections.

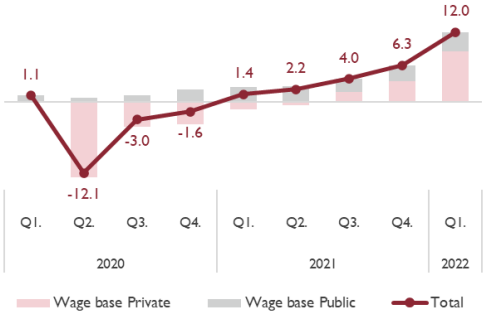
This evolution of the job market affects withholdings on work such that, at the start of the pandemic, the public sector balanced the fall in withholdings from the private sector through the contribution of withholdings on public employees and on pensioners and unemployment benefits alleviated the fall in income from work. This situation is reversed from the end of 2021 by the recovery of private employment, which intensified in the first quarter of 2022, in which private wages add almost 9 points of growth in total withholdings on work. Effective rates evolve in parallel with the increase in average compensation, and combine the impact of two effects: the growth in employment and the increase in average compensation.

EVOLUTION OF WAGES/WORKER VS AFFILIATION (2019=100)

2020

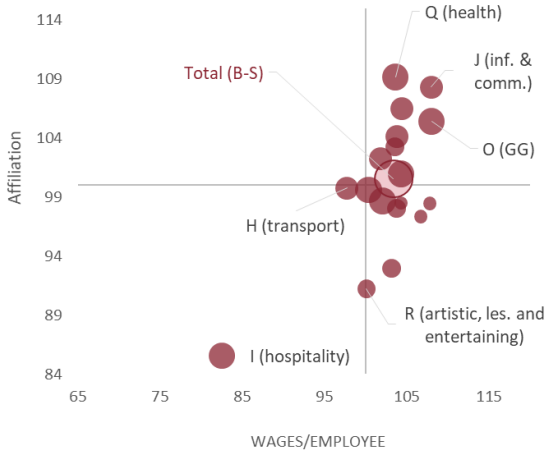


PIT BASES: CONTRIBUTION TO GROWTH (% CHANGE COMPARED WITH 2019)

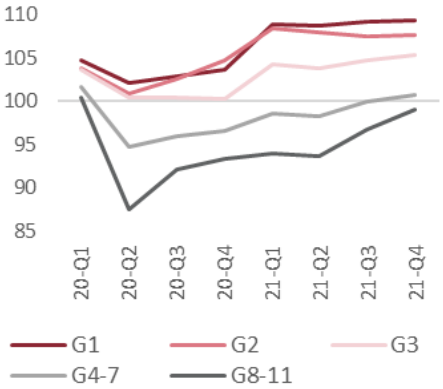


Source: AEAT, AIReF

2021

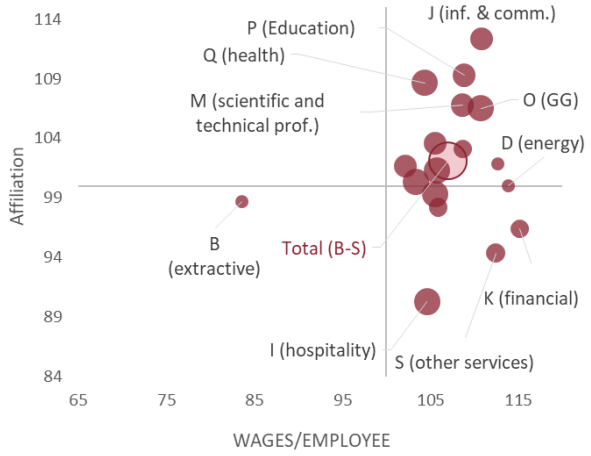


CONTRIBUTORS (NATURAL PERSON) BY CONTRIBUTION GROUP: INDICES (2019=100)



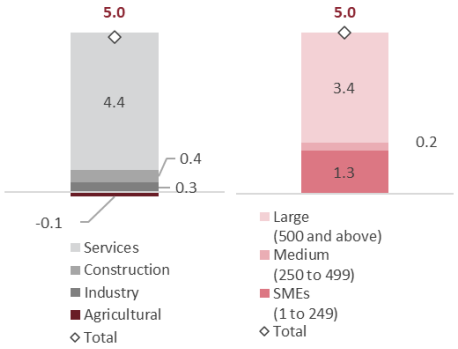
Source: Treasury General of the Social Security (TGSS), AIReF

2022 Q1 WORKERS ACCORDING TO COMPANIES REGISTERED IN THE SOCIAL SECURITY



Source: INE (quarterly labour cost survey) and TGSS (General Regime Affiliation), AIReF

(% CHANGE MAY 2022 VS MAY 2019)

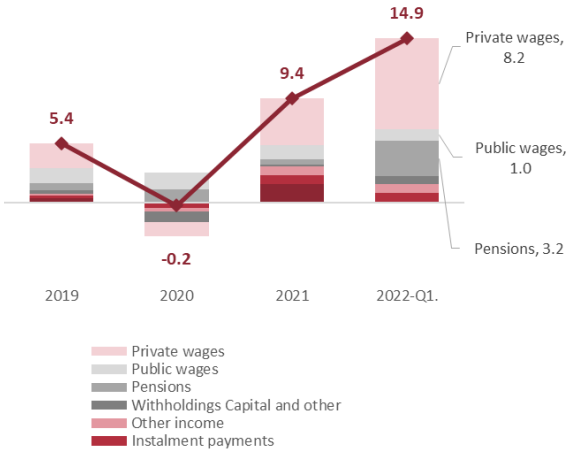


Source: MITES. Statistics companies Registered in Social Security

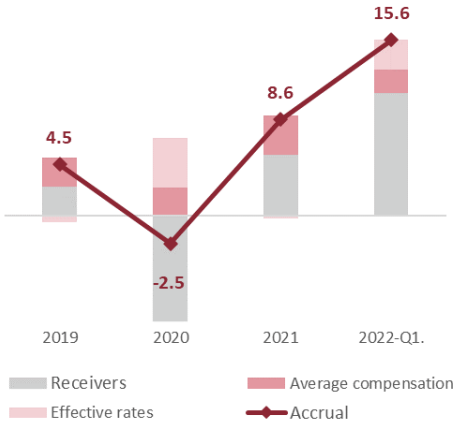
In the first quarter of 2022, the combined effect of the boost in private employment, the general increase in average remuneration and the growth in pensions, together with the consequent increases in effective rates, are responsible for the increase in withholdings on work, which account for 89% of total accrued PIT and 13.2 points of its growth. Withholdings on private wages mainly increase as a result of the increase in employment and contribute 8.2 points to the growth in PIT. Although wages are the main growth factor, pensions show notable growth at the start of 2022 and add 3.2 points of growth as a result of the pension increase, together with the extraordinary payment made in January. For their part, public wages add one point of growth.

ACCRUED PIT CONTRIBUTIONS TO GROWTH (% CHANGE YEAR-ON-YEAR)

ACCRUED PIT

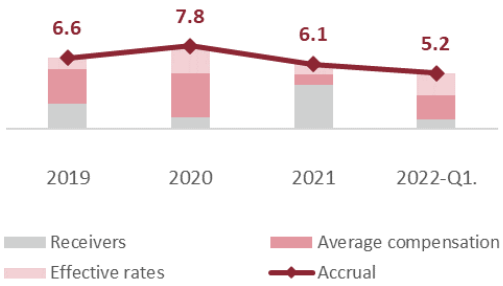


PRIVATE WAGES

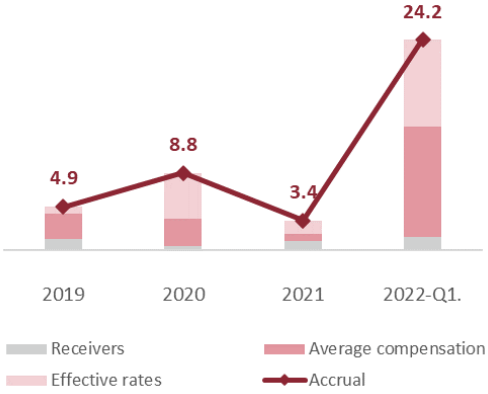


Source: AEAT, AIReF

PUBLIC WAGES

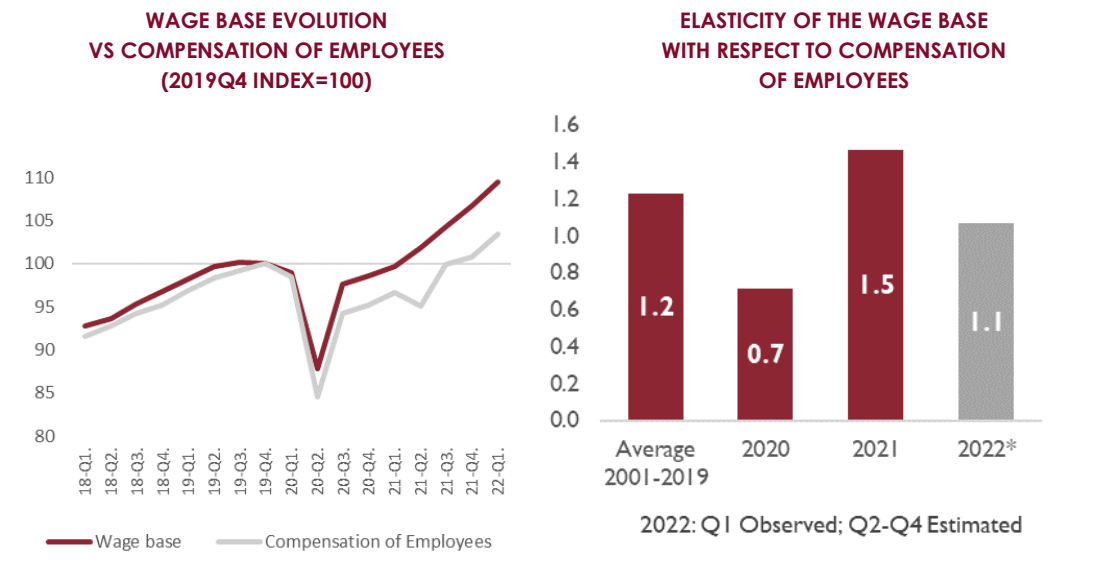


PENSIONS



Source: AEAT, AIReF

In this period, there was a decoupling with respect to the macroeconomic variable of compensation of employees, linked to the growth of PIT, with a smaller fall in PIT wage bases in 2020 and a larger recovery in 2021 and the start of 2022. AIReF's forecasting models readjust these imbalances and produce values that have an elasticity with respect to compensation of employees that is lower than the historical average in 2022.

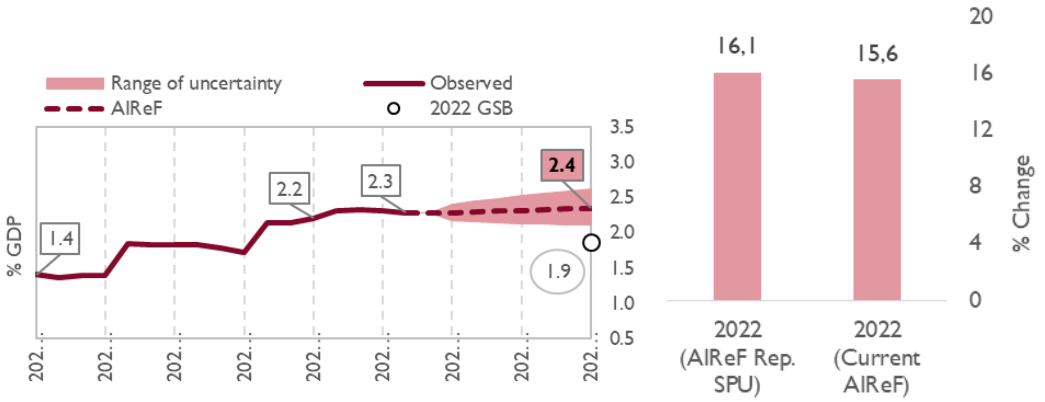


Source: INE, AEAT and AIReF

4.2.2 Corporate Income Tax

AIReF maintains its forecast of cash income from Corporate Income Tax at 2.4 points of GDP at year-end 2022. Following the incorporation of the latest available data, which include the first instalment payment of the year, and the update of the macroeconomic scenario, the estimates are updated, which keep the forecast practically unchanged, albeit with a slight increase in both revenue and refunds. As a result, the rate of change shows a slight decrease of 0.5 points compared with the May forecast, to stand at 15.6%. However, the relevant information on the evolution of the full year is still subject to uncertainty as two of the largest instalments and the settlement of the 2021 campaign are recorded in the last few months of the year.

FIGURE 19. EVOLUTION CORPORATE INCOME TAX IN CASH (% GDP AND % CHANGE YEAR-ON-YEAR)



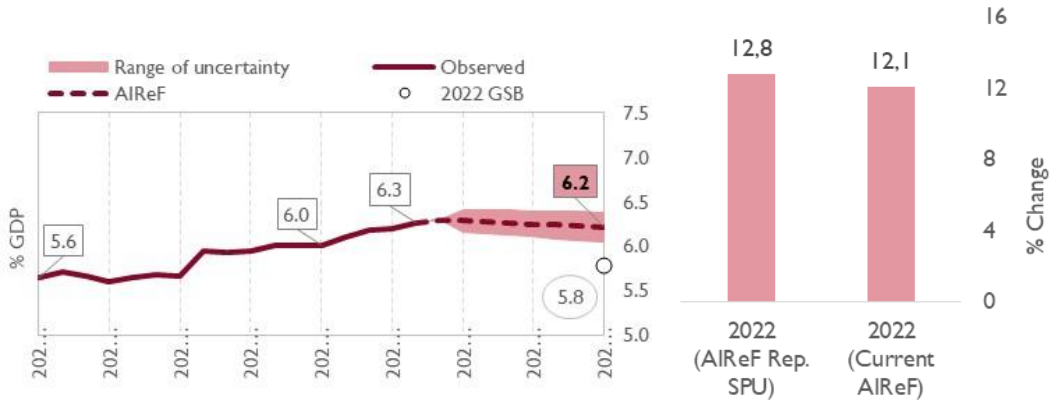
Source: AIReF and IGAE

In national accounting terms, AIReF maintains its projections for Corporate Income Tax at 2.3% of GDP, as in the previous report. The update of the results raises the estimates of both revenue and refunds, resulting in a slight increase in the national accounting adjustment as a result of the transfer of refunds to the year in which they were applied for. This produces a revision of the year-on-year rate of change of 0.6 points in the opposite direction to that recorded in cash terms.

4.2.3 VAT

AIReF lowers its cash forecast of VAT, reducing its weight over GDP to 6.2%, 0.1 points down on the previous report. The change is the result of the update of the collection results and the changes in the reduction of VAT on electricity after the approval of the RDL 11/2022 (see section on measures). With higher-than-expected data observed, higher revenue is projected that adds an additional 2.6 points to the growth forecast in the previous report. However, this is offset by higher refunds and therefore the estimate is maintained in net terms. The legislative measures subtract just under 0.8 points due to incorporation of the reduction in rates adopted up to December 2022 in Royal Decree Law 11/2022 of June 25th. As a consequence of the above, AIReF forecasts that VAT will grow by 12.1% at year-end 2022, almost 0.8 points below its previous forecast.

FIGURE 20. EVOLUTION OF VAT IN CASH (% PIB AND % CHANGE YEAR-ON-YEAR)



Source: AIReF and IGAE

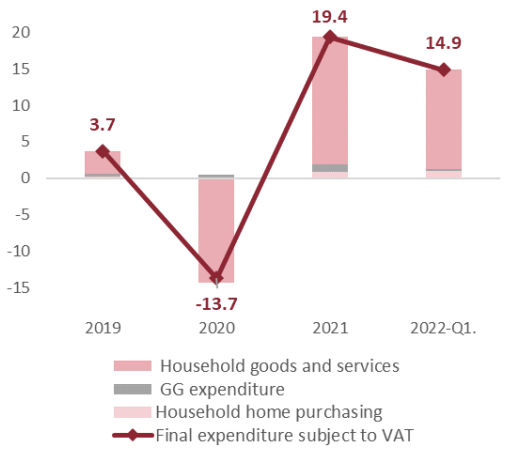
The weight of VAT over GDP in national accounting terms also falls by 0.1 points compared with the previous report, to stand at 6.2%. The year-on-year rate of change stands at 9.3%, with a slightly higher revision than that carried out in cash terms. This is due to the extension of the electricity measures until December 2022, which reduces the cash figure for the months of January and February 2023 from the accrual in November and December 2022. Given that in national accounting terms the revenue is recorded in its month of accrual,

the shift of the effect of the measures from the cash position in the first few months of 2023 to the accrual period produces a reduction in the growth in national accounting terms of one point, somewhat greater than the revision in cash terms.

BOX 3. Evolution of VAT revenue 2020-2022

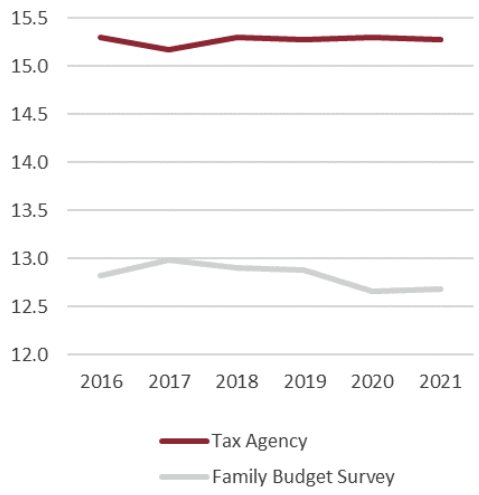
Household VAT expenditure is responsible for its fall at the start of the pandemic and drives its growth from the second half of 2021. Household expenditure is the main component of VAT and responsible for its fall during the pandemic, in which collection could have been affected by changes in consumer behaviour, such as the increase in card payments and the substitution of the consumption of services for goods, as reflected in the Family Budget Survey. This fall extends until the first half of 2021, and from the second half of this year, household spending drives 70% of the increase in VAT. For its part, the General Government increases in its contribution to VAT growth in 2021, although it returns to its usual weight at the start of 2022. Finally, the purchase of new housing slows down during the lockdown and grows as from the second half of 2021, with a greater contribution to growth in 2022.

FINAL EXPENDITURE SUBJECT TO VAT: CONTRIBUTIONS (% CHANGE YEAR-ON-YEAR)



Source: AEAT
Prepared by AIReF.

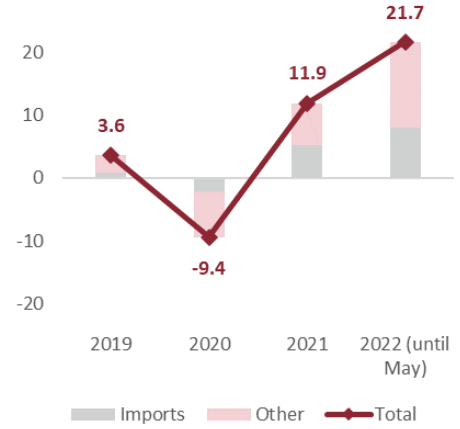
EFFECTIVE VAT RATES



Source: AEAT, INE (Family Budget Survey).

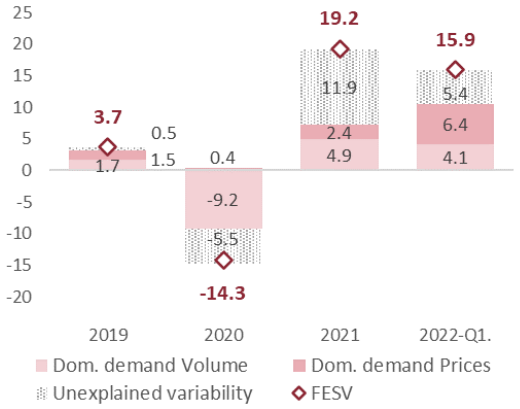
As of the second half of 2021, sales of both large companies and SMEs and business turnover in industry and services increase. Imports are driving the increase in VAT collection in parallel with the start of the rise in energy prices. Although in 2021 the impact of inflation is still limited, in the first quarter of 2022 it explains over 6 points of the growth of Final Expenditure Subject to VAT.

