

Report on General Government Budgetary Execution, Public Debt and Expenditure Rule 2022.

AIReF RAISES ITS INFLATION FORECAST TO 7.8% AND STATES THAT IT IS HAVING AN IMPACT ON HOUSEHOLDS

- The Independent Authority for Fiscal Responsibility reduces the expected growth for 2022 by 0.1 points, to 4.2%, and raises its inflation forecast from 6.5% to 7.8% after verifying that the risks are materialising
- It notes that the intensity and persistence of inflation is having a major impact on households' purchasing power, particularly lower income households, and it raises the risk of a loss of competitiveness *vis-à-vis* the outside world
- It highlights the challenge the ECB faces of preventing inflation expectations from de-anchoring and triggering inflationary spirals
- AIReF places the GG deficit at 4.5% in 2022, 0.3 points higher than the figure estimated in May, and worsens the forecast in all sub-sectors. Seven Autonomous Regions (ARs) will end the year above the reference rate and eight large Local Governments (LGs) will record deficits in 2022
- It indicates that the sustainability of public finances is a source of vulnerability, especially in a context of tightening financing conditions
- AIReF recommends that the Ministry of Finance and the ARs should frame the preparation of budgets for 2023 within a medium-term fiscal strategy
- It recommends that the ARs should avoid increases in expenditure or reductions in revenue of a structural nature whose permanent funding is not guaranteed and it issues several recommendations so that borrowing is adapted to actual financing needs

The Independent Authority for Fiscal Responsibility (AIReF) published today on its website the Report on General Government Budgetary Execution, Public Debt and Expenditure Rule 2022, in which it updates its macroeconomic and fiscal forecasts in a context in which downside risks to economic growth mainly predominate. Specifically, AIReF slightly revises downward the real growth forecast for 2022, to 4.2%, and raises its inflation forecast from 6.5% to 7.8%. In addition, AIReF states that inflation is having an impact on households. In the

fiscal area, AIReF raises the projected deficit for the GG as a whole in 2022 by 0.3 points to 4.5% of GDP.

Regarding the macroeconomic scenario, AIReF notes that 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, AIReF maintains that 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 a domestic level, the intensity of inflation is causing a contraction in households' purchasing power 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.

In addition, AIReF maintains the assumption that the Recovery, Transformation and Resilience Plan (RTRP) 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.

Regarding inflation, AIReF notes that it has continued to record unexpected increases and the percentage of products and services in the consumer basket showing high price increases is rising. The report indicates that the intensity and persistence of inflation is having a major impact on households' purchasing power, 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. In this context, the European Central Bank (ECB), which has already announced rate hikes and the termination of the asset purchase programmes, 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.

Fiscal forecasts

AIReF has also revised its fiscal forecasts and estimates, in its central scenario, 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 energy crisis, the revision of the macro outlook and the latest available information explain the change.

Specifically, 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. For its part, the higher increase in macroeconomic variables in nominal terms as a result of inflation means an improvement in the 2022 balance of 0.2 points. 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

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withdrawal of the measures related to the pandemic, which accounts for 2.3 points of GDP. Likewise, the structural revenue-increasing measures of 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, 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 RTRP, will amount to 42.4% of GDP, 0.1 points higher than the forecast in the previous report due to the revision of the macroeconomic scenario and the positive execution data, which offset the lower collection resulting from the extension of the measures. For its part, expenditure, excluding the RTRP, will stand at 46.9% of GDP, 0.4 points higher than the forecast in the previous report. The extension of the measures, including the fuel rebate, and the increase in defence spending result in higher expenditure of 0.4 point of GDP. On the other hand, the execution data raise expenditure under certain headings, 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.

The deficit forecast is somewhat worse for every sub-sector compared with May. The Central Government 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 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 due to higher than expected execution of expenditure and lower forecast revenue from European funds. Finally, the forecast surplus of the LGs falls slightly, although it remains at 0.2%.

AIReF also published today on its website the individual reports of the ARs that complete the pronouncement on the sub-sector. Almost every AR worsens its forecasts for year-end 2022 and up to seven will end the year above the reference rate, with five of them ending the year well above it. At the other extreme, five regions maintain positive balances or very close to a balanced budget. In addition, AIReF published the Supplementary Report on the Individual Evaluation of the Local Governments, in which it estimates that eight large Local Governments will record deficits in 2022. In this report, AIReF maintains the sustainability risk rating for all the public authorities with problems. The city councils of Arroyomolinos and Lepe are removed from the analysis and the situation of the city councils of Alcorcón, Algeciras, Aranjuez, Gandía, Los Barrios, and San Andrés del Rabanedo improves. On the other hand, the critical situation of Jaén and Parla is consolidated as they generate negative balances and Barbate once again fails to comply with its duty to cooperate.

Sustainability

Regarding sustainability, AIReF notes that the increase in public debt means that the sustainability of public finances is 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. However, the ratio will return to an upward path in a scenario in which the structural balance remains constant. AIReF performs various simulations that show that maintaining a structural primary deficit of between 1.5% and 2.5% of GDP from 2025 would place the debt ratio between 125% and 140% of GDP in 2040. Higher expected interest rates contribute towards exacerbating the debt trend.

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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% in 2022. 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 balanced in the coming years.

Recommendations

In this context, AIReF further stresses the need for a medium-term fiscal strategy for the process of drawing up the 2023 budgets. Specifically, it repeats the recommendation to design a national strategy that will act as fiscal guidance and will realistically and credibly ensure the financial sustainability of the General Government. 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. As indicated by the institution, 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.

In addition, taking into account that the benefits of this strategy are applicable individually to each public authority, AIReF issues a new recommendation addressed to the Ministry of Finance and Civil Service and each Autonomous Region on the need to frame the preparation of budgets for 2023 within a medium-term fiscal strategy.

Furthermore, as a specific version of the recommendations submitted to the Ministry of Finance in May, 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 guaranteed once the extraordinary revenue flows expected in these coming years disappear.

According to AIReF, the pandemic and the measures to mitigate its effects have distorted the normal evolution of the Regional Financing System (RFS) and may contribute to the idea that there is room to increase expenditure or reduce income structurally. For this reason, the benefits of the national medium-term fiscal strategy are applicable individually to each public authority.

In addition, AIReF indicated that 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.