

PRESS RELEASE
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AIReF CONSIDERS THAT THE EXCEPTIONAL CIRCUMSTANCES FOR MAINTAINING THE ESCAPE CLAUSE ACTIVE WILL STILL BE PRESENT IN 2023

- The Independent Authority for Fiscal Responsibility (AIReF) states that the energy crisis and uncertainty over the war in Ukraine are exceptional circumstances that justify maintaining the escape clause active
- In addition, inflation is leading to a tightening of financing conditions and the coronavirus remains a conditioning factor for the economy
- AIReF's most recent estimates suggest GDP growth of around 2% for 2023, in line with other organisations such as the EC and the IMF
- If the threat of a total cut-off of Russian gas supplies crystallises, there would be a drastic change in growth prospects for 2023
- At a fiscal level, AIReF's medium-term estimates point to a more vulnerable position in terms of structural deficit and debt
- The assessment of macroeconomic conditions 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
- AIReF reminds the Government of the legal obligation to carry out a rebalancing plan and recommends that it establish a national medium-term strategy that will act as fiscal guidance and will realistically and credibly ensure the financial sustainability of the General Government

The Independent Authority for Fiscal Responsibility (AIReF) today issued and published on its website the Report on the existence of the circumstances for maintaining the escape clause active in 2023. In that report, AIReF considers that in 2023 the exceptional circumstances referred to in Article 11.3 of the Organic Law on Budgetary Stability and Financial Sustainability will still be present as a result of the energy crisis and the uncertainty caused by the war in Ukraine.

The Ministry's request for a report is based on the direct impact at a national level of the extension of the safeguard clause in 2023 at a European level on the basis of, among other reasons, the unprecedented rise in energy prices. The European Commission (EC) and the European Council agreed to extend the existing general safeguard clause in the Stability and Growth Pact (SGP) until 2023 due to increased uncertainty, strong downside risks to the economic outlook, unprecedented rises in energy prices and continued supply chain disruptions.

2023 will be the fourth consecutive year in which this general safeguard clause has been activated. This activation does not imply the suspension of Stability and Growth Pact

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(SGP) procedures, but allows Member States to make the fiscal policy response more flexible to meet the challenges. The European fiscal supervision framework that will prevail when the general safeguard clause is deactivated, which is expected to take place in 2024, is yet to be defined. The review process was resumed at the end of last year and is still currently being debated.

The Government asked the Congress of Deputies to maintain the escape clause activated in 2023, in line with the EC decision. This is the third time that it has asked Congress to rule on the existence of the circumstances provided for in the Organic Law on Budgetary Stability and Financial Sustainability. The activation and maintenance of this escape clause has rendered without effect the fiscal rules for 2020, 2021 and 2022. AIReF already reported in 2020 and 2021 on the existence of exceptional circumstances in two reports on October 13th, 2020 and July 29th, 2021.

In this report, AIReF expresses its opinion again and considers that in 2023 the exceptional circumstances for maintaining the escape clause active are present as a result of the energy crisis and the uncertainty caused by the war in Ukraine. The tensions in global value chains and raw material markets that emerged in 2021 have intensified following the invasion of Ukraine, 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 for 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. AIReF believes that some of the risks identified in May are currently materialising, particularly those related to the energy emergency, as 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. 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 takes place in a context in which savings margins that 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 EC has made a proposal for a Council Regulation setting targets for reducing gas demand and the possibility of declaring, after consultation with Member States, a "Union alert", which would entail limitations on gas demand. Should this scenario materialise, ECB estimates suggest that euro area GDP could contract by 1.7%, compared with a 2.1% increase in the central scenario. Inflation would rise to 6.4% in 2023, compared with 3.5%. The effects would be very uneven between countries. In some economies

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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, in July AIReF worsened its estimate of the GG deficit from the 4.2% of GDP in 2022 forecast in its May report on the 2022-2025 Stability Programme (SPU) to 4.5%, with a reduction to 3% of GDP in 2025. The worsening is 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.

In the medium term, AIReF's estimates point to a more vulnerable fiscal position in terms of structural deficit and debt. In particular, the structural position of public finances will record a balance of -4% of GDP in 2025, which means an increase compared with the pre-pandemic position of over 0.5 points. Debt, which stood at 118% in 2021, will fall to 108.8% in 2025. From that year, maintaining a structural primary deficit of between 1.5% and 2.5% of GDP would initiate an upward trend in the path of the debt ratio. This is compounded by the existence of other risks relevant 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 of the population.

In this context, 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 level of debt, in line with the decisions adopted within the framework of European fiscal supervision.

Despite maintaining the safeguard clause in 2023, the European Union (EU) recommends that countries with high debt, including Spain, pursue a prudent fiscal policy. This translates into limiting the growth of nationally-financed current primary public expenditure in 2023 to a rate lower than medium-term potential growth, taking into account the changing situation, the need to increase green and digital public investment as well as energy supply security. Therefore, Spain will have to limit the growth of nationally-financed primary current expenditure in 2023. In its report on the 2022-2025 SPU, AIReF estimated growth in nationally-financed primary current expenditure in 2022 below the medium-term potential GDP benchmark. However, in the period 2023-2025, 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. According to AIReF, 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. Furthermore, this risk is amplified by the absence of a medium-term fiscal strategy.

In this regard, AIReF reiterates that under Spanish law the activation of the escape clause is associated with the approval of a rebalancing plan that must set out the correction of the structural deficit, taking into account the exceptional circumstance that

gave rise to the non-compliance. To date, the aforementioned plan has still not been presented despite the activation of the clause in October 2020. AIReF considers that the preparation of a medium-term plan is an essential element in the strategy of recovery and strengthening of medium-term growth by contributing to providing security and transparency for all economic agents and allowing greater control of budget execution and implementation and impact of the measures adopted.

Recommendations

In this context, AIReF once again recommends that the Government 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 GG. This requires involving all tiers of government, making fiscal targets and milestone schedules explicit, including a time horizon that is long enough to place debt on a path that will reduce its level of vulnerability, integrating the macroeconomic and fiscal implications of the RTRP, and basing the strategy on realistic macroeconomic and fiscal forecasts.

Since the activation of the escape clause in 2020, AIReF has repeatedly recommended that the Government establish this fiscal strategy. The Government considers that it is implementing the recommendation through the different processes that affect the configuration of the public accounts, such as the Stability Programme Update (SPU). However, AIReF considers that the content of the SPU sent to the European institutions is far from a comprehensive medium-term fiscal strategy, as it has already said on numerous occasions.

According to AIReF, the absence of a medium-term fiscal strategy 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 growth and allowing public debt to be brought to levels that mitigate the vulnerability of the Spanish economy to future crises.