VAT: GROSS REVENUE. CONTRIBUTIONS TO SEASONALLY-ADJUSTED GROWTH (% Y-O-Y CHANGE)



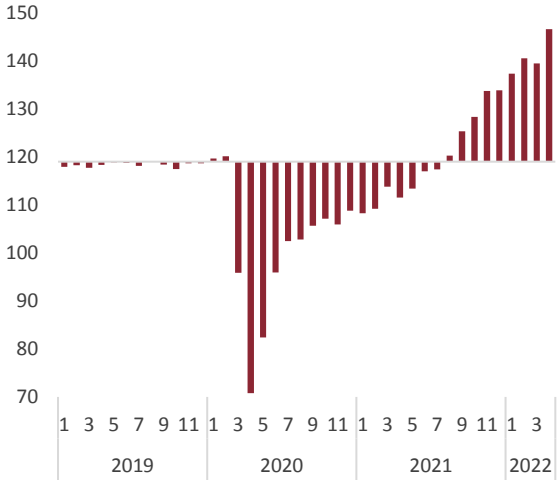
Source: AEAT

EVOLUTION OF FINAL EXPENDITURE SUBJECT TO VAT (% Y-O-Y CHANGE)



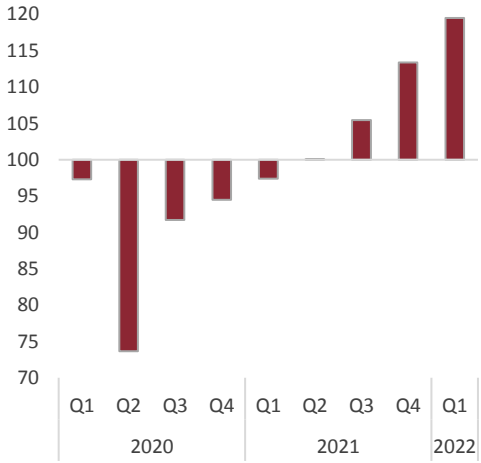
Source: AEAT, INE and AIReF

BUSINESS TURNOVER INDICES (WITH RESPECT TO THE AVERAGE OF 2019)



Source: INE

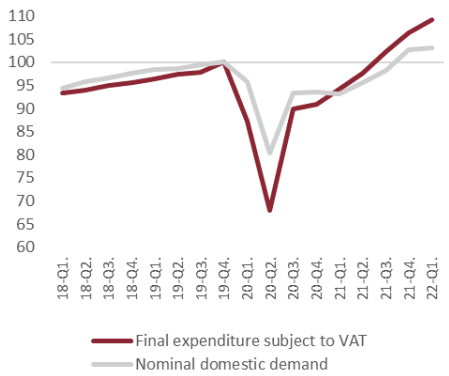
SALES OF LARGE COMPANIES AND SMES (QUARTERS 2019=100)



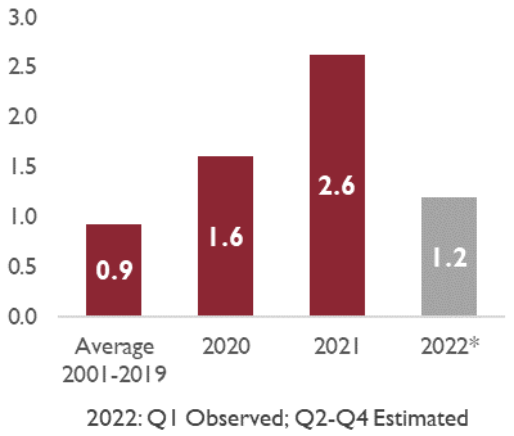
Source: AEAT

The outbreak of the pandemic led to a separation between the evolution of VAT and that of the macroeconomic variable of domestic demand, with a greater fall in Final Expenditure Subject to VAT in 2020 and more dynamic growth in 2021 and so far in 2022. As with Personal Income Tax, AIReF's forecasting models readjust these imbalances and generate an elasticity with respect to domestic demand that decreases over 2022 to readjust to the historical average.

EVOLUTION FINAL EXPENDITURE SUBJECT TO VAT VS NOMINAL DOMESTIC DEMAND (2019Q4 INDEX=100)



ELASTICITY OF FINAL EXPENDITURE SUBJECT TO VAT WITH RESPECT TO NOMINAL DOMESTIC DEMAND

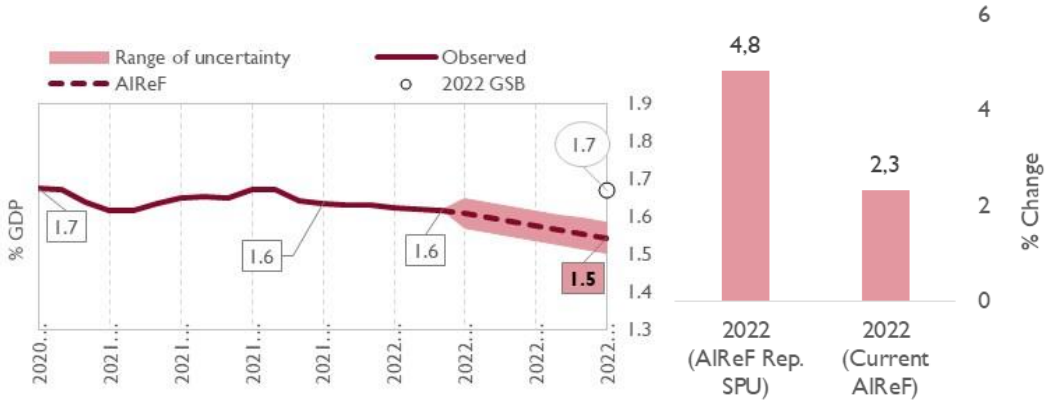


Source: INE, AEAT and AIReF

4.2.4 Special Taxes

The collection of Special Taxes reduces its weight over GDP by less than 0.1 points compared with the forecast in May, placing it at 1.5%. The year-on-year rate of change stands at 2.3%, down 2.5 points on the previous forecast. This revision is due to the extension of the rate reduction in the Special Tax on Electricity approved in RDL 11/2022, which subtracts 2.6 points of growth in terms of year-on-year change compared with the previous report. The new information available also produces slight revisions in the Tax on Alcohol, which contributes an additional 0.3 points to the growth and in the Tax on Hydrocarbons, which subtracts 0.2 points.

FIGURE 21. STS IN CASH (% GDP AND % CHANGE)



Source: AIReF and IGAE

4.2.5 Other tax revenue

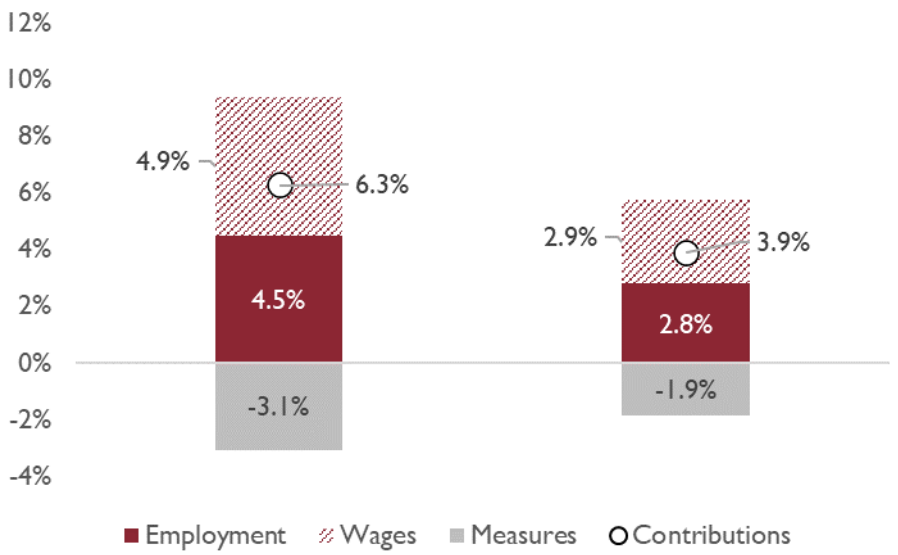
Other tax revenue in national accounting terms maintains its weight over GDP at 0.8%, as in the previous report. Although its weight over GDP is maintained, the year-on-year rate of change is reduced by 3.5 points to -3.2%. This decrease is due to the extension of the suspension of the Tax on the Value of Electricity Production approved in RDL 11/2022, which subtracts 6.4 points of year-on-year growth, and is partially offset by an upward revision of 2.2 points as a result of the incorporation of the latest known information and the upward revision of nominal GDP.

4.2.6 Social contributions

AIReF expects the weight of contributions as a proportion of GDP to fall from 14.3% in 2021 to 13.7% in 2022, similar to the estimate in the Report on the 2022 SPU. The national accounting data published up to April and the data on budgetary execution up to May show less dynamic behaviour of contributions than that estimated in the SPU, with lower elasticity with respect to compensation of employees. The downward revision of elasticity is offset by the upward revision of compensation of employees in the update of the macroeconomic outlook, which leaves the forecast for revenue from social contributions unchanged.

Employment and wages moderate their contribution to the growth in social contributions between 2021 and 2022. The measures have a negative contribution to growth in both years due to the phasing out of COVID-19 measures.

FIGURE 22. BREAKDOWN OF GROWTH IN SOCIAL CONTRIBUTIONS (% CHANGE)



Source: AIReF and IGAE

4.2.7 Other revenue

The weight of other revenue, excluding the RTRP, in relation to GDP falls by 0.1 points compared with the estimate in the SPU, to stand at 4.2% of GDP. This reduction is due to a downward revision of the forecasts for traditional EU funds for the ARs.

4.3. Evolution of General Government expenditure

According to AIReF's estimates, expenditure in 2022, excluding the RTRP, will be 46.9%, compared with 46.4% in the previous report. In this case, the new spending measures adopted by the Government are the main factor that explains the increase in the forecast compared with the previous report. This increase of 0.4 points of GDP is concentrated in intermediate consumption and subsidies. However, the increase under these headings is also partly due to the reclassification within the expenditure headings of some anti-crisis measures following the new information on their recording in national accounting. This change in the composition of expenditure explains why the sharp increase in these items is partially offset by a reduction in expenditure on social transfers in kind and other expenditure. In addition, the higher-than-expected execution of certain expenditure has also raised the forecast. Including the RTRP, expenditure would stand at 48.8% of GDP.

TABLE 6. COMPARISON OF AIREF SCENARIOS: EXPENDITURE WITHOUT RTRP (% GDP)

	2022 (Rep. SPU)	2022 (Current)	Current-SPU Difference
EXPENDITURE	**46,4**	**46,9**	**0,4**
Compensation of employees	11,6	11,6	0,0
Intermediate consumption	5,6	5,7	0,2
Social transfers in kind via market	2,9	2,8	-0,1
Social benefits in cash	17,5	17,5	0,0
Interest	2,1	2,1	0,0
Gross capital formation	2,4	2,4	0,0
Subsidies and other expenditure	4,5	4,8	0,4

Source: AIReF and IGAE

TABLE 7. COMPARISON OF AIREF SCENARIOS: EXPENDITURE WITH RTRP (% GDP)

	2022 (Rep. SPU)	2022 (Current)	Current-SPU Difference
EXPENDITURE	**48,4**	**48,8**	**0,4**
Compensation of employees	11,6	11,6	0,0
Intermediate consumption	5,6	5,8	0,2
Social transfers in kind via market	2,9	2,9	-0,1
Social benefits in cash	17,5	17,5	0,0
Interest	2,1	2,1	0,0
Gross capital formation	3,2	3,1	0,0
Subsidies and other expenditure	5,5	5,9	0,4

Source: AIReF and IGAE

4.3.1. Main components of public consumption expenditure

AIReF increases the forecast for the main components of public consumption for 2022 by 0.1 points of GDP to stand at 20.1%, excluding the RTRP. AIReF revises upwards all the main components of public consumption (compensation of employees, intermediate consumption and social transfers in kind), although with contrasting effects by component. Compared with the previous report, strong growth in intermediate consumption and a slight increase in compensation of employees is expected. In contrast, a reduction in social transfers in kind is estimated. With the current forecast, the main components of public consumption without the RTRP would grow by 3.9% compared with 2021, 0.8 points more than estimated in the previous report.

In the evolution by components, without the RTRP, compensation of employees increases in nominal terms, but maintains its weight at 11.6% of GDP. AIReF revises this expenditure upwards at both a central and territorial level. In the case of the CG, the increase is due to higher expected spending as a result of the recent approval of extraordinary military spending. With regard to the territorial administrations, there is greater dynamism in the expenditure on compensation of employees according to the execution data published. In particular, there is an update on the data on the estimated change in the workforce of the ARs, with a higher replacement rate in health and education, and of the Local Governments, in line with the execution data.

AIReF forecasts higher growth for intermediate consumption, which increases its weight over GDP by 0.2 points to stand at 5.7%. This expenditure is revised upwards in all sub-sectors, driven by the execution data published. In addition,

a significant increase is estimated in the CG for two reasons. Firstly, due to the expected impact of the approval of extraordinary military spending. Secondly, due to the allocation to intermediate consumption of part of the aid to refugees from Ukraine, approved by RDL 6/2022 in March, with a corresponding decrease in other current transfers, as a result of the change in the composition between expenditure headings of some measures as a result of the new information received. Currently, the estimated growth rate for this expenditure heading is 6.2% compared with 2021, much higher than the 3% of the previous forecast.

In contrast, AIReF reduces the estimate of social transfers in kind, which fall by 0.1 points of GDP compared with the previous report. This decrease is mainly due to the reclassification of the fuel rebate to individuals approved by RDL 6/2022 in March, according to the information published by the IGAE on the execution of this measure. This change in the composition between expenditure headings has meant reducing social transfers in kind, where the fuel rebate for individuals was recorded, in order to increase expenditure on subsidies. Therefore, AIReF's current forecast is that this expenditure heading will stand at 2.8% of GDP compared with the 2.9% estimated in the previous report.

4.3.2. Social benefits in cash

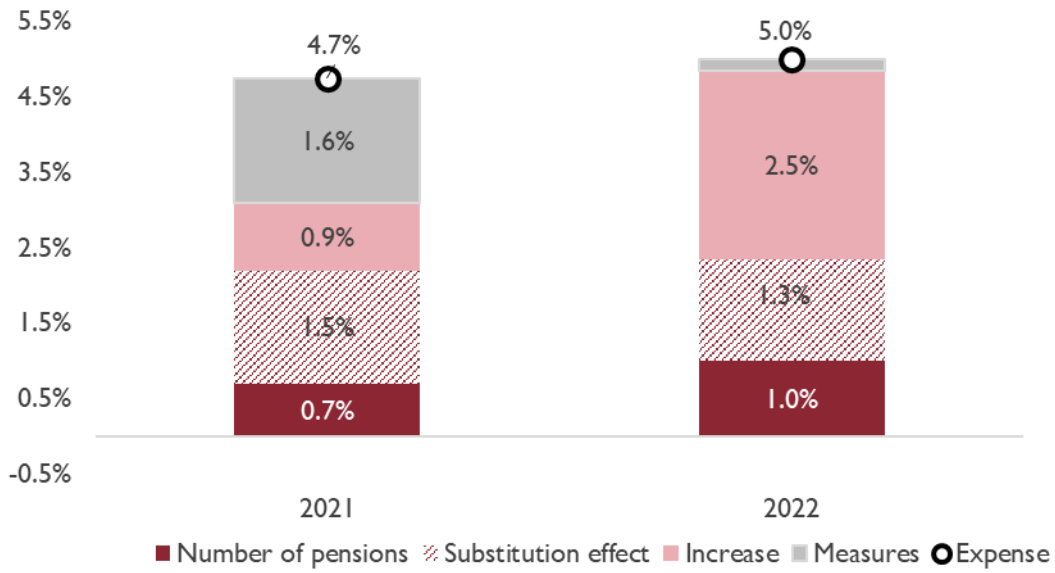
AIReF maintains the forecast for social benefits in cash for 2022 at the 17.5% of GDP estimated in the previous report. Since then, there have been some changes in the various headings resulting from the availability of new budget execution data from the national accounting, from the update of AIReF's macroeconomic outlook and from the adoption of new measures by the Government. Since May, the Government has extended the 15% increase in the Minimum Living Income that had been approved for three months to the period from July to December. This measure is expected to have an impact on spending of approximately €153m. This 15% increase has also been extended to non-contributory pensions for the period from July to December 2022, an initiative whose cost is estimated at around €200m. These increases in expenditure are offset by the denominator effect caused by the increase in nominal GDP in the macroeconomic outlook and, therefore, the weight of social benefits in cash over GDP remains unchanged.

AIReF estimates that pension expenditure will rise by 5% in 2022, 0.1 points more than the rate estimated in the Report on the 2022 SPU. AIReF updates its assessment for 2022 compared with the last report due to the introduction of the new measure in RDL 11/2022 to increase non-contributory pensions, while

the estimate of the substitution effect and the increase in the number of pensions is maintained.

The increase in the forecast for inflation in 2022 raises the growth of pension expenditure in 2023 to 10.1%. AIReF's inflation forecast for 2022 rises from 6.5% to 7.8%. Therefore, in accordance with the pension reform, the pension increase in 2023 would also rise by 1.3%. This increase, together with the increase in the number of pensions and the substitution effect, brings the growth in pension expenditure from 8.8% in the previous report to 10.1%, which is almost €2bn more than the previous forecast.

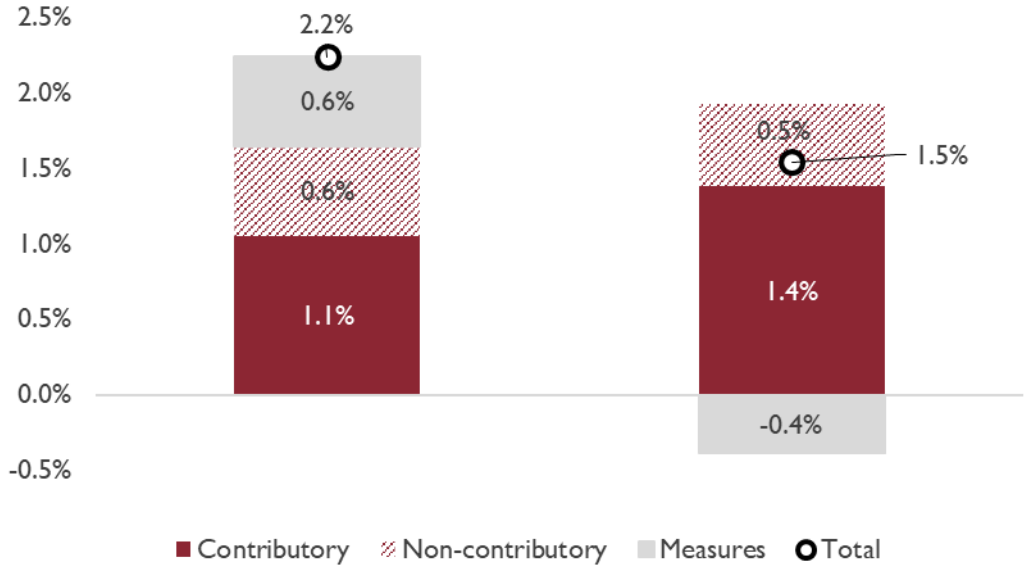
FIGURE 23. GROWTH IN PENSION EXPENDITURE (% CHANGE). AIREF PROJECTIONS



Source: AIReF and Social Security

Unemployment benefits fall from 2.2% of GDP in 2021 to 1.5% in 2022, the same estimate as in the SPU. In 2021, there is a revision from 2.3% to 2.2% of GDP resulting from the availability in June of the final settlement data from the SEPE, which was slightly lower than the preliminary information available at the time of publication of the Report on the SPU. The reduction in unemployment spending between 2021 and 2022 is mainly due to the reduction in ERTEs.

