

REPORT ON THE EXISTENCE OF THE
EXCEPTIONAL CIRCUMSTANCES REFERRED
TO IN ARTICLE 11.3 OF ORGANIC LAW
2/2012, OF APRIL 27TH, ON BUDGETARY
STABILITY AND FINANCIAL SUSTAINABILITY

REPORT 41/22



Independent Authority
for Fiscal Responsibility



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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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1. INTRODUCTION

The Ministry of Finance and Civil Service requested AIReF to report on the existence of the exceptional circumstances referred to in Article 11.3 of the Organic Law on Budgetary Stability and Financial Sustainability, which is the subject of this report. On July 26th, the Ministry of Finance and Civil Service requested AIReF to issue the report provided for in Article 22 of the Organic Law on the Establishment of AIReF, which gives this institution the obligation to report on the existence of the exceptional circumstances referred to in Article 11.3 of the Organic Law on Budgetary Stability and Financial Sustainability, prior to the parliamentary procedure provided for in that article. In particular, this article establishes that "Exceptionally, the State and the Autonomous Regions may incur a structural deficit in the event of natural disasters, serious economic recession or extraordinary emergency situations that are beyond the control of the General Government and significantly impair its financial position or its economic or social sustainability, as assessed by an absolute majority of the members of the Congress of Deputies".

The request for a report is based on the direct impact at a national level of the extension of the escape clause in 2023 at a European level on the basis of, among other reasons, the unprecedented rise in energy prices. The process of economic recovery and growth that began in 2021 has been suddenly affected by Russia's invasion of Ukraine, which has had a major impact on the economic outlook for the European Union in terms of lower economic growth and higher inflation and uncertainty. In this regard, the Ministry of Finance and Civil Service notes that the coordinated response adopted at a European level through the extension of the escape clause for 2023 has a direct impact at a national level, since it involves the implementation of the legal

mechanisms that allow the activation of the escape clause provided for in Spanish legislation.

In a European context, the European Commission (EC) and the European Council agreed to extend the existing general escape clause provided for in the Stability and Growth Pact (SGP) until 2023. On May 23rd, the EC announced the extension of the SGP escape clause to 2023, which was approved by the Council on June 17th. Increased uncertainty, strong downside risks to the economic outlook, unprecedented rises in energy prices and continued supply chain disruptions justify this extension. 2023 will be the fourth consecutive year in which this general escape has been activated. It was activated for 2020 and 2021, and was maintained for 2022, given the severity of the economic recession in the European Union and the euro area as a whole caused by the pandemic. This activation does not imply the suspension of SGP procedures but allows Member States to make the fiscal policy response more flexible to meet the challenges, first from the pandemic and now from the energy crisis and the uncertainty resulting from the war in Ukraine. The European fiscal supervisory framework that will prevail when the general escape clause is deactivated, which is expected to take place in 2024, has not yet been defined. The review process was resumed at the end of last year¹ and it is still under discussion.

At a national level, the Government requested the Congress of Deputies to maintain the escape clause provided for in Article 11.3 of the Organic Law on Budgetary Stability and Financial Sustainability. At its session held on July 26th, 2022, the Council of Ministers requested that the escape clause be maintained in 2023, in line with the EC's decision to maintain the escape clause of the Stability and Growth Pact also for 2023, which provides countries with more flexibility to deal with the crisis resulting from the invasion of Ukraine. This is the third time that the Government has asked Parliament to rule on the existence of the circumstances provided for in Article 11.3 of the Organic Law on Budgetary Stability and Financial Sustainability. Previously, at its session held on October 6th, 2020, the Council of Ministers had requested the activation of the escape clause for 2020 and 2021 as a result of the extraordinary emergency situation resulting from the pandemic which, following a report from AIReF, was approved by Parliament on October 20th, 2020. The following year, the Council of Ministers, on July 27th, 2021, decided to maintain the escape clause for 2022, which was also ratified by Parliament on September 13th, 2021, following a report from AIReF. The activation and maintenance of

¹ See "[AIReF's Contribution to the European Commission's Public Consultation on the Reform of the European Fiscal Framework](#)", Working Paper 1/2022

this escape clause has rendered the fiscal rules for 2020, 2021 and 2022 without effect.

