

ENDORSEMENT OF THE MACROECONOMIC FORECASTS OF THE DRAFT GENERAL STATE BUDGET FOR 2023

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Autoridad Independiente
de Responsabilidad Fiscal



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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ENDORSEMENT OF THE MACROECONOMIC FORECASTS OF THE DRAFT GENERAL STATE BUDGET FOR 2023

The Independent Authority for Fiscal Responsibility, AAI (AIReF) has received the Government's request for a report on the macroeconomic scenario that will be incorporated into the draft General State Budget for 2023 (2023 GSB). Article 14 of Organic Law 6/2013, of November 14th, on the establishment of AIReF provides that the General Government must request that AIReF issue a report on the macroeconomic forecasts to be incorporated in the draft budget or in the Stability Programme Update (SPU), indicating therein whether such forecasts are endorsed.

The purpose of this report is to verify that the budgetary scenario is based on realistic macroeconomic forecasts. AIReF's assessment of the GSB, as fiscal supervisor, starts with an analysis of the Government's macroeconomic scenario in order to verify that the budgetary forecasts of revenue and expenditure are based on reasonable macroeconomic variables within the current uncertainty regarding the national and international context.

For these purposes, and without prejudice to the implications of their composition in the medium term, the relevant variables are not only real growth and employment, but also those expressed in nominal terms. In particular, tax revenues are correlated with the evolution of different components of GDP in current terms with an elasticity that in the last two years is well above the historical average. For its part, some expenditure, such as pensions, are indexed to inflation.

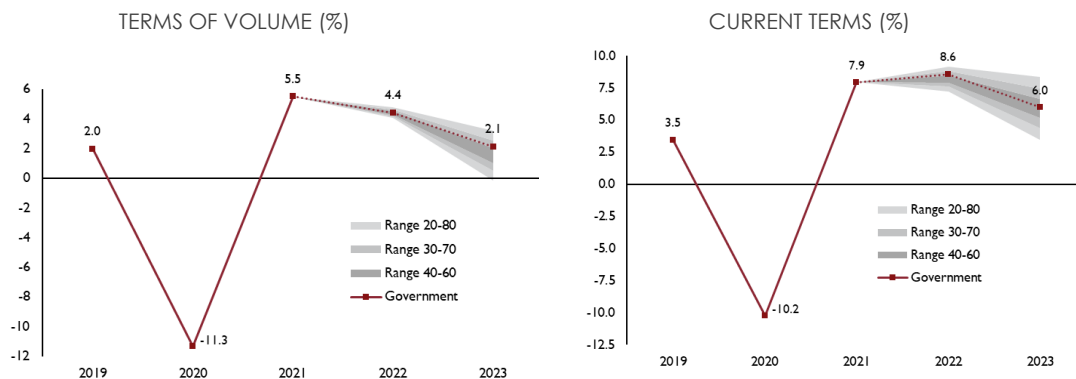
AIReF endorses the macroeconomic scenario that accompanies the 2023 GSB as it considers that both the GDP growth path and the inflation forecasts are feasible, although there are significant downside risks in the case of the former.

The Government's scenario assumes real GDP growth of 4.4% in 2022 and 2.1% in 2023. By component, this slowdown is based on a lower contribution of the external balance to growth which, after contributing 2.9 pp in 2022, would have a negative contribution in 2023 (-0.3 pp). According to the Government's forecasts, this behaviour would be partially offset by the evolution of domestic demand, which would contribute 2.4 pp in 2023 compared with 1.5 pp in 2022, due to the expansion of gross fixed capital formation, especially in construction.

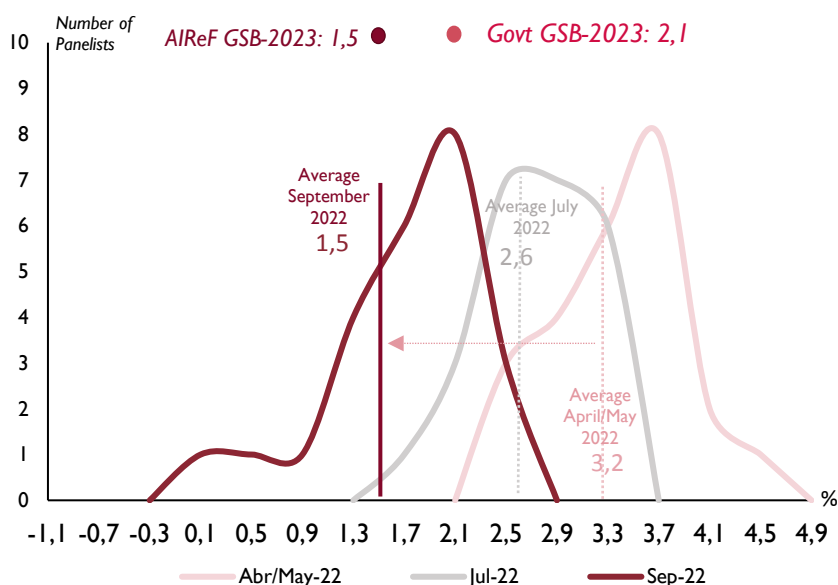
Private consumption would maintain moderate growth rates in both years. This scenario of moderate growth would be accompanied by a stagnation of full-time equivalent employment, while the unemployment rate would stand at 12.2% of the active population in 2023 - compared with the 12.8% that the Government expects on average for 2022. Regarding prices, the Government's scenario envisages a slight reduction in the GDP deflator in 2023 to 3.8%, compared with the 4% expected for 2022, in a scenario of a sharp deceleration of the private consumption deflator.