FIGURE 24. EVOLUTION OF UNEMPLOYMENT EXPENDITURE (% OF GDP). AIREF'S FORECASTS



Source: AIReF and SEPE

The weight of the other benefits falls from 4.4% of GDP in 2021 to 4% in 2022, similar figures to those included in the Report on the 2022 SPU. The increase in the cost of the MLI resulting from the extension of the 15% increase from July to December is offset by the increase in nominal GDP in the revision of the macroeconomic outlook.

4.3.3. Interest

AIReF maintains its interest expenditure forecast for 2022 at 2.1% of GDP. The increase in interest rates has meant re-evaluating the impact on the interest burden in 2022 due to the new financing conditions. However, the high duration of the debt portfolio (between eight and ten years) and the high percentage of borrowing already covered at this point in the year (with more than 60% of debt issues made), will imply a slow pass-through of interest rate increases in this year. For this reason, AIReF keeps its forecast in line with the estimate in the previous report. At any event, if it persists over time, the accumulated effects of the increase in interest rates will be more significant, above all, taking into account that the volume of debt of the GG as a whole currently exceeds €1.45tn.

4.3.4. Gross capital formation

The weight of gross capital formation remains at the 2.4% of GDP forecast in the previous report, excluding the RTRP. The revision of this heading is uneven across sub-sectors. The decline is marked by the downward revision of the

gross capital formation of the LGs as a result of the redistribution of capital expenditure, less gross formation and more investment support, based on the execution data published for the first quarter of 2022. In the opposite direction, the expenditure forecast is revised slightly upwards in the ARs, in accordance with the execution data observed up to April, and in the CG. This upward revision for the CG is due to the allocation of part of the expected effect of approval of extraordinary military expenditure, as well as the recording of part of the aid to refugees from Ukraine, after reclassifying this measure approved by RDL 6/2022 in March, with the corresponding decrease in the heading of other current transfers.

4.3.5. Subsidies and other expenditure

Other expenditure excluding the RTRP will amount to 4.8% of GDP in 2022, 0.4 points higher than in the previous report. One of the main factors that explain the increase in expenditure on subsidies is the estimated cost of the new RDL 11/2022 anti-crisis package, where the majority of the support granted is considered subsidies, as well as the reclassification of the fuel rebate to individuals under RDL 6/2022 approved in March, which is recorded under subsidies and de-recognised from the heading of social transfers in kind, as indicated earlier. This increase is partially offset by the decrease in spending on subsidies as a result of the extension of the temporary suspension of the Tax on the Value of Electricity Production to December 31st, 2022.

4.4. Analysis by sub-sector

AIReF estimates a worsening of the balance of all the sub-sectors in nominal terms, although in terms of weight over GDP the balance of the ARs only worsens by just under 0.2 points and the balance of the CG by 0.1 points. In the revision of the balance by sub-sector, AIReF raises the CG deficit by 0.1 points to 3.3% of GDP. For their part, the ARs worsen their deficit by almost 0.2 points, from 0.7% to 0.9% of GDP. Finally, the SSFs and the LGs maintain the balance forecast in the previous report in terms of GDP, i.e. a deficit of 0.5% and a surplus of 0.2%, respectively.

TABLE 8. BALANCE BY SUB-SECTOR (% GDP)

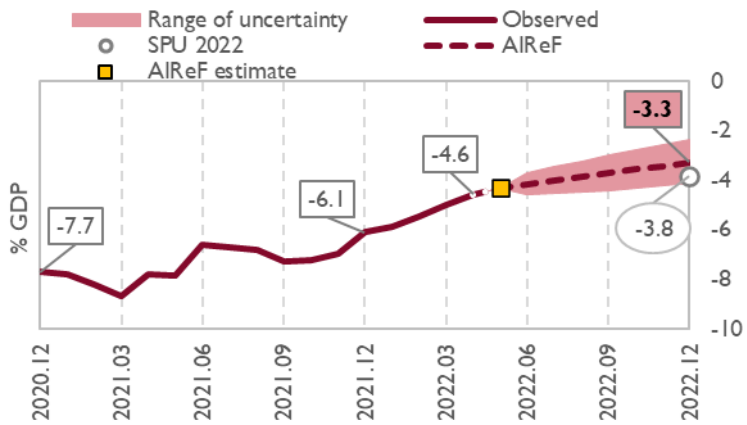
	2022 (Government SPU)	AIReF estimate 2022 (Rep. SPU)	AIReF estimate 2022 (Current)	Current-SPU Difference
GG	**-5.0**	**-4.2**	**-4.5**	**-0.3**
CG	-3.8	-3.2	-3.3	-0.1
SSFs	-0.5	-0.5	-0.5	0.0
ARs	-0.8	-0.7	-0.9	-0.1
LGs	0.1	0.2	0.2	0.0

Source: AIReF and IGAE

4.4.1. Central Government

AIReF slightly worsens the deficit of the CG, increasing its weight over GDP by 0.1 points compared with the forecast in the Report on the SPU, to stand at 3.3%. The estimated CG deficit worsens by 0.1 points of GDP. The increase in expenditure, driven by the cost of the new anti-crisis package approved by the Government in June and the recently approved military expenditure, slightly exceeds the upward revision of the revenue forecast due to better-than-expected collection data, mainly in PIT. Therefore, the improvement in the revenue forecast due to the recovery of the economy, instead of translating into a lower deficit forecast for the CG, offsets the spending measures adopted in the current economic and geopolitical context. As a result, AIReF raises its deficit forecast to 3.3% of GDP, 0.5 points of GDP more favourable than the Government's forecast of 3.8% of GDP included in the 2022-2025 SPU.

FIGURE 25. CG NET LENDING/BORROWING (% GDP)



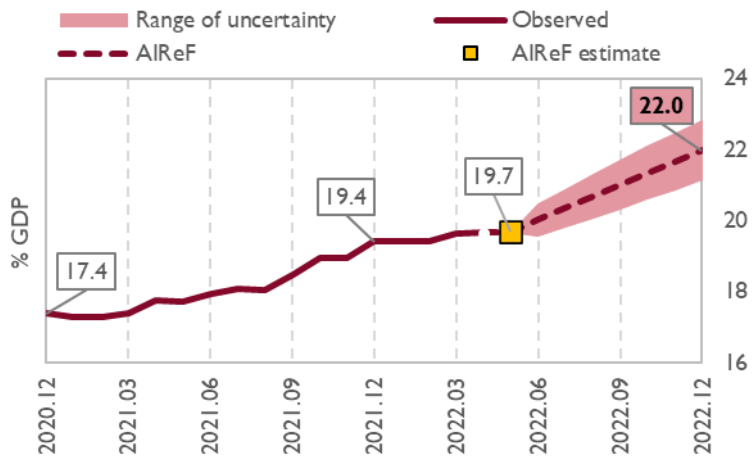
Source: AIReF and IGAE

4.4.1.1 Central Government revenue

AIReF forecasts that CG revenue will amount to 20% of GDP in 2022, excluding the RTRP, 0.3 points more than in the previous report. Overall CG revenue has been revised upwards. Since the transfer set by the financing system is fixed, all changes taking place with respect to the previous tax estimate are absorbed by this sub-sector. Therefore, the changes in the estimates, explained in the previous section, fall on the CG. In turn, it will determine higher payments in 2024 for the settlement of the territorial financing systems.

Tax revenue rises by 0.3 points of GDP, driven by taxes on income, which now account for 7.2% of GDP from the previous 6.8%, while taxes on production reduce their weight by 0.2 points. In taxes on income, the increase is mainly due to the upward revision of PIT referred to above. This increase is partially offset by the effect of loss of collection of taxes on production, resulting from the recent review of regulatory measures to mitigate electricity prices, which reduce revenue from both VAT and Special Taxes.

FIGURE 26. REVENUE OF THE CG WITH RTRP (% GDP)



Source: AIReF and IGAE

4.4.1.2 Central Government expenditure

AIReF forecasts that CG expenditure, excluding the RTRP, will amount to 23.3% of GDP in 2022, a little over 0.3 points more than estimated in the Report on the SPU. The Government has taken further steps since the publication of the Report on the SPU in May. On June 25th, it approved a new anti-crisis package in Royal Decree-Law 11/2022 and, subsequently, on July 5th, an extraordinary appropriation to cover the extraordinary spending on the Armed Forces caused by the invasion of Ukraine. The estimated cost of these measures of around €5.5bn, as well as the latest execution data and the new information available, have led to an upward revision in the estimate of CG expenditure

of a little over 0.3 points of GDP, to stand at 23.3% for 2022. If RTRP expenditure is included, CG expenditure would amount to 25.2% of GDP.

AIReF estimates that the higher expenditure as a result of the new measures of RDL 11/2022 mainly affects subsidies and, to a lesser extent, other current transfers and transfers between GG sub-sectors The main increases are expected in expenditure on subsidies and other current transfers, as they affect support granted to different sectors of the economy and to individuals (*inter alia*, support for the gas-intensive industry and the agricultural sector, fuel rebates and support for low-income individuals). However, the increase in subsidies would have been greater if it had not been partially offset by the extension of the suspension of the Tax on the Value of Electricity Production until the end of the year. In addition, it is estimated that there will be an increase in spending on current transfers between GG sub-sectors. These rise as a result of those measures which, although they are financed by the State, are the responsibility of other administrations which are in charge of their management, whether they be the territorial administrations (measures affecting urban and interurban transport and support managed by the Basque Country and Navarre authorities) or the Social Security Funds (increases in the Minimum Living Income and non-contributory pensions).

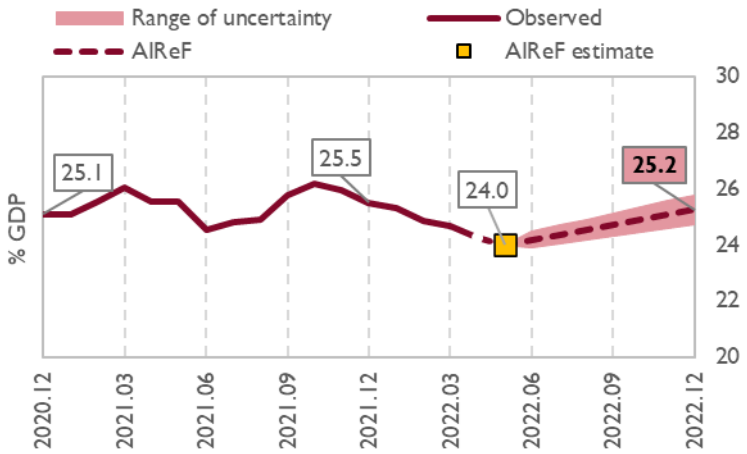
Both current and capital government expenditure are also expected to increase due to the extraordinary military expenditure approved. AIReF estimates that the approval by the Government of an extraordinary appropriation, amounting to almost €1bn, just under 0.1 points of GDP, to cover the expenses of the Armed Forces caused by the invasion of Ukraine, will result in an increase in current expenditure, in particular compensation of employees and intermediate consumption, as well as capital expenditure, with an increase in gross capital formation.

Lastly, some measures under RDL 6/2022 are reclassified on the basis of information published on their execution in national accounting. In view of the new information, two measures under RDL 6/2022 are reclassified, which results in a change in the composition of expenditure, but without this upward and downward revision for the same amount of some items affecting the total amount. Consequently, on the one hand, support for Ukrainian refugees ceases to be recorded in other current transfers and is mainly attributable to intermediate consumption and subsidies and, to a lesser degree, to gross capital formation. On the other hand, the fuel rebate for private individuals is no longer recorded in social transfers in kind but, like those granted to hauliers, is charged to expenditure on subsidies.

As for the evolution of eligible expenditure for the purpose of the expenditure rule, AIReF expects a reduction of around 4% in 2022 compared with 2021. This

expected negative change is due, firstly, to the decrease in COVID spending, which practically ceases to have an impact for the CG in 2022. In this regard, it is considered that the transfers to the territorial administrations in 2022 to offset the VAT management system (SII) or the negative settlements are not part of the eligible expenditure because they are linked to the regional and local financing system. Secondly, a significant decrease in non-recurring expenditure is expected in 2022 compared with 2021, a year in which it was particularly high due to, *inter alia*, the standardised guarantees of the pandemic-related ICO loans and the substantial sums of various judgments. Thirdly, increases in revenue from policy changes, estimated at 0.2% of GDP, are expected to help reduce eligible spending in 2022. At any event, the combined effect of these three factors on the reduction of eligible expenditure is estimated to be higher than the increase in this expenditure due to the measures adopted by the Government for 2022.

FIGURE 27. EXPENDITURE OF THE CG WITH RTRP (% GDP)

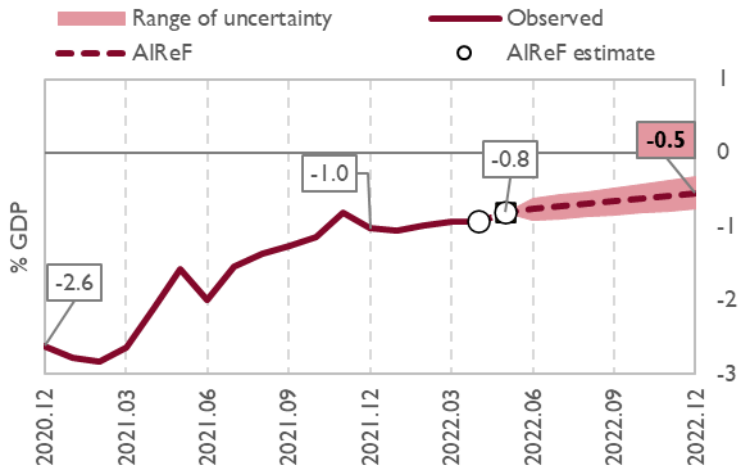


Source: AIReF and IGAE

4.4.2. Social Security Funds

AIReF forecasts a deficit of the Social Security Funds (SSFs) in 2022 of 0.5 points of GDP, similar to that estimated in the Report on the SPU published in May. The reduction in the deficit to half the weight over GDP at the end of 2021 is due to a moderation in SSF expenditure over 2022 at a rate higher than the reduction in revenue over the same period. This balance of the SSFs is similar to the Government's latest estimate published in the 2022 Stability Programme Update.

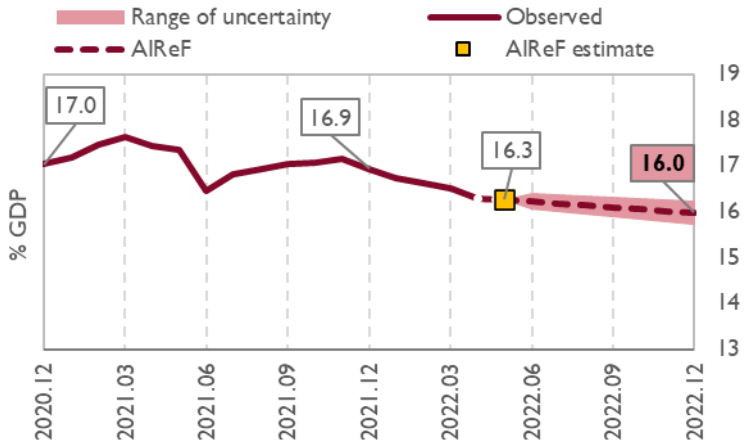
FIGURE 28. NET LENDING/BORROWING OF THE SSFS (% GDP)



Source: AIReF and IGAE

AIReF estimates that the weight of SSF revenue in 2022 will be 15.9 points of GDP without the RTRP funds (0.1 points more when taking them into account), a figure similar to that estimated in the Report on the 2022 SPU. Compensation of employees is revised upwards slightly in the latest update of the macroeconomic outlook. However, the evolution of revenue from social contributions up to April in national accounting terms shows slightly lower elasticity with respect to compensation of employees than that estimated in the Report on the 2022 SPU. Therefore, the forecast of revenue from social contributions for 2022 remains unchanged. State transfers increase by €500m, mainly to finance the increase in the Minimum Living Income and non-contributory pensions approved under RDL 11/2022 in June 2022 for the second half of the year. Some reduction in the rate of growth of revenue over the year is expected due to lower dynamism in the growth of contributions and the fall in transfers from the State compared with those received in 2021.

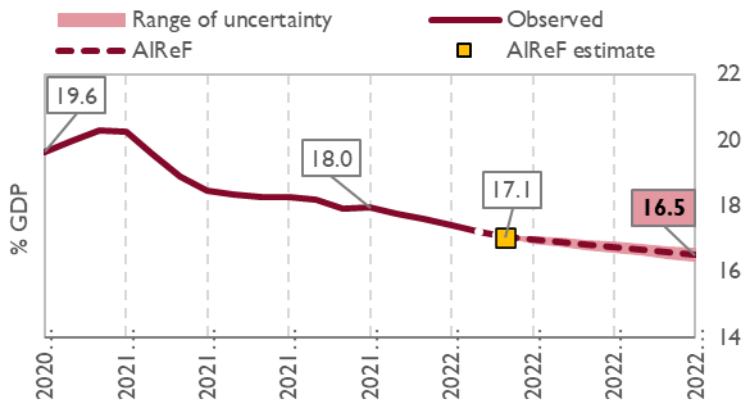
FIGURE 29. REVENUE WITH RTRP OF THE SSFS (% GDP)



Source: AIReF and IGAE

AIReF estimates that SSF expenditure will have a weight over GDP of 16.4 points in 2022 excluding RTRP funds (0.1 points more if taken into account), a value that also matches the estimate made in the previous report. Since the publication of the Report on the 2022 SPU, the Government has introduced measures affecting the expenditure of the SSFs through RDL 11/2022. On the one hand, the 15% increase in the Minimum Living Income that had been approved for the three months from April to June 2022 through RDL 6/2022 has been extended to the period from July to December. It is estimated that this measure will have a budgetary impact of around €153m. In addition, the 15% increase has been extended to non-contributory pensions for the period from July to December. The impact for this measure is estimated at around €200m. Finally, the estimated amount of the temporary incapacity benefit is revised upwards on the basis of the most recent data on budget execution. The three changes, although of the same sign and of a total amount close to €500m, are offset by the denominator effect caused by the increase in nominal GDP in the macroeconomic outlook, and therefore their weight over GDP remains unchanged from the previous report.

FIGURE 30. EXPENDITURE WITH RTRP OF THE SSFS (% GDP)



Source: AIReF and IGAE

This evolution does not affect the various agents of the Social Security Funds equally. The deficit of the Social Security Funds fell by 1.6 points of GDP in 2021, of which 1.2 points corresponded to the SEPE and 0.4 to the Social Security System. In that year, the SEPE reduced its deficit to a greater extent due to both an increase in transfers and a reduction in the cost of COVID-19 measures. The Social Security System also reduced the cost of the measures compared with 2020, but received lower transfers than in 2020, and therefore the impact on the deficit was not so large. In addition, the cost of pensions in 2021 increases the expenditure of the Social Security System. For 2022, the deficit is reduced by an additional 0.5 points, with 0.2 points corresponding to the Social Security System and 0.3 points to the SEPE. In the case of the Social

Security System, this fall is due to higher transfers and lower cost of the measures that manage to offset the increase in the pension bill. In the case of the SEPE, the reduction in transfers from other GG sub-sectors in 2022 does not prevent the effect of the reduction in the cost of ERTEs from having a positive impact.