AIReF already reported in 2020 and 2021 on the existence of the exceptional circumstances referred to in Article 11.3 of the Organic Law on Budgetary Stability and Financial Sustainability. Prior to its approval by Parliament, AIReF issued two reports, on October 13th, 2020² and on July 29th, 2021³, noting the existence of the exceptional circumstances referred to in Article 11.3 of the Organic Law on Budgetary Stability and Financial Sustainability, as required by Article 22 of the Law on the establishment of AIReF. In these reports, AIReF took the view that the serious crisis caused by the pandemic could be considered an extraordinary situation beyond the control of the General Government, within the exceptional circumstances referred to in the Organic Law on Budgetary Stability and Financial Sustainability. In this report, AIReF again offers its opinion on whether there are exceptional circumstances in 2023.

² [AIReF's 2020 Report on exceptional circumstances of Article 11.3 of the Organic Law on Budgetary Stability and Financial Sustainability](#)

³ [AIReF's 2021 Report on exceptional circumstances of Article 11.3 of the Organic Law on Budgetary Stability and Financial Sustainability](#)

2. ASSESSMENT

AIReF considers that in 2023 the exceptional circumstances referred to in Article 11.3 of the Organic Law on Budgetary Stability and Financial Sustainability are present as a result of the energy crisis and the uncertainty caused by the war in Ukraine. The serious economic crisis triggered by the COVID-19 pandemic was the cause of the activation of the escape clause in 2020 and its maintenance until 2022. However, two years after the outbreak of the pandemic, 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 raw materials markets that emerged in 2021 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, leading to a tightening of the economy's financing conditions. For its part, the coronavirus remains a key determining factor of the economic situation.

On the macroeconomic front, both the Government and AIReF have lowered their growth forecasts for the Spanish economy in their latest reports. In the Stability Programme Update (SPU) scenario, the Government stated that the GDP growth of the Spanish economy could stand at 4.3% in 2022, significantly lower than the figure the Government expected last autumn (7%). AIReF considered that the Government's scenario was feasible, although subject to significant downside risks. These were related to possible cuts in the energy supply by Russia, disruptions in supply chains accentuated by China's Covid-zero policy and the implications that high and persistent inflation might have on household confidence and purchasing power, companies'

competitiveness and the financing conditions of the economy. The absence of information that allows an assessment of the impact of the RTRP on the real economy adds another source of uncertainty. More recently, the Government has maintained its growth forecast for 2022, but lowered its growth forecast for 2023 to 2.7%.

AIReF believes that some of the risks identified in May in the Report on the SPU are currently materialising, particularly those related to the energy emergency. Total or partial cuts in Russian gas supplies to some European countries have gradually materialised. In addition, shortages of supplies of other food and industrial raw materials persist. Against this backdrop, inflation has continued to record unexpected increases in most European economies and is triggering a dramatic fall in consumer confidence and a further tightening of financial conditions. The European Central Bank (ECB) ended its net asset purchase programmes in July and raised official interest rates by 50 bps, above that previously indicated, thus putting an end to a cycle of negative interest rates. This decision means an intensification of the restrictive monetary policy stance for euro area countries. However, the complexity of the economic situation led the ECB to create a new bond purchase programme - the Transmission Protection Instrument (TPI) - aimed at ensuring the smooth transmission of monetary policy decisions to all euro area countries and avoiding the fragmentation of financial markets within the EMU.

On the domestic front, the intensity and persistence of inflation is causing a contraction in 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. All this in a context in which savings margins accumulated during the pandemic have shrunk and financing conditions are starting to tighten. Consequently, AIReF's most recent estimates suggest GDP growth of around 2% for 2023, in line with other organisations such as the EC and the International Monetary Fund (IMF). For its part, the inflation rate could rise to above 3% in that year after being close to 7.8% in 2022.

This scenario does not incorporate the risk that the threat of a total cut-off of Russian gas supplies to European economies will materialise. The risk of a cut or further restrictions on the supply of Russian gas is highly likely to materialise. In fact, Gazprom has announced since July 25th a further cut in the supply of gas through Nord Stream 1, to only 20% of its capacity. This might prevent Europe from topping up its gas supplies for the winter and would require the rationing of electricity use in some countries. In this context, the EC has made a proposal for a Council Regulation setting targets for reducing gas demand – by 15% between August 1st, 2022 and March 31st, 2023 – and the possibility of

declaring, after consultation with Member States, a “Union alert” on supply security, which would entail limitations on gas demand for Member States. Should this scenario materialise or should the war escalate, the ECB estimates suggest that euro area GDP could contract by 1.7% (compared with a 2.1% increase in the central scenario) and inflation would reach 6.4% in 2023 (compared with 3.5% in the central scenario). The effects would be very uneven between countries. In some economies, such as Hungary, Slovakia, the Czech Republic and Italy, GDP could contract by up to 6% according to the latest IMF estimates. The contraction could be around 2.5% in Germany and around 1% in France and Spain. Although the Spanish economy is less dependent on Russian supplies than other EU countries, this would mean a drastic change in growth prospects for 2023.