AIReF believes that downside risks to the economic growth estimated by the Government will predominate in 2023. Real growth estimates are in the upper range of the probability intervals estimated by AIReF on the basis of its own forecast scenarios, while GDP deflator estimates are in the central range (see Figure 1). These forecasts will be published shortly with the report on the 2023 GSB and suggest real growth for 2023 of 1.5% and an increase in the GDP deflator of 4.3%. In addition, real growth forecasts are also above the average of the most recent estimates made by the leading analysts (see Figure 2).

FIGURE 1. GROSS DOMESTIC PRODUCT GROWTH FORECASTS



Source: National Statistics Institute, Ministry of Economic Affairs and Digital Transformation and AIReF.

FIGURE 2. COMPARISON OF GDP GROWTH FORECASTS IN TERMS OF VOLUME FOR 2023


Source: forecasting panels, and AIRcF.

Note: the averages and distributions have been calculated using only those entities that had issued new forecasts in September.

The energy crisis has led to a deterioration in the growth prospects of the major advanced economies and an increase in gas prices higher than that set out in the technical assumptions of the Government's scenario. In particular, the assumptions about the growth of European economies in the Government's scenario come from the forecasting exercise prepared by the ECB at the beginning of September, just before the Russian gas supply was cut off. Since then, there has been a marked deterioration in growth prospects in the United States, China and all European economies as a result of the cut-off of the supply of Russian gas and the uncertainty about the course of the war in Ukraine, as reflected in the most recent forecasts of the OECD and other public and private institutions. The downward revisions in expected growth are significant in the case of Germany, which is noteworthy given the close interrelationships of this country with the other European economies and, in particular, its weight in Spanish exports (approximately 10% of goods exports and 11% of service exports in 2021). In addition, gas prices in futures markets for 2023 are higher than those included in the Government's assumptions, although volatility in recent months has been high - at September 30th, natural gas futures for 2023 were around €150/MWh in the national market, compared with €118.8/MWh in the scenario of the 2023 GSB.

The escalation of geopolitical tensions with Russia and the difficulties of European economies in managing the energy crisis pose additional risks to the economic growth considered in the Government's scenario, and also in AIReF's. There is a great deal of uncertainty about whether European economies will be able to find alternative energy sources to Russian gas at reasonable prices and whether energy-saving measures will be effective. So far, all forecasting scenarios for European economies are based on the assumption that no widespread rationing of energy demand will be necessary in the coming months. The risk scenarios that relax this hypothesis suggest that European economies could experience a contraction in activity in 2023, which would affect Spain's growth path, even if it has more secure energy supplies. Also noteworthy are the warning signs issued by the European Systemic Risk Board that more recent geopolitical developments have exacerbated the risk of extreme scenarios that could endanger the solvency of families and companies and the stability of the entire financial system. Furthermore, high food and fertiliser prices raise the risk of a food crisis in some emerging economies. On the positive side, the set of measures being introduced by some European economies to mitigate the impact of the energy crisis on economic activity could cushion the fall in their activity.

At a domestic level, the deterioration in the purchasing power of households and confidence is another source of downside risks. Despite the favourable performance of employment, the deterioration in the purchasing power of Spanish households as a result of the fall in real wages is high. In the first half of 2022, there was a contraction in real compensation per employee of close to 6%, thus exceeding the contraction of 5.2% recorded in the fourth quarter of 2012. In addition, a rapid tightening of financing conditions is taking place. This, coupled with the deterioration in their confidence - which stands at levels similar to those observed in the months of strict lockdown at the start of the pandemic - could lead to a greater increase in savings for precautionary reasons than that considered in the Government's scenario.

Regarding prices, the Government's forecasts seem reasonable since the base effects on energy and the outlook for decelerating global demand lead to inflation being expected to fall in 2023. In particular, the slowdown in global demand is easing supply problems in global value chains and has led to a fall in non-energy raw material prices and oil prices in international markets. In addition, high inflation rates have led to a rapid tightening of monetary policy at a global level with the aim of avoiding de-anchoring of expectations and to avoid wage and price spirals.

In addition, measures have been taken by the Government and other countries to limit the rise in energy prices. All this explains the slowdown in inflation included in the Government's macroeconomic scenario. However, the persistence of high inflation rates raises the risk that companies and households will try to recover their margins and their purchasing power.