TABLE 9. BALANCE BY AGENT OF THE SOCIAL SECURITY FUNDS (% GDP)

	2020	2021	2022
SSFs	**-2.6**	**-1.0**	**-0.5**
SSS	-1.5	-1.1	-0.9
SEPE	-1.1	0.1	0.4

Source: AIReF, Social Security and IGAE

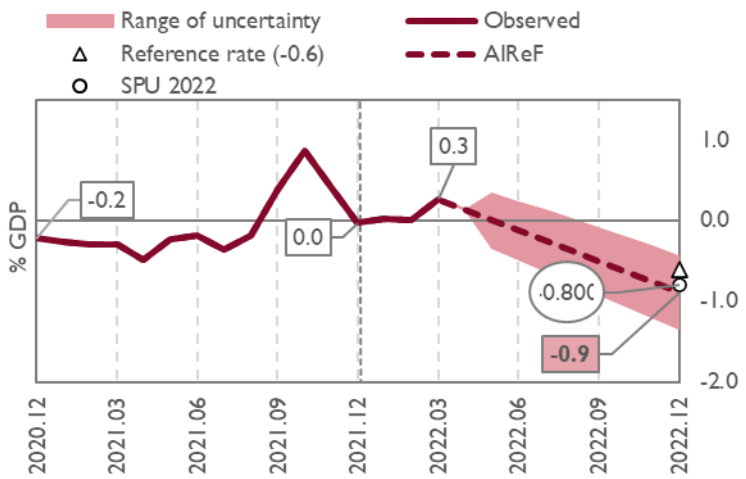
4.4.3. Autonomous Regions

4.4.3.1 Analysis of the sub-sector

AIReF forecasts that the ARs will close 2022 with a deficit of 0.9% of GDP, 0.2 points higher than the deficit estimated in the previous report. This level worsens the balance by 0.1 points with respect to the -0.8% forecast by the government in the SPU for the sub-sector and deviates from the reference rate of -0.6% of GDP by 0.3 points. The change is primarily the result of the upward revision of expenditure due to the observed execution data to date, which might reflect a higher level of pandemic-related spending than estimated in the previous report.

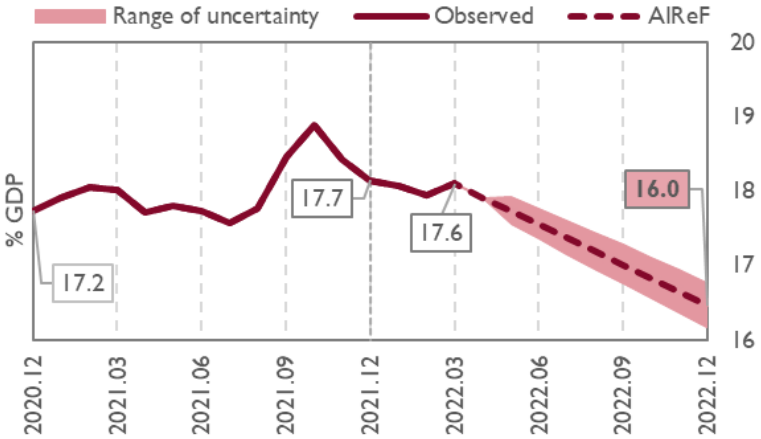
The regions maintain slightly more optimistic forecasts overall, although with very different positions at an individual level. In most cases, they maintain the balance forecasts in 2022 contained in the medium-term budget plans. However, the Canary Islands, Extremadura and Rioja worsen their forecasts (although in the case of Extremadura and Rioja they remain more positive than those included in their initial budget); while Asturias, Castile-La Mancha, Murcia and the Basque Country improve their forecasts. These figures, in short, would lead the sub-sector to a deficit of 0.7% of GDP, with a lower level of expenditure than that estimated by AIReF, without taking into account RTRP funds.

FIGURE 31. NET LENDING/BORROWING OF THE ARS (% GDP)



AIReF forecasts that the revenue of the ARs at the end of 2022, excluding the RTRP, will amount to 15.1% of GDP. Although the changes are not significant overall, there have been significant changes in its composition compared with the previous report: the forecasts of revenue from traditional EU funds are lower, new State transfers resulting from Royal Decree Law 11/2022 are incorporated and the estimates of tax revenue other than that subject to instalment payments are improved. Considering the potential revenue from the RTRP, revenue would stand at 16% of GDP.

FIGURE 32. REVENUE OF THE ARS (% GDP)



Without considering the RTRP funds, regional revenue will fall by about 7% on 2021. This drop in revenue, which would be 4% without taking into account the support for companies resulting from Royal Decree Law 5/2021, is mainly conditioned by the reduction in State transfers: resources from the financing system for ARs under the ordinary regime; extraordinary unconditional transfers; support for companies under the COVID Line; and other operations such as the allocation in Catalonia in 2021 of the total settlement made in that

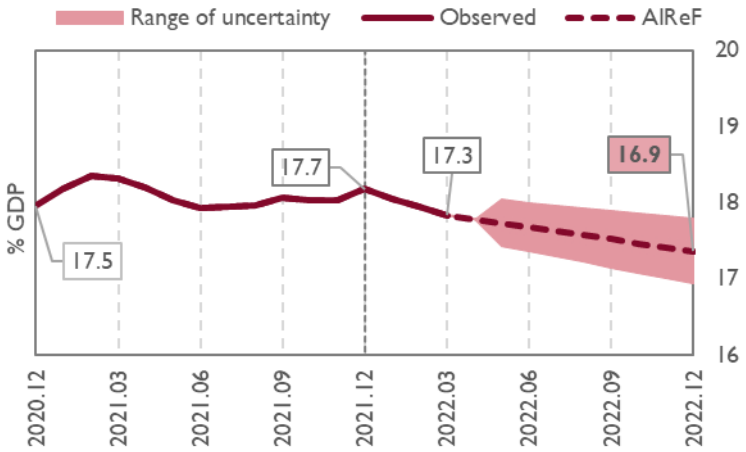
year's result of the financing of the regional police force, whose payment is divided into three years.

TABLE 10. EVOLUTION OF AR REVENUE WITHOUT RTRP (% GDP AND % CHANGE)

	Year-end 2021 (% GDP)	AIReF forecast 2022 (% GDP)	% Change 2022/ 2021
Net revenue without RTRP	**17.6**	**15.1**	**-6.8**
RFS	9.5	8.4	-4.1
Fund extra deficit/Compensation CSA	1.1	0.5	-47.7
Tax on Asset Transfers & Documented Legal Acts	0.9	0.9	11.4
Inheritance and Gift Tax	0.3	0.2	-9.2
Other revenue	5.8	5.1	-6.0
REACT-EU revenue	*0.3*	*0.3*	*-1.3*
Support for companies RD Law 5/21	*0.6*		*0.0*
Other	*5.0*	*4.8*	*4.6*

AIReF raises its expenditure forecasts in the sub-sector from its previous estimate to 16% of GDP. AIReF has revised upwards the forecast expenditure at year-end 2022 by almost €1.6bn on the estimate in the Report on the SPU. The changes are mainly the result of the execution data to date, information on recorded pandemic-related expenditure, and the new measures adopted to combat the energy crisis and issues arising from the war in Ukraine. The data published to date show a significant growth in intermediate consumption, subsidies and gross fixed capital formation, which has led to an increase on the year-end estimates considered in May. In this regard, it is expected that in 2022 over 45% of pandemic-related spending could be maintained in 2022, 5% higher than estimated in the previous report. In addition, although with a non-significant overall impact on the sub-sector, measures have been adopted in several ARs since April aimed at specific groups in order to combat the effects of the war in Ukraine and the energy crisis. Considering the possible expenditure financed by the RTRP, expenditure could reach 16.9% of GDP.

FIGURE 33. EXPENDITURE OF THE ARS (% GDP)



Expenditure, excluding that associated with the RTRP, will be just over 1% lower than the level of the previous year. This fall is the result of the expected reduction in all regional COVID-19 related measures, the support for companies under Royal Decree Law 5/2021 (from €5.93bn in 2021 to €1.04bn to be repaid in 2022). These decreases, however, are largely offset by the expected growth in other expenditure not associated with the pandemic.

TABLE 11. EVOLUTION OF AR EXPENDITURE WITHOUT RTRP (% GDP AND % CHANGE)

	Year-end 2021 (% GDP)	AIReF forecast 2022 (% GDP)	% Change 2022/ 2021
Net expenditure without RTRP	**17,7**	**16,0**	**-1,5**
Healthcare	6,9	6,6	3,7
Education	4,2	3,9	1,7
Other expenditure	6,6	5,5	-8,9
Of all this, EU-REACT expenditure	*0,3*	*0,3*	*-1,3*
Support for companies RD Law 5/21	*0,5*	*0,1*	*-82,4*

AIReF estimates that the eligible expenditure for the purposes of the expenditure rule will grow by 2% in 2022. Starting from a change of 7.5% in 2021, the eligible expenditure for the ARs will increase in 2022 by 2% over the level of the previous year as a result of the expected evolution of net expenditure and EU funds and payments for the financing system of ARs under the ordinary regime.

4.4.3.2 Individual analysis

At an individual level, the outlook worsens compared with that included in the reports on the initial budgets in almost every case. AIReF worsens in all ARs, except Galicia and the Basque Country, the forecasts contained in the reports on the initial budgets. With the current information available, AIReF estimates that seven ARs - Andalusia, Castile and Leon, Castile-La Mancha, Catalonia, Extremadura, Murcia and Valencia - will reach a balance above the reference of -0.6% of GDP. Five other ARs - Aragon, Asturias, Canary Islands, Galicia and Madrid - would close with a deficit close to this rate. The remaining five ARs - the Balearic Islands, Cantabria, Navarre, the Basque Country and Rioja - could close with balances close to equilibrium or even a surplus.

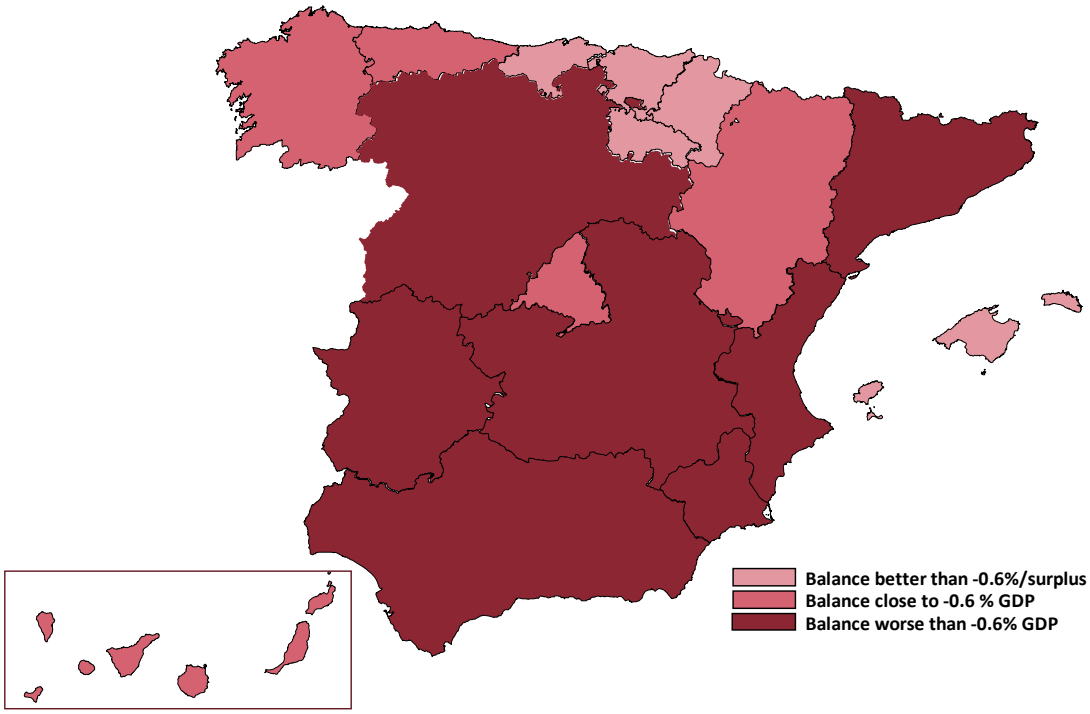
Most of the ARs expect to achieve a deficit similar to or higher than the established reference. The current year-end forecasts of Andalusia, Asturias, Castile and Leon and Extremadura include a deficit higher than the reference set for the sub-sector (-0.6%). Only Navarre, the Basque Country and Rioja expect to end the year below the reference rate (-0.9% in Navarre and the Basque Country). The other ARs estimate a balance similar to -0.6% of GDP.

A detailed analysis of each AR is included in the individual reports published with this report.

TABLE 12. CHANGES IN THE BALANCE FORECASTS FOR 2022 BY AR (% GDP)

ARs	AIReF Forecasts		AR forecasts	
	Current	Report on Budgets	Current	Report on Budgets
ANDALUSIA	-1.1%	-0.8%	-1.1%	-1.1%
ARAGON	-0.5%	-0.4%	-0.6%	-0.6%
ASTURIAS	-0.5%	-0.1%	-0.8%	-1.2%
BALEARIC ISLANDS	0.2%	0.6%	-0.6%	-0.6%
CANARY ISLANDS	-0.6%	-0.5%	-0.6%	-0.4%
CANTABRIA	0.2%	0.7%	-0.6%	-0.6%
CASTILE AND LEON	-0.8%	-0.6%	-0.8%	
CASTILE-LA MANCHA	-1.1%	-0.7%	-0.6%	-1.2%
CATALONIA	-1.2%	-1.0%	-0.6%	-0.6%
EXTREMADURA	-0.7%	-0.6%	-0.8%	-0.6%
GALICIA	-0.6%	-0.6%	-0.6%	-0.6%
MADRID	-0.5%	-0.3%	-0.6%	-0.6%
MURCIA	-2.6%	-2.2%	-0.6%	-0.9%
NAVARRE	1.1%	1.2%	-0.5%	-0.5%
BASQUE COUNTRY	0.4%	0.2%	-0.3%	-1.4%
RIOJA	0.1%	0.2%	-0.2%	0.0%
VALENCIA	-2.5%	-2.1%	-0.6%	-0.6%
TOTAL AUTONOMOUS REGIONS	**-0.9%**	**-0.7%**	**-0.7%**	**-0.7%**

FIGURE 34. MAP OF ARS NET LENDING/BORROWING IN 2022 IN RELATION TO THE SUB-SECTOR REFERENCE



4.4.3.3 Medium-term outlook

AIReF estimates that the revenue from the financing system of the Autonomous Regions under the ordinary regime will be exceptionally positive over the next two years, returning to normal as from 2025. The actual collection in 2021 was well above the forecasts under which the instalment payments of the financing system for that year were calculated. This will generate a very positive settlement in 2023 which, on the negative figure of the previous year (without prejudice to the fact that it may have been offset) will imply exceptional growth in the revenue from the financing system. A similar situation could be repeated in 2024, since everything suggests that the actual collection in 2022 will be higher than that estimated to calculate this year's instalment payments. In short, the flow of revenue associated with the system is not expected to normalise until 2025. The revenue of the financing system could grow, according to AIReF's estimates, by more than 20% and 10%, respectively, in 2023 and 2024. In contrast, in 2025 it could fall slightly on the level of the previous year.

TABLE 13. EVOLUTION OF REVENUE 2019-2022 ARS (% GDP)

	Year-end 2019	Year-end 2020	Year-end 2021	AIReF forecast 2022	AIReF forecast 2023	AIReF forecast 2024	AIReF forecast 2025
Net revenue without RTRP	**14.0**	**17.2**	**17.6**	**15.1**	**15.6**	**15.7**	**15.2**
RFS	8.8	10.4	9.5	8.4	9.7	10.3	9.8
Extraordinary fund/compensation		1.4	1.1	0.5			
Tax on Asset Transfers and Documented Legal Acts	0.7	0.7	0.9	0.9	0.9	0.8	0.8
Inheritance and Gift Tax	0.2	0.2	0.3	0.2	0.2	0.2	0.2
Other revenue	4.3	4.5	5.8	5.1	4.8	4.4	4.4
REACT revenue			*0.3*	*0.3*	*0.2*		
Support for companies			*0.6*				
Other			*5.0*	*4.8*	*4.6*	*4.4*	*4.4*

If the expenditure not associated with EU funds evolves in the following years in line with the baseline growth estimated by AIReF, the expected fiscal deterioration in 2022 could be reversed in the following years. Under the aforementioned forecasts of revenue evolution, and considering baseline growth of expenditure not associated with European funds, the deterioration of the 2022 balance could be reversed in the following years. This would make it possible to face 2025 with a balance close to equilibrium in order to make progress in reducing the structural deficit.

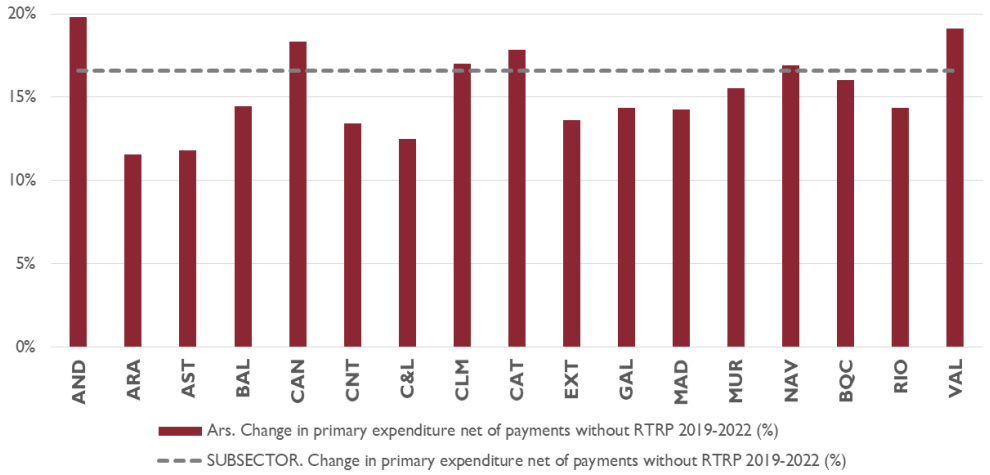
BOX 4. Evolution of the ARs 2019-2022.

In the last three years, the measures taken for ARs to deal with the pandemic have distorted the normal operation of the regional financing system. This, together with the direct consequences of the pandemic, has resulted in an irregular evolution of the main regional revenues.

In this context, it is also necessary to observe the behaviour of expenditure up to 2022, without taking into account the RTRP. In this year, COVID-related expenditure begins to lose importance, and the expenditure still in place become structural at a higher proportion.

AIReF's forecasts on the level of primary expenditure, net of payments as a result of the financing system, that the Autonomous Regions will reach in 2022 without taking into account that associated with the RTRP, show an average growth of 16.6% from 2019, which is unevenly distributed across the ARs, with a maximum of 19.8% and a minimum of 11.6%. Several regions - Andalusia, Valencia, the Canary Islands and Catalonia - record growth in primary expenditure that is not only higher than the average, but which has a major effect on said average, given the weight that these ARs have in the sub-sector. In fact, the median growth would be 14.4%.