On the fiscal front, AIReF worsened its estimate of the GG deficit from the 4.2% of GDP in 2022 forecast in its Report on the 2022-2025 Stability Programme (SPU) to 4.5%, with a reduction to 3% of GDP in 2025. In its report on the 2022-2025 SPU, AIReF expected a reduction in the deficit in 2022 to 4.2% in the absence of additional measures, while the Government's forecast was for 5% despite 2021 closing with a deficit 1.5 points lower than its forecast. However, in the last report on budgetary execution, public debt and the expenditure rule for 2022 published on July 15th, AIReF worsened this 2022 deficit forecast to 4.5% of GDP. This was mainly due to the Government's approval of the extension of measures to mitigate the effects of the energy crisis and the war in Ukraine, as well as to higher spending executed so far, especially at a regional level. For the other years, AIReF forecasts a smaller reduction in the deficit than the Government, to reach 3% of GDP in 2024, a level that is maintained in 2025. However, these factors are amplified by the energy crisis and the lack of specifics on the fundamental elements of the RTRP, both in relation to investments and reforms.

Despite the forecast reduction in the deficit in nominal terms, AIReF's medium-term estimates point to a more vulnerable fiscal position in terms of structural deficit and debt. According to AIReF's estimates, when an output gap level equivalent to that seen before the pandemic is recovered, the structural position of Spanish public finances will record a balance of -4% of GDP in 2025. This means an increase in the structural deficit compared with the pre-pandemic position of over 0.5 percentage points. AIReF's projections do not incorporate any impact associated with the RTRP on long-term potential growth and therefore there is a convergence to pre-pandemic levels over the forecast horizon, with AIReF estimating potential growth of 1.3% in 2025. In addition, government debt stood at 118% of GDP in 2021, 20.1 points more than the pre-pandemic level. AIReF forecasts that it will fall to 108.8% in 2025. The increase in the stock of government debt, on top of the previous high

level, places sustainability in a position of greater vulnerability. Maintaining a structural primary deficit of between 1.5% and 2.5% of GDP as from 2025 (in line with Government's and AIReF's estimates, respectively) would initiate an upward trend in the debt ratio path. This is compounded by the existence of significant short and medium-term risks to sustainability, such as those arising from inflation and the tightening of financing conditions, as well as the increase in expenditure associated with the ageing population.

Therefore, the assessment of macroeconomic conditions performed by AIReF leads to the conclusion that the escape clause should be maintained, without forgetting the vulnerability associated with the structural deficit and the level of debt, in line with the decisions adopted within the framework of European fiscal supervision. In principle, European legislation only specifies the conditions necessary for the activation of the escape clauses provided for in the SGP⁴. On the basis of these requirements, on May 23rd, the EC announced the extension of the SGP escape clause to 2023, which was approved by the Council on June 17th. The determining factors for maintaining the clause are increasing uncertainty, strong downside risks to the economic outlook, unprecedented rises in energy prices and continued supply chain disruptions. Said activation implies the non-suspension of the SGP procedures but allows some flexibility to adopt fiscal measures if necessary, providing the sustainability of public accounts is preserved.

At a European level, the general escape clause has been active since March 2020. In its Communication of March 3rd, 2021⁵, the Commission pointed out that the decision regarding the deactivation or continued activation of the general escape clause must be based on an overall assessment of the state of the economy, using as the key quantitative criterion a comparison of the level of economic activity in the EU or euro area with the pre-crisis levels (end of 2019). In this regard, increased uncertainty and the high risk of overestimation of the economic outlook in the context of the war in Europe,

⁴ In particular, European legislation contains two clauses: the unusual events clause and the general escape clause. The former will apply in the event of an unusual event which is beyond the control of the Member State concerned which has a major impact on the financial position of the General Government. The general escape clause refers to periods of severe economic crisis in the euro area or in the Union as a whole and is intended to facilitate a coordinated fiscal policy response in these circumstances. In both cases, Member States are allowed to temporarily deviate from the adjustment path towards the medium-term budgetary target, provided that said deviation does not jeopardise medium-term budgetary sustainability. [EUR-Lex - 01997R1466-20111213 - EN - EUR-Lex \(europa.eu\)](#)

⁵ [Communication from the Commission to the Council "One year since the outbreak of COVID-19: fiscal policy response" Brussels, March 3rd, 2021, COM \(2021\) 105 final](#)

unprecedented rises in energy prices and continued supply chain disruptions justify the extension of the general escape clause of the SGP during 2023.