Compared with the Government's scenario, AIReF estimates a lower impact on economic growth associated with the Recovery, Transformation and Resilience Plan (RTRP). The estimates recently presented by the Ministry of Economic Affairs and Digital Transformation suggest that, since the start of 2021, the Plan would have increased economic growth, based on a strong effect on agents' expectations. The materialisation of investment calls would have gradually taken over from the impact on expectations over 2022 and 2023. The above is in addition to the impact of the reforms implemented, which, according to the ministerial department, would raise GDP in 2022 by 0.6 points, and by almost 1.3 points in 2023. Overall, the RTRP would have increased the level of GDP by 0.7 pp in 2021, 1.9 pp in 2022 and 2.8 pp in 2023, compared with a scenario without the Plan. In contrast, AIReF estimates that in 2021 the impact would have been practically zero due to the delay in the materialisation of the investments, while an impact of 0.8 pp in 2022 and 2 pp in 2023 on the level of GDP is estimated compared with a scenario without the Plan. Unlike the Government, AIReF does not consider that the Plan could have had a major impact on agents' expectations nor has it incorporated in its estimates the potential impact associated with the reforms implemented and, in particular, with the labour market reform, until a complete diagnosis is available based on evidence of its effects on the economy's capacity to create jobs and the nature of the employment created. Finally, information in national accounting terms is not yet available to approximate the rate at which the investments associated with the RTRP are materialising.

Summary and recommendations

Based on all these considerations, AIReF estimates that the macroeconomic scenario that underpins the draft General State Budget for 2023 is achievable. The Government's scenario is within the confidence bands estimated by AIReF, although it should be noted that these bands, prepared using statistical criteria, do not reflect that the main sources of uncertainty currently existing pose downside risks to economic growth. Particularly noteworthy is the recent escalation in geopolitical tensions and uncertainty about the ability of European economies to find alternative energies to Russian gas that are sufficient to avoid rationing energy demand and the persistence of high energy prices, which could result in a contraction in activity. The high inflation rates prevailing in the EMU are leading to a rapid tightening of the financing conditions of the economy and a squeezing of financial and debt markets, while at the same time accentuating

the loss of the purchasing power of households. All these elements pose downside risks regarding the growth expected by the Government and by AIReF itself for 2023. As regards prices, risks are more balanced as the tensions associated with the energy crisis could be offset by the deceleration of global demand that would mitigate supply problems in value chains and prices of other non-gas raw materials.

AIReF makes three recommendations:

- 1. Firstly, a new recommendation is made for the Ministry of Economic Affairs and Digital Transformation to consult AIReF on the Report on the Situation of the Spanish Economy prepared by that ministerial department as provided for in Article 15.5 of Organic Law 2/2012, of April 27th, on Budgetary Stability and Financial Sustainability.** This Law establishes that the Ministry of Economic Affairs and Digital Transformation will prepare an annual report, after consulting the Bank of Spain and taking into account the forecasts of the European Central Bank and the European Commission. This report is the basis for setting the budgetary stability and public debt targets which constitute the first step in the preparation of the draft General Government Budget, which must be in line with these targets. This report, which is drawn up around June or July, contains an estimate of the multi-year economic scenario that serves as a basis for drawing up the GSB and which many administrations take as a starting point for preparing their own macroeconomic and budgetary scenarios. Therefore, AIReF should be able to issue its opinion given that two or three months later it has to endorse the macroeconomic scenario when the budgets are already drawn up.
- 2. AIReF reiterates to the Ministries of Economic Affairs and Digital Transformation and of Finance and the Civil Service the need to have appropriate information on the budgetary and fiscal measures incorporated into the macroeconomic scenario in order to increase the rigour of the endorsement process.** The purpose of AIReF's endorsement is to verify that the fiscal scenario is based on realistic macroeconomic forecasts. Therefore, given the interrelations between the macroeconomic outlook and the fiscal scenario, AIReF believes that a rigorous endorsement requires an understanding of the revenue and expenditure path that accompanies the Government's macroeconomic outlook and detailed information on the fiscal measures that it intends to incorporate into the budget.

3. **Finally, AIReF reiterates to the Ministry of Economic Affairs and Digital Transformation the need for the process of endorsing the macroeconomic forecasts to be regulated by an agreement between the parties.** Most EU countries have signed and published a “Memorandum of Understanding” between the Government and the independent fiscal institution in order to agree on the necessary procedures, deadlines and exchanges of information during the process of endorsing the macroeconomic forecasts. With the aim of making the process of endorsing the macroeconomic framework more transparent and efficient, AIReF reiterates its recommendation to the Government to regulate, in line with best practices in peer countries, the flow and timing of the exchange of information through an agreement or “Memorandum of Understanding”.

The President of AIReF

A handwritten signature in blue ink, consisting of a large, stylized initial 'C' followed by a series of loops and a long horizontal stroke.

Cristina Herrero Sánchez