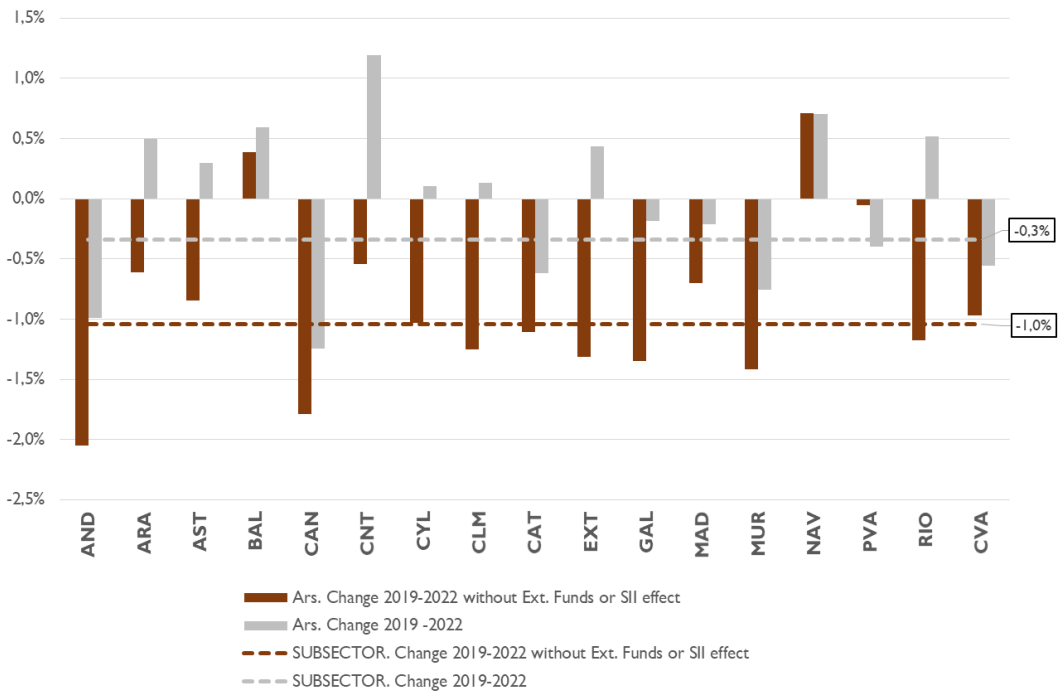
CHANGE IN PRIMARY EXPENDITURE WITHOUT RTRP 2019-2022 BY AR (% CHANGE)



When these expenditure levels are compared with the revenue received in 2019 and expected in 2022, the differences are transferred, with some significant nuances, to the evolution of the balance. The average increase in the deficit is 0.3% of GDP. The Canary Islands, Andalusia, Murcia, Catalonia and Valencia stand out for their above-average deterioration.

Excluding the effect of extraordinary State transfers, the deterioration of the primary balance is 1% of GDP. However, the compensation to be received by the ARs under the ordinary regime as a result of the negative settlement for 2020 has a very different impact across the regions, given the configuration of this compensation. Thus, there are regions that do not receive any amount, since they do not have a negative settlement, and others in which the amount, in proportion to the regional GDP, is very different, up to a maximum of 1.1% of GDP. This means that, if this compensation is eliminated and, furthermore, the effect of the VAT management system (SII) is corrected in the two reference years, there are significant differences in the deterioration of the balance, which is much more pronounced and higher than the average in Andalusia, the Canary Islands, Murcia, Galicia, Extremadura, Castile-La Mancha and Rioja.

CHANGE IN 2019-2022 BALANCE BY AR (% GDP)



4.4.4. Local Governments

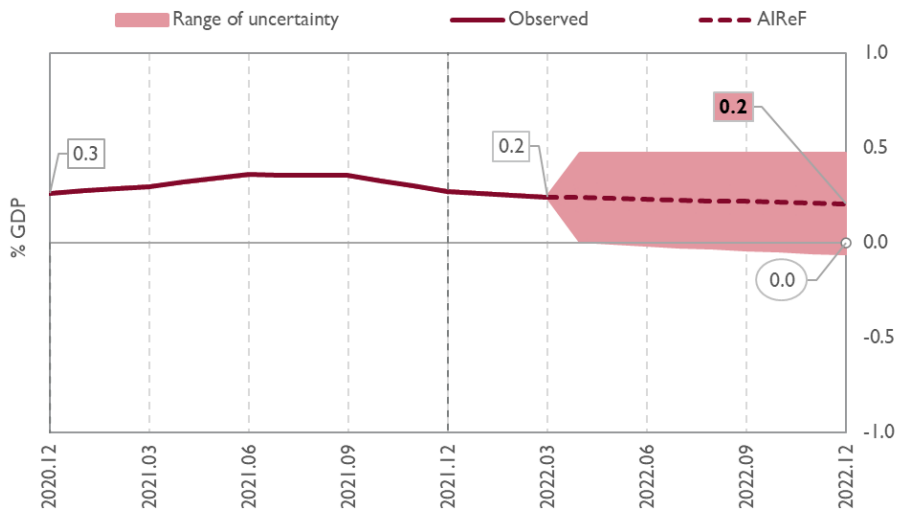
AIReF slightly corrects downwards the forecasts made in the Report on the SPU for the local sub-sector, although it remains at a surplus of 0.2% of GDP in 2022. Using the latest data published, AIReF has updated the forecast year-end result for Local Governments as a whole under the assumption, in its central scenario, that the economic impacts and measures adopted by these authorities for this year will continue into the second half of the year. In light of

the latest data available, corresponding to the execution in the first quarter of 2022 of the sub-sector's non-financial operations, the level of local debt and deposits at the end of the first quarter of 2022 and the data reported to AIReF by the large Local Governments monitored individually on the updated estimate for year-end 2022, AIReF maintains its forecast for the local sub-sector of a surplus of 0.2% of GDP this year. However, it is corrected downwards slightly given the greater expansion in current expenditure in the first quarter of the year. The recurring nature of most of this type of expenditure makes it possible to project a higher level at the end of the year than that forecast in May by AIReF, which is why the estimated surplus has been corrected downwards slightly.

AIReF's estimates of the local surplus for 2022 are consistent with those sent to the Ministry of Finance and Civil Service by the LGs raised to the national total. AIReF's current forecasts of the local balance to be obtained in 2022 are consistent with the year-end information submitted by the Ministry of Finance and Civil Service on the basis of the information sent by the LGs together with the budgetary execution at the end of the first quarter of 2022. This information is adjusted to a more realistic degree of realisation, as verified in the settlements of previous years. The year-end estimates submitted by the LGs in April of each year are very close to budgetary equilibrium, given that in terms of revenue they are very prudent (the degree of undervaluation of revenue is more than 20%), and in terms of expenditure they reflect a very optimistic level of execution in view of the resource constraints of the expenditure structures available.

This local balance in 2022 of 0.2% of GDP is the result of expected growth in revenue of over 6% and more than 7% in expenditure, excluding the RTRP. According to AIReF's current forecasts for year-end 2022, Local Government revenue could be around 10% higher than in 2021, to stand at 6.7% of GDP, while expenditure may rise by over 11%, to stand at 6.5% of GDP. If these increases did not take into account RTRP revenue and expenditures, they would be 6% and 7%, respectively, both of which would be partly neutralised by the expected GDP growth, as shown in the following figures.

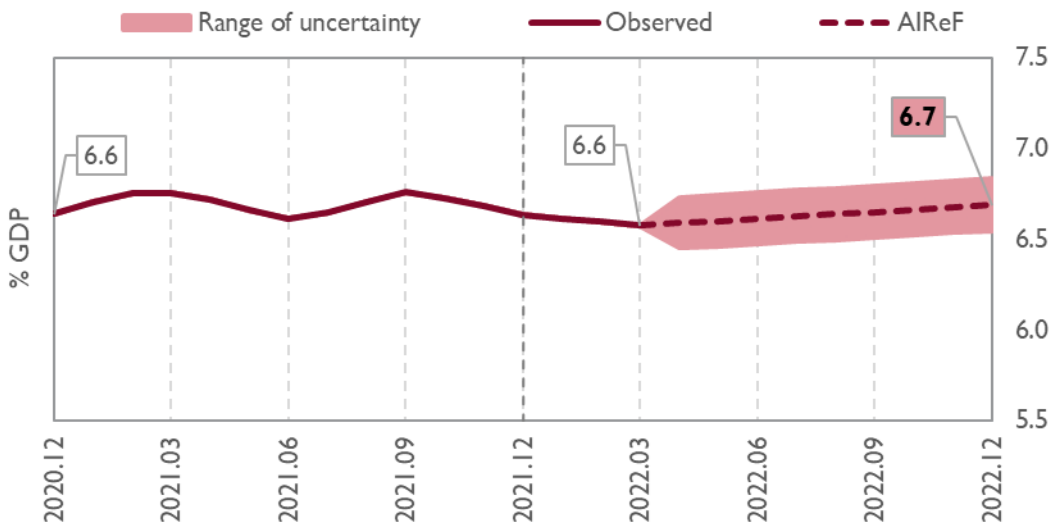
FIGURE 35. NET LENDING/BORROWING OF THE LG SUB-SECTOR (% GDP)



Source: AIReF and IGAE

The increase in local revenue in 2022 mainly affects revenue linked to economic activity, revenue from the State financing system and the injection of EU resources. The increase in local revenue at the end of 2022 estimated by AIReF is mainly due to the increase in revenue linked to economic activity (mainly that coming from the provincial councils of the Basque Country), due to the increase in revenue to be received from the State financing system in the year, as well as the injection of resources from the EU linked to the RTRP Funds.

FIGURE 36. EVOLUTION OF REVENUE OF THE LG SUB-SECTOR (% GDP)

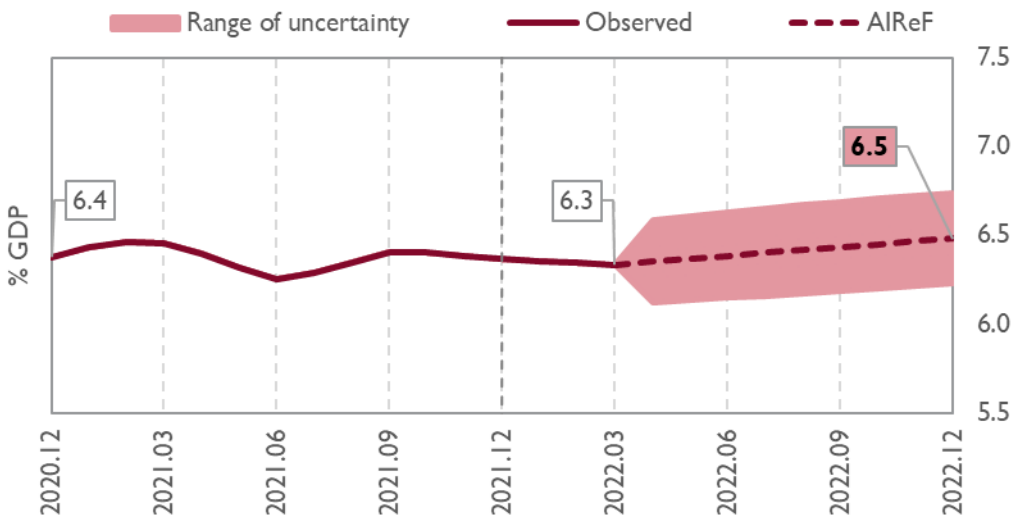


Source: AIReF and IGAE

The growth in local expenditure in 2022 expected by AIReF is mainly the result of the greater growth in expenditure in the context of the absence of fiscal rules, additional expenditure associated with the RTRP funds and the increase in transfers from the provincial councils of the Basque Country. AIReF forecasts year-on-year expenditure growth of over 11% for 2022, above the increase in revenue. This expected increase in local expenditure is the result of the growth observed in the first quarter of the year in current expenditure, the expansion of investment expenditure financed both with revenue for the year and with savings from previous years and/or new EU RTRP funds. There is also a considerable increase in transfers from the Basque Country provincial councils to the Basque Country Autonomous Region in order to share in the growth in transferred tax revenue.

AIReF maintains the uncertainty about the impact on the 2022 result of expenditure financed with surpluses from previous years and the substitution effect it will have on expenditure financed with revenue from the year. AIReF has estimated that the greater additional expenditure to be financed with cash surpluses in 2022, in the current context of suspended fiscal rules, may amount to around 0.2 points of GDP. As already highlighted in previous reports, AIReF's central scenario may be altered upwards or downwards by the limitations to the scope resulting from the quantification in 2022 of the expenditure that may be carried out by the LGs with savings from previous years, as well as the impact on the level of overall spending that is eventually recorded. Increased expenditure with cumulative savings from previous years may displace new expenditure from revenue from the year. However, in 2022, as it is the second full year of application of the escape clause, it is estimated that better planning of projected expenditure will attenuate this substitution effect.

FIGURE 37. EVOLUTION OF THE EXPENDITURE OF THE LG SUB-SECTOR (% GDP)



Source: AIReF and IGAE

AIReF estimates that in 2022 eligible expenditure for the purposes of the expenditure rule could be over 2% higher than the 2021 level, which would place growth since 2018 at almost 13%. The eligible expenditure of the LGs could increase by around 2% in 2022. However, this increase is on the level recorded in 2021, a year in which expenditure was 6.5% higher than the previous year. In the medium term, from 2018 to 2022, local eligible expenditure could increase by almost 13%, as a result of the application of savings from previous years to expenditure, due to the suspension of fiscal rules and, in addition, the significant expansion in expenditure in 2019, of around 6%, despite fiscal rules being in place in that year. The future recurrence of part of this expenditure could jeopardise the medium-term sustainability of local finances if there is insufficient recurring revenue to cover it.

The information for 2022 sent to AIReF by the large LGs confirms their trend of expanding expenditure, which began in 2019, although it shows an improvement in the overall surplus of this group. As is customary in AIReF's reports, this report is supplemented by an individual assessment of the large LGs, due to their importance in terms of population and budgets (over 25%). According to the data provided to AIReF by these large Local Governments on the forecast for the end of this year, made on the basis of the execution of the first quarter of the year, the expected results of this group amount to almost 2% of non-financial revenue, over three times higher than the 0.5% estimated in April.

In the current context of suspended fiscal rules, the performance of the large LGs is not representative of the sub-sector, as they have more specialised procurement structures that allow them to make greater use of their savings. As has already been shown in previous reports, the large LGs have more stable revenue than the variations of the economic cycle. They also have much better equipped spending structures with more specialised staff, which allows better planning and execution of spending in a context such as the current one. Therefore, in these years of activation of the escape clause, the greater expansion of the expenditure of these large Local Governments cannot be replicated in smaller ones with less well-equipped expenditure structures, which means that their performance is not representative of the sub-sector as a whole.

4.5. Impact of the measures on the General Government accounts

The measures against the pandemic have progressively less impact on the deficit, while the Government has approved and extended measures to

mitigate the effects of the energy crisis. AIReF includes in its deficit estimates an assessment of the measures approved by the Government to date, including the new measures to mitigate the energy crisis and the war in Ukraine, a series of measures that affect revenue structurally, the remaining COVID measures and others. The new measures, which AIReF considers to have a weight of 1 point of GDP, include those approved in Royal Decree-Law 6/2022, the extensions of measures and new measures approved in Royal Decree-Law 11/2022 and the increase in defence spending approved by the Council of Ministers. Alongside these, AIReF assesses the impact of the measures affecting structural revenue at 0.2 points of GDP.

AIReF considers that a significant part of the costs associated with COVID that are maintained in 2022 are of a structural nature. A little over 45% of the increase in expenditure associated with COVID would be permanent according to the information provided by the ARs. Regarding the remainder of the COVID-19 measures, AIReF considers that in 2022 they will have a negative impact on revenue of less than 0.05 points of GDP. COVID measures relating to the application of a zero rate for VAT on medical devices and the rebate on the rental income of premises used for certain economic activities affected by the pandemic during the first quarter of 2021 (RDL 35/2020), which is moved to 2022 as this is the year in which the 2021 Personal Income Tax settlement has been filed, will remain in force. In addition to the COVID-19 measures, AIReF estimates a reduction in revenue in 2022 of €173m as a result of the tax incentive established for PIT aimed at contributing towards improving energy efficiency (RDL 19/2021), which will be financed with the Recovery, Transformation and Resilience Plan, and will therefore have no impact on the deficit.

4.5.1. Measures for the energy crisis and war in Ukraine

The extension of the measures to mitigate the effects of the energy crisis and the effects of the war in Ukraine result in an increase in the deficit of 0.6 points of GDP. Several measures were recently extended until December 31st, 2022 by means of Royal Decree-Law 11/2022 of June 25th, such as the rebate per litre on fuel consumption, the 15% increase in the MLI and certain sectoral support, specifically that aimed at the agricultural sector and the gas-intensive business sector. In addition, three new measures were approved: one aimed at support, through a direct line of support for individuals with a low level of income and wealth, for €540m, a rebate for urban and commuter train and bus passes, with a total cost of €221m, and a 15%-increase in non-contributory pensions. Although part of the cost is transferred to 2023, as in the case of fuel rebates, these measures were intended to be temporary, yet the

current situation does not rule out the possibility of further extensions being approved.

The total cost of the spending measures caused by the economic crisis and the war in Ukraine amounts to 0.7% of GDP. The impact for 2022 of the spending measures for the CG resulting from the National Response Plan for the economic and social consequences of the Russian war, approved on March 29th, has increased by almost €4.5bn, due to the extension of some of the measures included in said plan and the creation of new measures. In the report on the Stability Plan Update, AIReF took into account the impact on expenditure of the measures included in Royal Decree 6/2022 of March 29th for an amount of more than €4.2 billion, 0.3% of GDP. Particular noteworthy for its size is the fuel price rebate, which would have a total cost of €5.12bn.

In addition, an extraordinary appropriation for defence expenditure of almost €1bn is included as an expenditure measure for the CG. Following the approval of RDL 6/2022 on March 29th and RDL 11/2022 of June 25th, on July 5th, the Council of Ministers approved the authorisation for the application of the Contingency Fund and an extraordinary appropriation for the Ministry of Defence for an amount of almost €1bn. AIReF estimates that this amount will be used for expenditure on compensation of employees, intermediate consumption and gross fixed capital formation. Contrary to the previous measures, designed with a fixed duration, this increase in expenditure could be of a structural nature as it is part of the commitment expressed by the Government in the context of NATO to allocate 2% of GDP in 2029 to defence spending.

Finally, the measures that were announced in the debate on the state of the nation on July 12th have also been incorporated into the forecast. The package of new measures announced on July 12th is still pending quantification and implementation, although the impact of some of them has already been analysed and estimated by AIReF. Specifically, a supplement of €100 per month has been announced until 31 December for students over 16 years of age currently receiving scholarships, with an impact of €400m in 2022. Pending further clarification, it is not known whether this increase will be temporary or permanent. In addition, the percentage of the rebate on commuter and medium-distance transport passes has been increased to 100% from the 50% in force since approval of RDL 11/2022. According to AIReF's estimates, its impact on costs will be almost an additional €20m.

With regard to revenue, the measures adopted in Royal Decree-Law 11/2022 to alleviate electricity prices result in an additional revenue reduction of almost €1.8bn in national accounting terms. Royal Decree-Law 11/2022 of June 25th intensifies the reduction in the rate of VAT on electricity consumption,

which in addition to being extended until the end of the year is reduced[8] from 10% to 5%, and it extends the reduction in the rate of Special Tax[9] on Electricity until December 31st, 2022. AIReF estimates that the extension of this measure until the end of the year has a negative effect on revenue of €792m, while the new reduction in the rate results in an additional reduction of €360m. This gives a total reduction in revenue of €1.15bn, of which €384m will correspond to the cash figure for the months of January and February 2023, resulting from the accrual in November and December 2022. With regard to the extension of the reduction in the rate of the Special Tax on Electricity until the end of the year, AIReF estimates a negative impact of €620m. Overall, the measures adopted result in a reduction in revenue of almost €3.6bn in 2022. As with expenditure, these measures are intended to be temporary, although part of their effect is transferred to 2023.

[8] Reduction in the VAT rate on the electricity bill of consumers with up to 10 kW of contracted power, provided that the average monthly price of the wholesale market of the previous month is greater than €45/MWh.