Despite maintaining the escape clause in 2023, the European Union (EU) recommends that countries with high debt, including Spain, pursue a prudent fiscal policy. This translates into limiting in 2023 the growth of nationally financed current primary public expenditure to a rate lower than medium-term potential growth. This benchmark will be assessed taking into account the changing situation and the need to increase green and digital public investment as well as energy supply security, particularly from EU funds (using the Recovery and Resilience Facility, the REPowerEU plan and other EU funds). For the post-2023 period, high-debt countries are recommended to ensure a credible gradual debt reduction and preserve the sustainability of public finances in the medium term, through gradual consolidation, investment and reforms.

Therefore, Spain will have to limit the growth of nationally financed primary current expenditure in 2023. In particular, this expenditure should be increased below medium-term potential growth, taking into account the continuation of temporary and specific support for households and businesses that are most vulnerable to rises in energy prices and for people leaving Ukraine. With regard to Spain's compliance with this expenditure rule, in its report on the 2022-2025 SPU⁶, AIReF estimated growth in nationally financed primary current expenditure in 2022 below the medium-term potential GDP benchmark. However, in the period 2023-2024, its rate of change will only fall below this benchmark on one occasion, towards the end of the programme horizon.

As for the fiscal policy stance, the Commission is in favour of maintaining an expansionary fiscal policy for the EU and the euro area as a whole. However, it advises caution at the level of individual Member States. The EC Communication calls for the continuation of the activation of the general escape clause in 2023, so that there is scope for national fiscal policy to react rapidly if necessary, while ensuring a smooth transition from broader and more comprehensive support for the economy during the pandemic to an approach more focused on temporary and specific measures and a prudent fiscal policy to ensure sustainability in the medium term.

Fiscal policy continues to be a necessary tool to meet the challenges arising from the current geopolitical and economic context. The Government has adopted a plan of economic response measures to the war in Ukraine. Furthermore, the possibility of more adverse scenarios should also be

⁶ [AIReF Report on the 2022-2025 SPU](#)

considered, which makes it advisable to maintain the necessary flexibility to facilitate a robust response if warranted by the circumstances.

However, at any event, fiscal policy must be geared towards guaranteeing the sustainability of public finances. As AIReF has pointed out on numerous occasions, the suspension of fiscal rules, far from implying a relaxation of fiscal responsibility, means that the actions of the General Government should continue to be geared towards ensuring the sustainability of the public accounts in the medium and long term, which, as stated in Article 11.3 of the Organic Law on Budgetary Stability and Financial Stability, cannot be endangered by temporary deviations in the deficit. There is a risk that, in a context of suspended fiscal rules, the GG will take on increases in structural expenditure without providing for sources of funding that are also structural, either via higher revenues or lower expenditure on other policies. This risk is amplified by the absence of a medium-term fiscal strategy that would give greater predictability to the actions of each tier of government.

In this regard, AIReF reiterates that in Spanish law the activation of the escape clause is associated with the approval of a rebalancing plan. This plan must provide for the correction of the structural deficit taking into consideration the exceptional circumstance that caused the non-compliance, which would have allowed the deficit path to be adjusted to the duration of the exceptional circumstances, and serve as the foundation for the new budgetary cycle. To date, the aforementioned plan has still not been presented despite the activation of the clause in October 2020. The Government does not state in its request for a report that it will implement a plan to rebalance the public accounts. AIReF considers that the preparation of a medium-term plan is an essential element in the strategy for recovery and to strengthen medium-term growth by contributing to providing security and transparency to all economic agents and allowing greater control of budget execution and the implementation and impact of the measures adopted.

3. RECOMMENDATIONS

3.1. Live recommendations⁷

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.

For its part, 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).

The SPU is, in theory, the medium-term national fiscal plan required by European regulation. However, once again, the SPU sent to the European

⁷ 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 them 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.

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, in 2025 the structural deficit stands 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 stand 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. In addition, the RTRP is still not integrated into the SPU, both in terms of reforms and investments.

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.

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

That it should 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.***
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The President of AIReF



Cristina Herrero Sánchez