[9] Reduction in the rate of the Special Tax on Electricity from 5.1% to 0.5%

TABLE 14. IMPACT OF MEASURES IN RESPONSE TO THE ENERGY CRISIS IN NATIONAL ACCOUNTING TERMS: AIREF ESTIMATE

Impact of the CG measures approved in response to the energy crisis (RDL 6/2022 and RDL 11/2022)	AIReF 2022 impact in National Accounting terms (€m)		
	Measures until 30-Jun	Extension until 31-Dec	Measures until 31-Dec
Revenue Measures	**-1.803**	**-1.772**	**-3.575**
VAT: Reduction of electricity rate to 10% (RDL 12, 17 & 29 /2021 & 6/2022) & to 5% since July (RDL 11/2022)	-724	-1.152	-1.876
STs Electricity rate reduction (RDL 17, 29/2021, 6/2022 & 11/2022)	-1.079	-620	-1.699
Expenditure Measures	**4.272**	**4.456**	**8.727**
Fuel rebate*	1.658	2.881	4.540
Sectoral support	1.258	452	1.710
Direct support to individuals	0	540	540
Other support to individuals	155	583	738
Support to refugees	1.200	0	1.200
TOTAL	**-6.074**	**-6.228**	**-12.302**
TOTAL (% GDP)	**-0,5**	**-0,5**	**-0,9**

**This measure will have an additional impact of €584m in 2023*

Source: AIReF and Government

The extension of the suspension of the Tax on the Value of Electricity Production until the end of 2022 results in a reduction in revenue of less than 0.1 points of GDP that is neutral in the deficit. RDL 11/2022 extends until December 21st, 2022 the suspension of the Tax on the Value of Electricity Production, applied since the third quarter of 2021, which had been set until the second quarter of 2022 and is now extended for two more quarters, the last of which will be paid in the first quarter of 2023. AIReF estimates the negative impact of this extension on revenue at €793m. It should be noted that the suspension of the Tax on the Value of Electricity Production does not affect the public deficit as it entails a reduction of the same amount in the transfer from the budget of the Ministry

of Energy to the National Commission on Markets and Competition (Spanish acronym: CNMC).

4.5.2. Structural revenue measures

AIReF estimates that the tax measures approved to date will result in additional revenue of 0.2 points of GDP at year-end 2022. With hardly any changes since the last report, most of the structural measures which were approved in the 2021 General State Budget and various Royal Decrees began to take effect over that year. However, it is in 2022 when their full impact will be recorded with the filing of the 2021 Personal Income Tax and Corporate Income Tax settlements and as a result of the transfer of part of the 2021 accrual to 2022 cash. For their part, the measures incorporated in the 2022 General State Budget will shift their impact to 2023 when the settlements of both taxes relating to 2022 are filed. The new Taxes on Waste and Plastics included in the Law on Waste and Contaminated Soils approved on March 31st, 2022 will not enter into force until 2023.

TABLE 15. STRUCTURAL REVENUE MEASURES IN CASH TERMS: AIREF ESTIMATE

Structural revenue measures: AIReF estimate Differential impact 2022 compared with 2021			
Measures	**Source**	**€m**	**% GDP**
PIT		**1,131**	**0.1**
Increase in rates on the highest income bases	PGE21.	370	0.0
Modification of pension plan contribution limits	PGE21.	761	0.1
Corporate income tax		**1,358**	**0.1**
Limitation on exemption for dividends and capital gains	PGE21.	1,347	0.1
Increase in SOCIMI (Spanish REIT company) tax rate	RDL 34/2020	11	0.0
VAT		**75**	**0.0**
Increase in rates on sugary drinks	PGE21.	75	0.0
OTHER		**129**	**0.0**
Financial Transaction Tax: Establishment	Law 5/2020	28	0.0
Tax on Certain Digital Services: Establishment	Law 4/2020	55	0.0
Tax on Insurance Premiums: Increase in rates	RDL 12, 17/2021	46	0.0
TOTAL		**2,693**	**0.2**

Source: AIReF

4.6. Contingent liabilities and fiscal risks

The materialisation of fiscal risks generated by the current economic and geopolitical context has so far led to an increase in the deficit of 1% of GDP in

2022. In the Report on the SPU[10], published in May, AIReF warned of the risk of a greater deficit due to measures in the short and medium term if the crisis in the energy sector, exacerbated by the war in Ukraine, persists. As the duration of the conflict continues to put pressure on the general price level, the Government recently approved a new package of measures in June. At any event, the risk remains that the worsening of inflation could lead to the adoption of some additional measures for the remainder of the year, as announced in the debate on the state of the nation, causing a further increase in the deficit for the current year.

In addition, AIReF forecasts the materialisation in 2022 of the fiscal risk of default as a result of the new €10bn ICO guarantee line under RDL 6/2022, with the allocation of potential losses to this fiscal year. Firstly, due to the pandemic and then due to the war in Ukraine, the Government has granted several lines of ICO guarantees in the last three years for a total amount of €150bn. Although guarantees are fiscal risks that do not affect the public deficit as long as there are no defaults, their early materialisation in the public accounts takes place with the allocation of the forecast potential losses over the life of the standardised guarantees. In 2021, more than €4.3bn was allocated for potential losses of the two ICO guarantee lines for a combined amount of €140bn linked to the pandemic. In 2022, the corresponding allocation for the new ICO guarantee line is expected to amount to €10 billion for the economic response measures to the war in Ukraine (RDL 6/2022).

In addition, there remains a risk that a worse macroeconomic scenario than that considered in the fiscal projections will materialise and affect the 2022 deficit. The macroeconomic scenario underpinning the 2022 deficit forecasts remains subject to a great deal of uncertainty. In addition to the persistence of problems related to bottlenecks in manufacturing production and in logistics and the increase in raw material prices, there is also inflation, the rise in interest rates and the uncertainty resulting from the war in Ukraine. This high level of uncertainty regarding the macroeconomic scenario is compounded by the risk of a lower-than-planned pace of RTRP execution and by COVID-19, which remains a key determining factor for the economic situation. All these elements remain key in the evolution of certain variables such as employment, wages, private consumption and gross operating surplus, which will affect the final path of tax revenue and contributions, as well as unemployment and interest expenditure, with an impact on the deficit for the year.

In addition, there are other fiscal risks without a macroeconomic origin, some of which have already materialised in 2022 for a value of 0.1% of GDP. These

[10] Report on the 2021-2024 SPU

are mainly risks arising from the enforcement of judgments, some of which AIReF had already warned about in previous reports. Firstly, the judgment of the Court of Justice of the European Union in 2022, which found the national legislation on the obligation to declare assets or rights abroad to be contrary to EU law, which is expected to have a cost for the State of €250m. And, secondly, the judgment of the National High Court in 2021 in favour of Telefónica regarding company tax settlements for 2009 and 2010. Although an appeal has been lodged with the Supreme Court, if it is upheld, it may cost the State around €1.1bn. In addition, the judgment on the income tax of non-residents, whose expected impact in 2022 amounts to €450m.

Lastly, there are other fiscal risks that may have an impact on the 2022 accounts, whose amount is repeatedly unknown and no information is provided. Investments in defence modernisation programmes are underway and involve a significant volume of expenditure with a major impact on the deficit. However, no information is published on the planning of these military deliveries and their impact on the public deficit. There is also no information on the possible impact of the risks assumed by public-private partnership contracts or loans granted by public administrations that might prove to be doubtful receivables.

5. PUBLIC DEBT

5.1. General Government

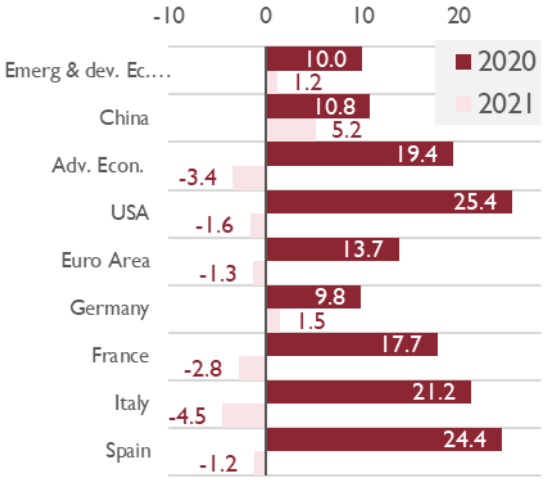
5.1.1. Recent evolution and medium-term projections

The unprecedented fiscal measures taken to address the Covid-19 pandemic, together with the operation of automatic stabilisers, have led to a very significant deterioration in public accounts around the world. Very significant government deficits were recorded in 2020 and 2021, which have contributed to a considerable increase in public debt ratios in economies around the world. In particular, the euro area ratio has risen by 12.5 points of GDP from the pre-pandemic level, to close to 100%. In the short term, the expected significant nominal growth (albeit with a downward outlook for real growth and an upward deflator) will continue to generate tailwinds in the evolution of the debt ratio.

The relaxation of what was already an accommodative monetary policy has contributed to mitigate the economic consequences of the pandemic. In addition to fiscal stimulus measures, the policies of accelerating quantitative easing on both sides of the Atlantic have contributed to mitigating the economic consequences in the toughest phase of the pandemic, placing the balance sheets of central banks at unprecedented levels of expansion, both in absolute levels and in relation to GDP. Official money rates at historic lows in a context of low inflation, together with bond purchase programmes, have

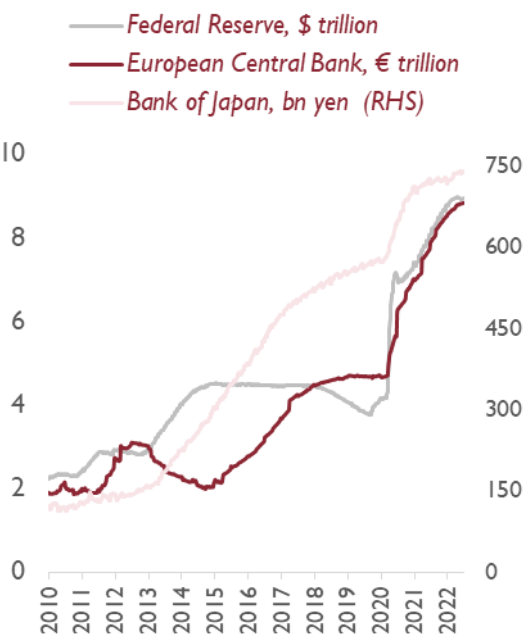
allowed Treasuries to borrow in 2020 and 2021 at minimum rates, with most rate curves in negative territory during this period, even in the long term.

FIGURE 38. INCREASE IN DEBT (% GDP)



Source: IMF (WEO April 2022)

FIGURE 39. CENTRAL BANK BALANCE SHEETS



Sources: ECB, FED and BoJ

Against this backdrop of high indebtedness and an expansionary monetary policy, 2022 has surprised with higher and more persistent inflation than initially anticipated, leading to a major shift in the monetary policy decisions of the main central banks around the world. The economic recovery after the health crisis led to an initial increase in inflation related to bottlenecks in global logistics and shortages of supplies at a time of strong demand. Inflation was considered to be of a temporary nature. However, factors such as the Russian invasion of Ukraine have driven up the already high price of energy, deepening and accelerating the increase in prices across the world. In this context, inflation has reached record levels. Central banks around the world have been reacting by joining in, to a greater or lesser extent, with the tightening of monetary policy in response to this record inflation. Although the temporary nature of this inflation is increasingly questioned, medium-term expectations remain anchored at contained values. More than 60 central banks, according to Bloomberg's calculations, have already raised rates this year.

In the case of the Spanish economy, the debt ratio has recorded four consecutive quarters of falls and stood at 117.7% of GDP in the first quarter of 2022. The cumulative reduction in the last year is 7.5 points, of which 0.7 points

have been recorded in the last quarter. This significant reduction is mainly due to the denominator effect, given the strong upturn in economic activity and prices. In absolute terms, public debt has continued to grow, adding €26.62bn to reach a new all-time high of €1.45tn.

The Bank of Spain has revised the historical series of EDP debt incorporating the effects of the reclassification of the Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria (SAREB) to the General Government sector since its creation in 2012, increasing the ratio up to 2020 by an average of 3.7 points of GDP. The EDP debt data from the end of 2020 are not affected by moving the reclassification of SAREB back in time, but the previous data are affected. This retrospective revision has raised the stock of debt as a result of the previous financial crisis by an average of 3.7 points of GDP in the revision period (2012-2020), raising the previous all-time high of late 2014 to 105.1% (from 100.7% previously) and placing the pre-pandemic debt stock three points higher.

FIGURE 40. DEBT (% GDP), QUARTER-ON-QUARTER EVOLUTION

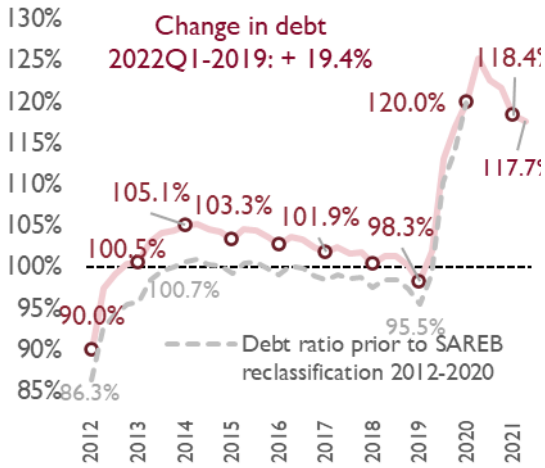
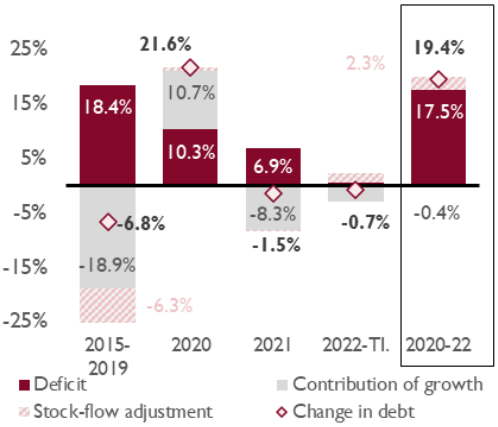


FIGURE 41. CONTRIBUTION TO THE CHANGE IN DEBT (% GDP)



Source: INE, Bank of Spain and AIReF

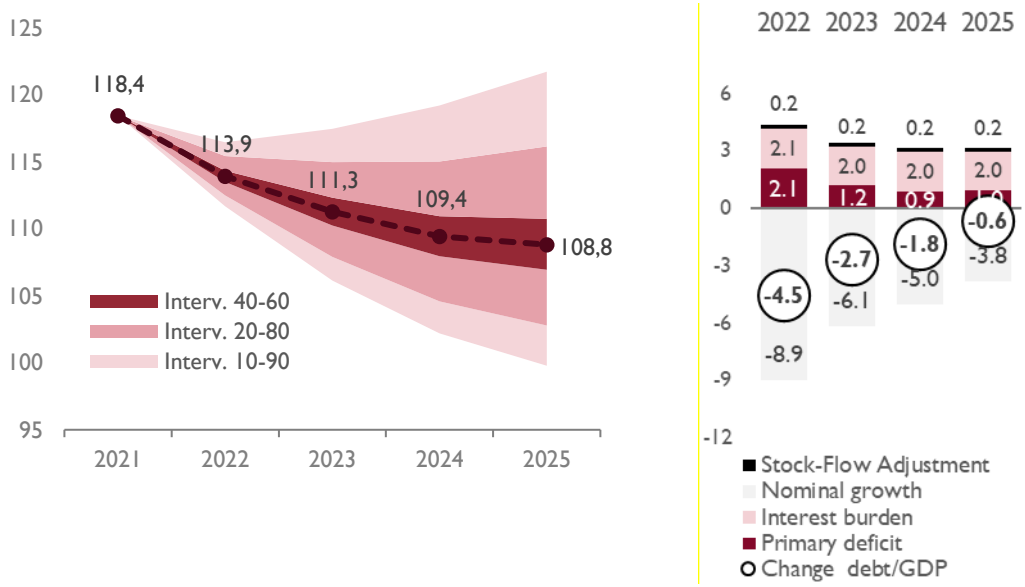
Compared with the level prior to the pandemic, the debt ratio has risen by 19.4 points. GDP - the denominator of the ratio - has already stopped contributing negatively to the increase resulting from the pandemic, with the public deficit causing almost all the change. At a sub-sector level, the largest increase in the debt ratio has taken place in the Central Government and the Social Security Funds. The debt ratio of the LGs has remained stable, while that of the ARs has recorded a slight increase.

Under the medium-term macro-fiscal forecasts prepared by AIReF, the debt-to-GDP ratio is expected to fall by 9.6 points over the next four years to stand

at 108.8% in 2025. After reaching its peak value in the first quarter of 2021 (125.2%), the debt ratio has started a downward path, to stand at 118.4% of GDP at the end of 2021. AIReF's projections show a continuation of this trend over the next four years, with the ratio expected to stand at around 114% at the end of this year, and in a range between 107% and 111% in the central interval of AIReF's stochastic projections for 2025.

The reduction in the ratio will be mainly supported by the growth in nominal GDP, where the deflator will make a very significant contribution. Most of the reduction in the debt ratio (7.2 out of the 9.6 points forecast up to 2025) takes place this year and next, coinciding with the economy's sharp nominal growth, while it is forecast to stabilise somewhat as from 2024. The government deficit will continue to contribute significantly to the increase in debt, with a financial burden that will rise in absolute terms, but will remain stable relative to GDP due to the sharp nominal increase in the latter. It should be noted that 2020 already saw a turning point in the evolution of the level of interest expenditure, starting an upward path after the long period of continuous falls that began in 2013.

FIGURE 42. DEBT FORECAST (% GDP) AND CONTRIBUTION TO CHANGE



Source: AIReF

5.1.2. Sustainability analysis

The significant increase in the stock of public debt and the worsening of financing conditions places the sustainability of public finances in a highly vulnerable position in the medium term. The scars of the previous financial crisis, together with the sharp increase in borrowing caused by the pandemic, have brought the debt-to-GDP ratio to an all-time high, thus considerably

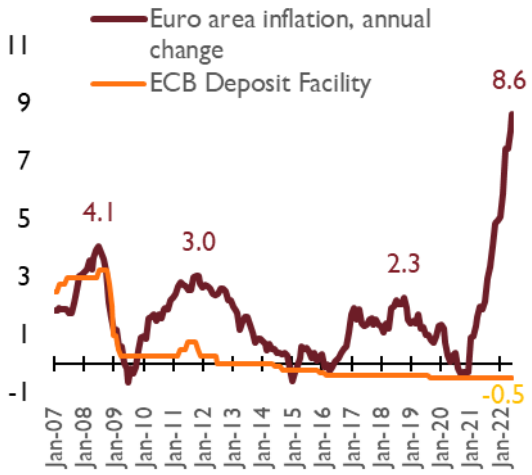
increasing the vulnerability of public finances over the medium term in a context of worsening financing conditions.

5.1.2.1 Financing conditions: inflation and interest rates

Much higher and more persistent inflation than initially expected is leading to an acceleration and intensification of the monetary policy decisions of the main central banks around the world. In order to stimulate the low inflation over recent years, central banks have long maintained interest rates well below inflation, which has led to very negative real interest rates. A worse than initially expected evolution of inflation (in June, year-on-year rates were at their highest levels in decades; euro area 8.6%, Spain 10.2%, Germany 8.2%, USA 9.1%, UK 9.1%,), together with a very expansive monetary policy, has generated the need for a sharp change in the decisions and expected actions of the central banks.

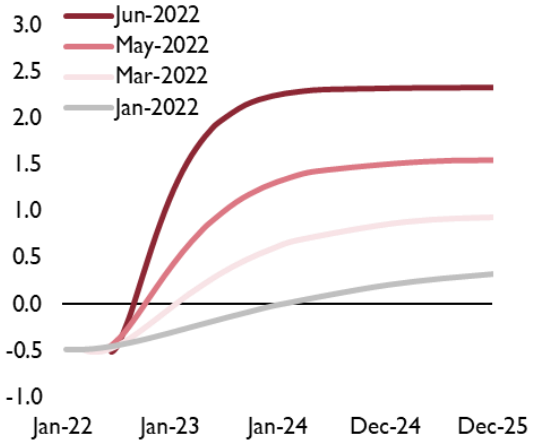
Most of the main central banks around the world have started (or announced) a path of increases in the price of money, adding to a greater or lesser extent to a reduction in liquidity. With these movements, central banks aim to reduce lending, lower asset prices, contain inflation expectations by reducing the risk of inflationary spirals, and cool down the economy (without plunging it into a recession) so that inflation will return to its path in a "soft landing" scenario. However, supply-side problems that are also contributing to global inflation are beyond the control of central banks.

FIGURE 43. INFLATION AND EURO INTEREST RATE (%)



Source: Refinitiv

FIGURE 44. EXPECTED DEPOSIT FACILITY RATE DISCOUNTED (*) BY THE MARKET (%)



Source: Refinitiv and AIReF
(*) With the instantaneous forward curve of the OIS

The risk of deteriorating financing conditions is materialising. The tightening of monetary policy is leading to sharp upturns in global sovereign debt yields, with a trend that has accelerated over the year as inflation has continued to record unexpected increases and communications from central banks have become more hawkish. So far this year, the yield on the Spanish ten-year bond has risen by 180 bp (exceeding 250 on June 14th), reaching values that had not been seen since 2014. The ten-year yields for Italy, Portugal, France and Germany have risen by 210, 185, 157 and 140 bp, respectively, so far this year. Outside the euro area, US debt yields have also risen sharply, by 142 bps.

FIGURE 45. SPANISH DEBT YIELD CURVE (%)

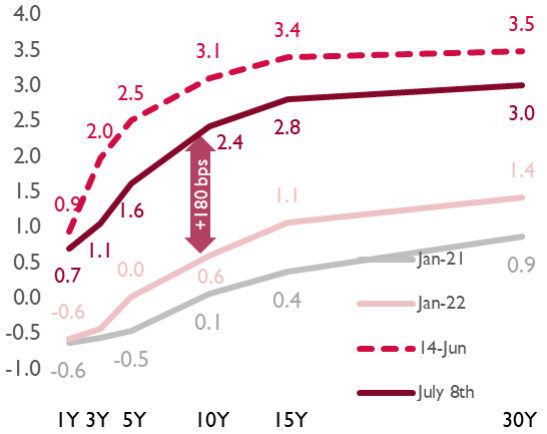
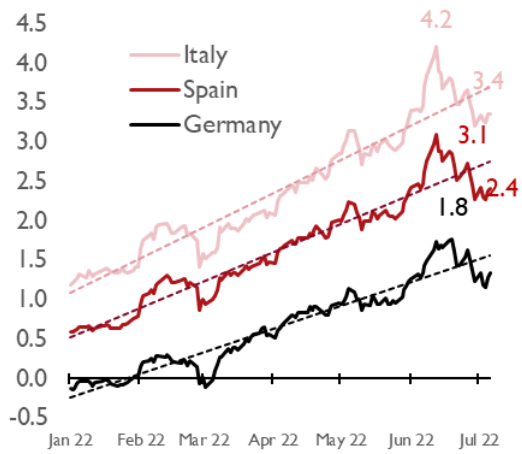


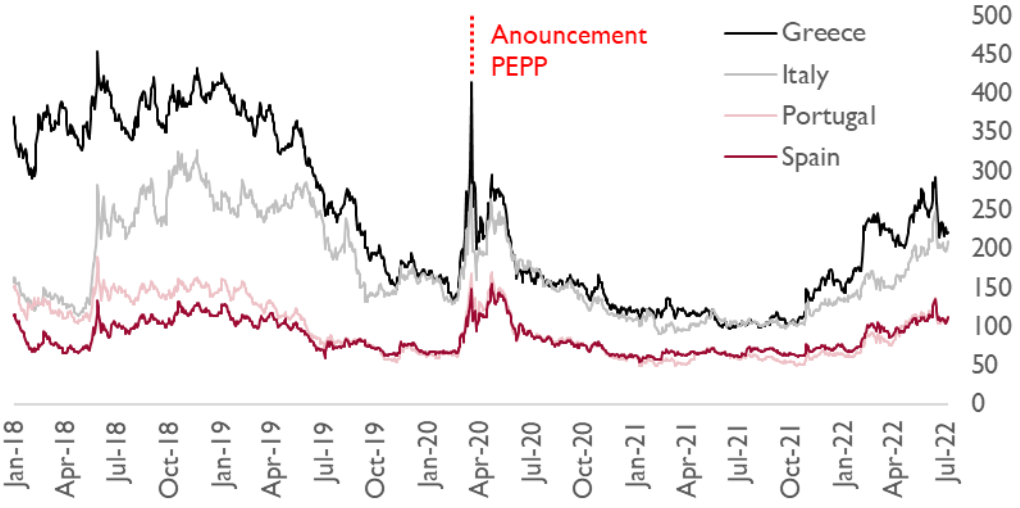
FIGURE 46. TEN-YEAR BOND YIELD (%)



Source: Refinitiv and AIReF

There is an upward trend in risk premiums, which is aggravated by the announcement of the end of the asset purchase programmes. The ECB's sovereign debt purchases (PSPPs since 2014, together with the emergency PEPP acquisitions during the pandemic) have kept peripheral debt spreads at bay, thus preventing credit fragmentation. The widening of spreads *vis-à-vis* Germany over the year has been accentuated by the announcement of the end of the asset purchases. Faced with these increases, the ECB has demonstrated its determination not to allow financial fragmentation of the euro area through the use of instruments such as the reinvestment of PEPP maturities towards countries with stressed debt or the implementation of a new anti-fragmentation tool.

FIGURE 47. TEN-YEAR SPREAD AGAINST GERMANY (BP)



Source: Refinitiv

With regard to the fiscal implications, the deterioration in financing conditions will eventually be transferred, albeit gradually, to the deficit and debt. The tightening of monetary policy is having a major impact on sovereign debt yields, which will result in a higher financial burden. Higher financing rates impact the new debt issues and will be transferred to the average rate of the portfolio gradually given the high average maturity. Compared with the SPU scenario, an increase in the average issuance rate of 100 basis points in line with recent developments would raise the implicit rate forecast by 0.3 points (up to 2.2% in 2025), the financial burden by 0.4 points of GDP (up to 2.4%), and the debt ratio by 0.7 points.

FIGURE 48. INTEREST RATES ON NEW ISSUES (%)

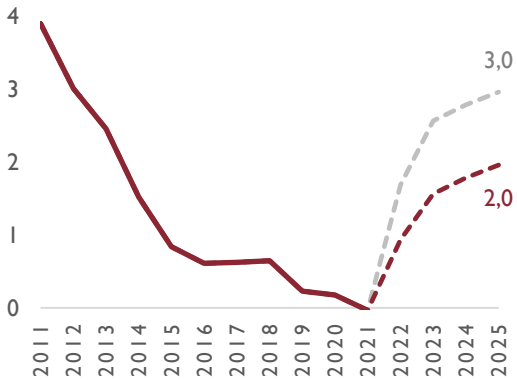
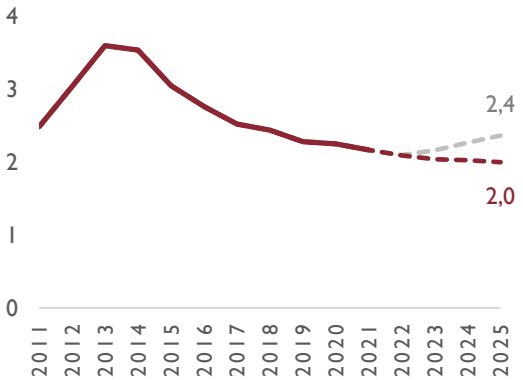


FIGURE 49. INTEREST EXPENDITURE (% GDP)



Source: AIReF

AIReF's projections paint an unfavourable trend in the medium- and long-term debt ratio under a scenario in which the structural balance remains constant. Beyond the reduction in the debt ratio that is expected up to 2025, once the

boost in growth as a result of the rebound in activity following the shutdown during the pandemic ends, the debt-to-GDP ratio will resume an upward path under the assumption of a no-policy-change scenario. The simulations performed by AIReF show that a structural primary deficit of between 1.5% and 2.5% of GDP from 2025 (in line with the latest estimates by the Government and AIReF, respectively) would place the debt ratio between 125% and 140% of GDP in 2040.

Expectations of higher interest rates aggravate debt dynamics. Higher interest rates will generate a greater financial burden, which, if not offset with some adjustments, will end up having an impact on the debt ratio. The simulations show that a financial burden between 1.3 and 1.8 points higher (depending on the scenario of the evolution of the primary balance) results in an increase in the debt ratio of between 12 and 16 points in 2040.

FIGURE 50. PRIMARY BALANCE (% GDP)

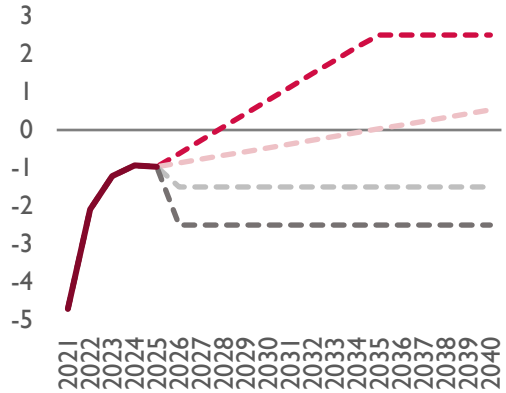


FIGURE 51. SCENARIOS FOR THE EVOLUTION OF THE PRIMARY BALANCE

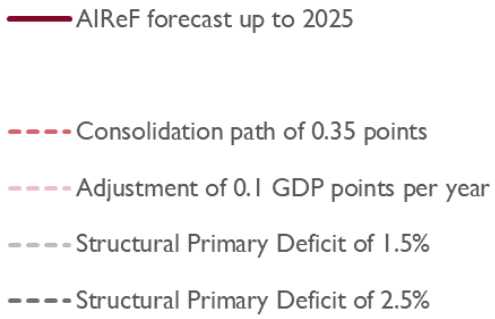


FIGURE 52. INTEREST (% GDP), SPU SCENARIOS

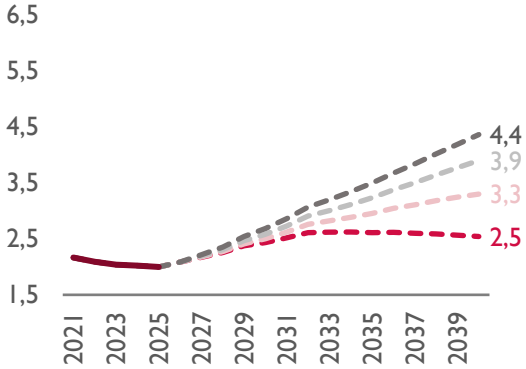


FIGURE 53. INTEREST (% GDP), SPU SCENARIOS +Δ RATES OF 100 BPS.

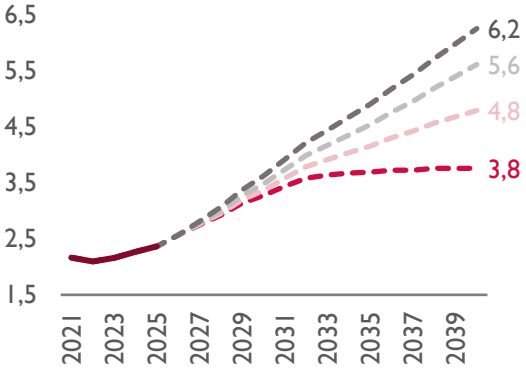


FIGURE 54. DEBT (% GDP), SPU SCENARIOS

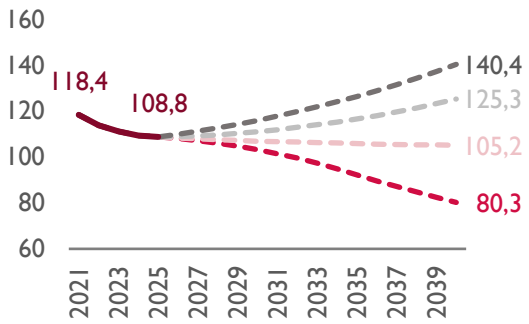
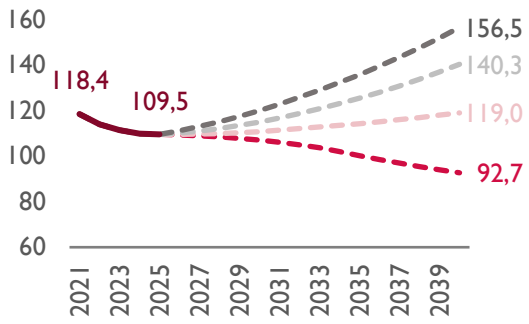


FIGURE 55. DEBT (% GDP), SPU SCENARIOS + Δ RATES OF 100 BPS.



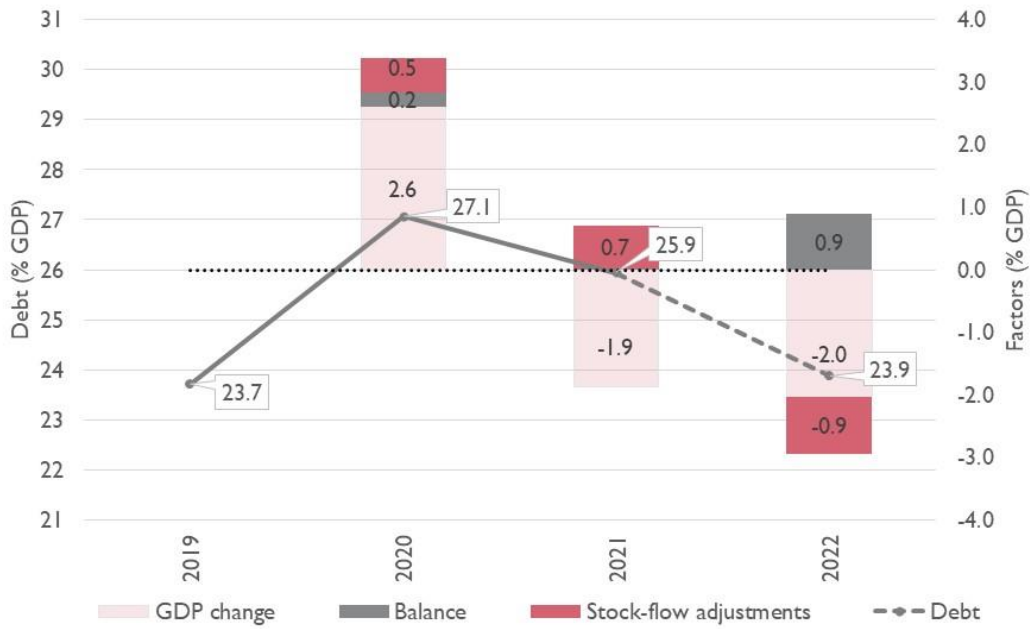
Source: AIReF

5.2. Autonomous Regions

5.2.1. Debt level

AIReF estimates that, fully applying the accumulated excess financing and under its 2022 forecasts, the debt-to-GDP ratio of the Autonomous Region sub-sector would stand at 23.9% at the end of the year. Starting from 25.9% in 2021, the ratio would improve due to the effect of expected GDP growth and, to a lesser extent, stock-flow adjustments, which would offset the effect of the expected deficit at year-end.

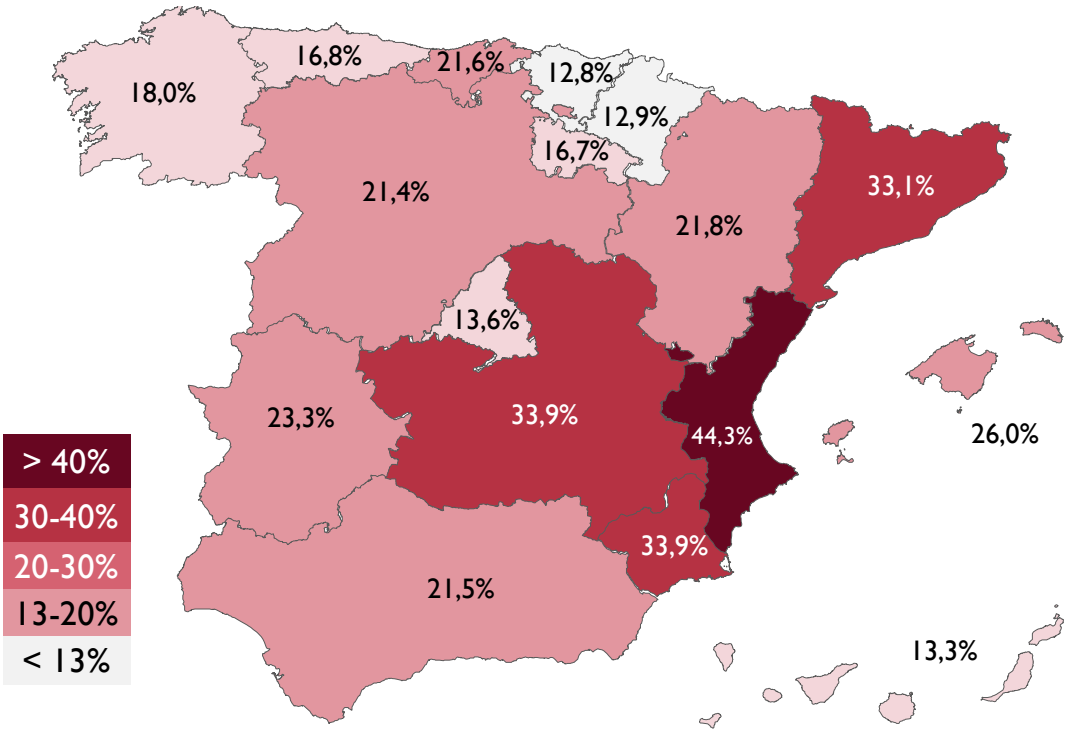
FIGURE 56. EVOLUTION OF THE DEBT-TO-GDP RATIO OF THE ARS AND EXPLANATORY FACTORS (% GDP)



The needs generated during the year would be offset by the liquidity accumulated in previous years. The impact of the expected deficit in 2022 would be offset by the excess financing from both the surplus generated in 2021 - 0.2 points of GDP - and the over-financing of the deficit of previous years - half a point of GDP. Most ARs plan to offset these elements this year. The excess financing considered amounts to €7.69bn, without including the €1.06bn of the Basque Country from 2020 (the application of which is postponed for five years from 2023 by agreement of the Joint Commission). These excesses are independent of the cash flows derived from the funds of the RTRP and REACT-EU, which in 2021 have had a positive net effect on the cash stock.

At an individual level, the debt-to-GDP ratio drops in all ARs, albeit unevenly. Mainly due to the effect of nominal GDP growth, all the ARs have seen their debt-to-GDP ratios fall. The largest reductions in percentage points of GDP are found in the Balearic Islands, the Basque Country and Cantabria. Under the aforementioned assumptions, the Canary Islands, Madrid, Navarre and the Basque Country could place their debt in 2022 at around 13%.

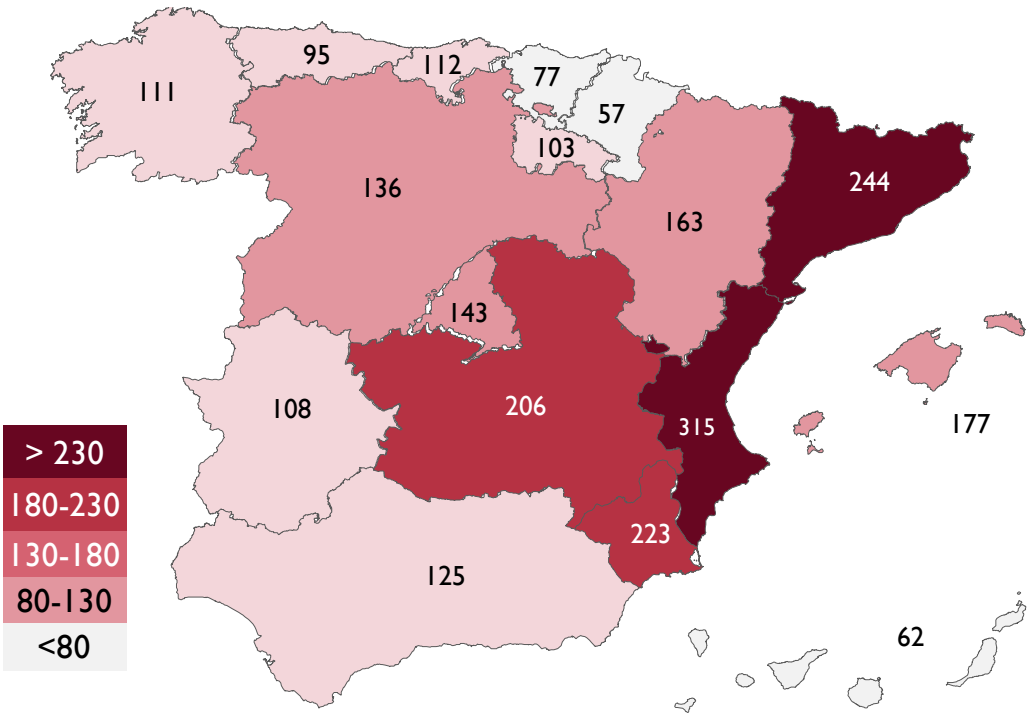
FIGURE 57. DEBT-TO-GDP RATIO OF THE ARS (% GDP)



The debt-to-current revenue ratio[11], on the other hand, grows in 2022. With some exceptions (Navarre, the Basque Country, Cantabria and Rioja), the debt-to-revenue ratio will rise in 2022, due to the decrease in transfers from the Central Government (extraordinary transfers and support for companies from the COVID line). The highest growth in the debt-to-current revenue ratio will occur in Valencia, the Balearic Islands, Murcia and Catalonia.

[11] AIReF calculates the revenue/debt ratio on the basis of the net current revenue in national accounting terms. The evolution of this ratio is dependent on the specific features of the regional financing system and the extraordinary transfers received by the Autonomous Regions in 2020 and 2021.

FIGURE 58. DEBT-TO-REVENUE RATIO OF THE ARS



5.2.2. Long-term projections

Under the assumptions of a regulatory scenario[12], where it is projected that the primary balance will worsen for 2022 and start to correct in the following years, a reduction in the debt-to-GDP ratio of 12.2 points of GDP is calculated for the next 15 years, with the pre-pandemic level reached in 2023. Economic growth will be the most decisive factor in the reduction of the ratio, supported by a fiscal balance that will remain at equilibrium in the coming years.

[12] The regulatory scenario implies an annual improvement in the primary balance of each AR of 0.25 points of GDP until a surplus of 0.75% is reached, which will be maintained providing the debt ratio exceeds the level of 13% of GDP. Once this limit is reached, the primary surplus will be equal to the financial burden, projecting a scenario of budgetary equilibrium.

FIGURE 59. DEBT PROJECTIONS (% GDP) AND YEAR OF ARRIVAL AT THE REFERENCE LEVEL OF 13%

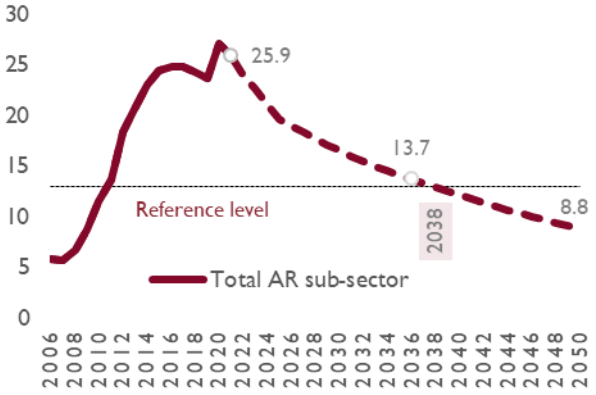
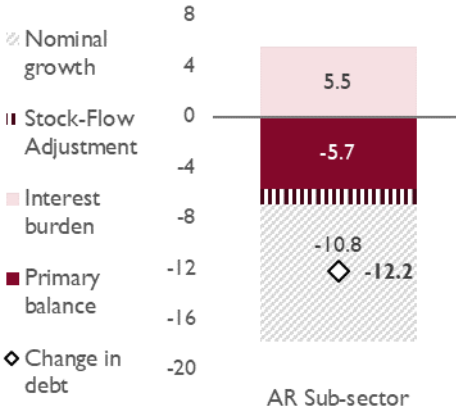


FIGURE 60. CONTRIBUTION TO THE CHANGE IN DEBT RATIO (% GDP) IN 15 YEARS (2022-2036)



Under a regulatory scenario, it is projected that over one decade will be required for the 13% reference limit to be reached. The reference limit of 13% is projected to be reached by the end of the next decade, while maintaining the budgetary balance of the sub-sector as a whole. At an individual level, the Basque Country, the Canary Islands, Madrid and Navarre are forecast to be below the reference level of 13% in the coming years. With a debt ratio close to 50% of its GDP, Valencia would rank as the region with the most vulnerable position.

A sensitivity analysis indicates that a rise in interest rates of 100 basis points would lead to a cumulative increase in the financial burden of almost 2 percentage points over the next 15 years. In contrast, a scenario involving higher potential economic growth of 1 pp would contribute to reducing the debt ratio by around 2 additional points in the same period.

FIGURE 61. DEBT PROJECTIONS (% GDP) AND SENSITIVITY TO RATE HIKES AND GROWTH SHOCK

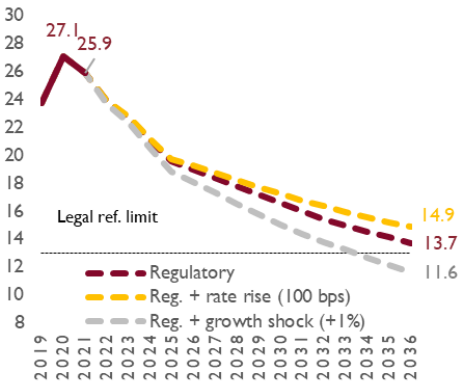
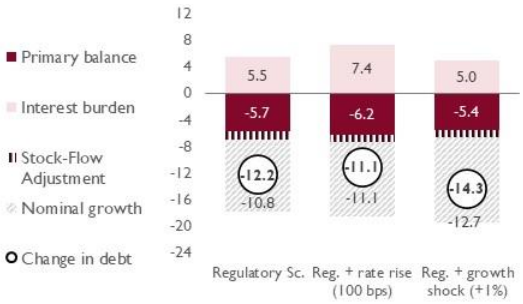


FIGURE 62. CONTRIBUTION TO THE CHANGE IN DEBT RATIO (% GDP) IN 15 YEARS (2021-2035)



5.3. Local Governments

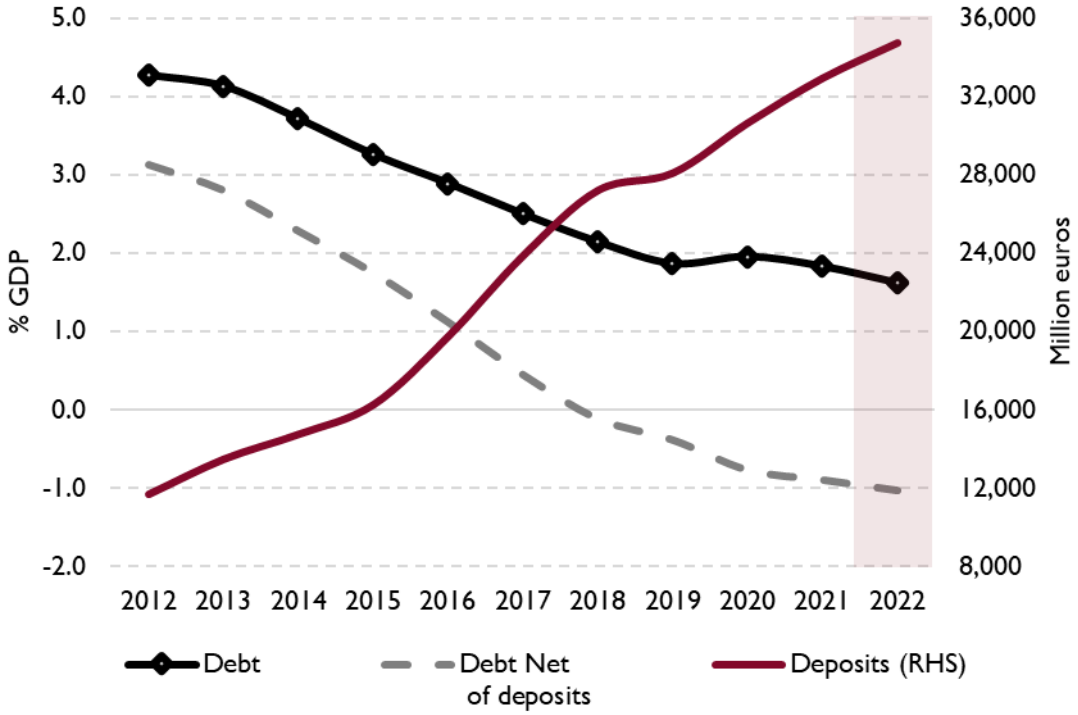
AIReF forecasts that the local sub-sector will reach a debt-to-GDP level of around 1.6% at the end of 2022. The latest data on debt and deposits in this sub-sector published by the Bank of Spain, corresponding to the end of the first quarter of 2022, show an increase in debt compared with the same period of 2021 of close to €400m. At this date, the LGs maintain a debt-to-GDP ratio of 1.8%, reducing by 0.2 points the ratio in the first quarter of last year and stabilising the ratio in terms of GDP at the end of 2021. By the end of this year, AIReF forecasts a local debt ratio of around 1.6%, although this estimate is subject to uncertainty regarding the level of expenditure made by the LGs at the end of the year in the current situation of an absence of fiscal rules.

With regard to the bank deposits of the LGs, AIReF estimates that their weight over GDP will stabilise at the level recorded at the end of 2021, of around 2.7%. The deposits corresponding to the first quarter of this year reflect an increase of almost €5 billion compared with the first quarter of 2021. In 2021, despite the financial consequences of the pandemic and the ensuing crisis, the LGs increased their deposits by €2.3bn. This trend is estimated to continue, albeit to a lesser extent, as a result of the growth in expenditure estimated for the sub-sector financed with cash surpluses, to stand at around €35bn.

The information available on the net asset position for the first quarter of 2022 makes it possible to predict the year-end results. Debt net of deposits, which has been negative since 2018, given that from then on deposits exceeded debt, stood at the end of 2021 at around -1% of GDP. AIReF expects this net asset position to maintain the level over GDP in 2022. AIReF's forecasts are dependent on uncertainties regarding the amount of local spending that will eventually be made in the year financed with savings from previous years.

The following figure shows the evolution of the observed data on debt, deposits and the net liability position of the LGs (as a percentage of GDP), from 2012 to 2021. It also shows AIReF's year-end forecast for 2022.

FIGURE 63. EVOLUTION OF DEBT AND DEPOSITS OF LOCAL GOVERNMENTS



Source: Bank of Spain and AIReF

6. RECOMMENDATIONS

6.1. New Recommendations

As already warned by AIReF in the last report of May 12th on the 2022-2025 SPU, various factors have caused revenue growth above that initially forecast in 2021 and 2022. These increases above the forecasts in the 2021 and 2022 GSB will have an impact on the ARs under the ordinary regime in 2023 and 2024 through the settlement of the financing system. There is a risk that this temporary revenue will be allocated to finance increases in expenditure or reductions in other revenue on a structural basis. These risks are exacerbated in a context of suspended fiscal rules and the absence of a general, and also a specific, strategy. Should they materialise, they could place the ARs in 2025 in a very vulnerable situation, with a high level of structural expenditure that does not have the necessary financing of the same nature, accompanied by a high level of debt.

Similarly, the Central Government will also see its path of revenue and expenditure altered by the functioning of the regional financing system.

Therefore, in the Report on the SPU, AIReF recommended GG sub-sectors to allocate *the revenue that materialises above the forecast and other temporary revenue towards accelerating the necessary reduction in the structural deficit and avoid increases in expenditure or reductions in revenue of a structural nature that do not have funding that is also structural*.

Along these lines, AIReF considers that the advantages of having a medium-term fiscal strategy at the national level are fully applicable to the specific

scope of action of each GG sub-sector. Therefore, the annual budget should be consistent with this medium-term strategy. Specifically at a regional level, it is necessary that in the process of drawing up the budgets for 2023, with a focus on the medium term, expenditure or revenue policies that result in an unsustainable situation from 2025, once the revenue flow is normalised, should be avoided. For this reason, **AIReF makes the recommendation to the Ministry of Finance and Civil Service and each one of the AR to:**

1. **Frame the preparation of budgets for 2023 within a medium-term fiscal strategy that considers the structural or cyclical nature of expenditure and revenue.**

Furthermore, as a specific version for the Autonomous Regions of the recommendation submitted to the Ministry of Finance and Civil Service as a result of the Report on the SPU, **AIReF recommends that each of the ARs should**:

2. **Avoid increases in expenditure or reductions in revenue of a structural nature whose permanent funding is not ensured once the extraordinary revenue flows expected in these coming years disappear.**

In addition, the extraordinary transfers received by the ARs in these recent years from the Central Government have favoured the achievement of more favourable deficits than those existing prior to the pandemic and those initially forecast. This, coupled with lax reference rates, has led to excess financing in the sub-sector of more than €8.7bn, which has placed the debt of the ARs at year-end 2021 at 25.9% of GDP. Some ARs do not plan to fully apply the accumulated excess financing (irrespective of the postponement by the Joint Commission of the excess generated in 2020 in the Basque Country). They are therefore given a specific recommendation in their individual report to *apply the excess financing existing at year-end 2021 and, as the case may be, the surpluses generated in 2021 pending application*.

In the same vein, it will be desirable for the Ministry of Finance and Civil Service to also take into account the debt authorisations of the year and the excesses generated and pending application. Thus, ***AIReF recommends that the Ministry of Finance should:***

3. ***Take into account the excess financing generated at the end of 2021 in the debt authorisations to the ARs, both through the financing funds and other mechanisms.***

Finally, the medium-term outlook suggests that the expected balance deterioration in 2022 might be reversed in 2023 and 2024. Although the SPU seems to include this outlook in the forecasts for the regional sub-sector, in

order to avoid a further accumulation of excess financing, this factor should be taken into account in the setting of references and targets for the coming years. ***AIReF therefore recommends that the Ministry of Finance Civil Service should*:**

> ***4. Take into account when setting these years' references or targets for the ARs the possibility of excess borrowing, and periodically and thoroughly monitor the year-end forecasts for each region, updated from time to time, in order to adjust the debt to the actual financing needs.***

In the same vein, it is essential that the regions themselves regularly review and update their forecasts, and adjust borrowing to their actual financing needs. Therefore, the individual reports contain a specific recommendation for each of them.

6.2. Live recommendations[13]

Medium-term fiscal strategy

Since the activation of the escape clause in 2020, AIReF has repeatedly recommended that the Government should establish a medium-term fiscal strategy to provide fiscal guidance and realistically and credibly guarantee the financial stability of the GG.

The Ministry of Finance and Civil Service has not drawn up this strategy as it considers that it was not the right time due to the existing uncertainty. Therefore, the Government has not submitted the rebalancing plan referred to in Articles 11.3, 13.3 and 22 of the Organic Law on Budgetary Stability and Financial Sustainability. However, the Ministry of Finance and Civil Service considers that it complies with this recommendation through the different processes that affect the configuration of the public accounts, that is, the Stability Programme Update (SPU) and its subsequent implementation in the Budgetary Plan and the GSB, as well as the Recovery, Transformation and Resilience Plan (RTRP).

[13] This section sets out recommendations made in previous reports which, even though the Ministry of Finance and Civil Service has explained the reasons why it deviates from compliance with the recommendations, AIReF considers important for achieving the effectiveness and credibility of fiscal rules and a robust fiscal framework, which it believes is not guaranteed by the usual system and practices. It therefore considers that these recommendations remain in force, they are "live recommendations" and it urges the Ministry of Finance and Civil Service to comply with them. Should this not be the case, it is not necessary to once again explain the reasons for deviating from them, unless they are no longer the same.

The SPU is, in theory, the medium-term national fiscal plan required by European regulations. However, once again, the SPU sent to the European institutions is far from being the medium-term fiscal strategy that AIReF has recommended that the Government should draw up on numerous occasions.

On the one hand, the structural deficit in 2025 will stand at around 4%, 0.6 points above the pre-pandemic level. Furthermore, it is noted that at the end of the period the margin to reduce the deficit without adopting additional measures is exhausted, with the deficit stabilising at around 3% in 2024 and 2025, which is the limit set by the Stability and Growth Pact. This stagnation in the reduction of the deficit will put a brake on the reduction of public debt, which in 2025 will still be at very high levels - 108.8% of GDP. This places Spain in a very vulnerable position in view of the likely tightening of monetary conditions.

On the other hand, the RTRP is still not integrated into the SPU. Firstly, no realistic path of execution of the investments in national accounting terms or their potential impact on structural spending is presented. Secondly, although the RTRP lists various measures aimed, in principle, at reducing the structural deficit, such as tax and pension reform, among others, the SPU does not integrate them into its budget scenario or quantify their potential impacts.

The absence of a medium-term fiscal strategy that encompasses all the key elements of fiscal and economic policy is of particular concern in the current macroeconomic scenario with significant downside risks. The situation requires the capacity to adapt economic policy to the possible materialisation of risks arising from, *inter alia*, the war in Ukraine, inflation and the pandemic. At the same time, a roadmap is required for reducing the structural deficit without hampering economic growth and allowing public debt to be brought to levels that mitigate the vulnerability of the Spanish economy to future crises.

AIReF considers that preparing a fiscal strategy involves planning in the medium term, i.e. setting future objectives and targets and planning actions to achieve them, which does not mean consolidation at the present time. In aggregate terms, it is necessary to lay down a fiscal policy that helps to recover pre-crisis activity levels and drive the future growth of the economy. At the same time, the sustainability of public finances requires reducing public debt to less vulnerable levels. This involves reducing the structural deficit that already existed before the crisis, and facing future challenges such as an ageing population. Although the implementation of the RTRP might help to reconcile both objectives, fitting all of these factors together requires a realistic and credible medium-term fiscal strategy.

Furthermore, the plan should be flexible with the ability to revise it depending on the circumstances that arise. The very existence of planning, which sets targets and allows for informed decision-making, is what provides certainty to economic agents and allows for greater control of budgetary activity. From AIReF's point of view, these revisions would in no case generate a lack of confidence, unease or confusion as they would be perfectly integrated and planned for in the budget cycle, as is, in fact, the usual case.

For all these reasons, **AIReF makes the following recommendations to the Government:**

To establish a national medium-term fiscal strategy that will act as fiscal guidance and will realistically and credibly ensure the financial sustainability of the General Government. This requires:

- ***The support of all tiers of government, considering their fiscal realities in terms of revenue and powers, in order to ensure appropriate coordination and co-responsibility.***
- ***Specifying the fiscal targets and milestone schedules.***
- ***Including a sufficiently long-time horizon to place the debt on a path that will reduce its level of vulnerability.***
- ***Integrating the macroeconomic and fiscal implications of the investments and reforms set out in the RTRP.***
- ***Basing the strategy on realistic macroeconomic and fiscal forecasts.***
- ***Including measures for contingency scenarios.***

The President of AIReF

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