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## AIRF ENDORSES MACROECONOMIC FORECASTS OF BUDGETARY PLAN BUT WARNS OF DOWNSIDE RISKS

- AIRF notes that the Government's nominal growth estimate is in the central range of the probability intervals of its scenario, albeit at the upper limit, which indicates downside risks
- Overall, AIRF sees the growth in domestic demand expected by the Government as optimistic, given the tightening of the financing conditions of the economy, the end of the measures to mitigate the impact of inflation and the worsening of business and household confidence
- As regards prices, the Government's scenario forecasts higher growth in the GDP deflator than estimated by AIRF
- AIRF underlines the uncertainty of the geopolitical context due to the war in Ukraine and the war between Gaza and Israel, along with the weakness of China
- AIRF issues a new recommendation on the need to publish the Report on the Situation of the Spanish Economy provided for in the Law on Budgetary Stability, including the reference rate of the expenditure rule which serves as the basis for the preparation of the budgets of the Autonomous Regions (ARs) and Local Governments (LGs)
- It also reiterates previous recommendations, such as regulating the endorsement process by means of an agreement between the parties

The Independent Authority for Fiscal Responsibility (AIRF) endorses the macroeconomic scenario that accompanies the Budgetary Plan for 2024, which provides for real GDP growth of 2.4% in 2023 and 2% in 2024. These figures are in the central range of the probability intervals prepared by AIRF, based on its own scenarios. As regards prices, the Government's scenario maintains high growth rates of the GDP deflator in both 2023 and 2024 (of 5.9% and 3.6% in 2023 and 2024, respectively), compared with 5.8% and 3.2% forecast by AIRF. This means that, in nominal terms, the Government's forecasts stand within the central intervals of the bands estimated by AIRF, albeit at the upper limit, which indicates the potential existence of downside risks.

AIRF's endorsement only relates to the macroeconomic scenario and does not amount to an endorsement of the Budgetary Plan, regarding which, once AIRF sees the content thereof, it will prepare the corresponding report within the legally established deadlines. The purpose of this report is to verify that the macroeconomic forecasts, which underpin the budgetary projections of revenue and expenditure contained in the Budgetary Plan,

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are reasonable given the uncertainty that exists at this time in both national and international contexts. To this end, an assessment is made of not only the real growth and expenditure, but also of the macroeconomic aggregates in nominal terms, given the high correlation between tax revenue and the evolution of different components of GDP in current terms and of some spending items, such as pensions.

### **Downside risks**

Despite endorsing the forecasts, AIRF considers that downside risks predominate in 2024 on the economic growth estimated by the Government. In particular, the Government's macroeconomic scenario includes a significant acceleration of private consumption which may be optimistic in a context of waning consumer confidence and the tightening of financing conditions for households. Furthermore, gross fixed capital formation is expected to rise significantly in 2024, which also entails downside risks given the impact that the tightening of financial conditions may have on business investment against a backdrop of worsening foreign trade, in particular in the euro area, and in the demand for residential property.

The Government's scenario forecasts a negative contribution from the foreign sector to growth, more than offset by the strong evolution of domestic demand. Overall, AIRF considers that the growth in national demand expected by the Government for 2024 is optimistic, given the tightening of the financing conditions of the economy, the withdrawal of the measures introduced to mitigate the impact of inflation and the worsening of business and household confidence. In this regard, it is key that the investment projects associated with the Recovery, Transformation and Resilience Plan (RTRP), the effect of which on the real economy is subject to significant uncertainty, are suitably rolled out.

As regards prices, the Government's scenario points to growth in the GDP deflator of 3.6% in 2024, underpinned by growth in salaries slightly below inflation and in the expansion of business margins. AIRF considers that the rise in domestic prices could be somewhat more moderate than the Government's forecast, due to the slowdown of economic activity and the impact of the rises of the reference interest rates of the European Central Bank and the measures to reduce the liquidity of the economy. Furthermore, the Government's scenario includes an improvement in the real terms of trade of the economy, which is subject to risks, given the tensions that persist in the raw materials markets, particularly the energy markets.

AIRF stresses the prevailing uncertainty at this time associated with the geopolitical context. The persistence of the war in Ukraine, and the breakout of war in Israel, may lead to a higher increase and greater price volatility of energy raw materials in the coming months regarding the external assumptions under which the Government has prepared its scenario. Furthermore, the weaknesses of China – an economy that has contributed significantly to global growth and the expansion of trade in recent decades – points to downside risks in regard to foreign trade growth, although the direct exposure of Spanish exports to this economy is not high.

### **Recommendations**

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In this context AIRF issues a new recommendation to the Ministry of Economic Affairs and Digital Transformation to publish the Report on the Situation of the Spanish Economy provided for in Article 15.5 of Organic Law 2/2012, of April 27<sup>th</sup>, on Budgetary Stability and Financial Sustainability (LOEPSF) and include the reference rate of the expenditure rule for 2024. This report has not yet been published, which is fundamental for the process to prepare the budgets of the different Autonomous Regions and Local Governments which, for the time being, only include the existing reference contained in the 2023-2026 Stability Programme Update. In the case of the Autonomous Regions, the reference rate corresponds to a situation of budgetary balance and, in the case of the Local Governments (LGs), to a surplus of 0.2% of GDP.

In this regard, AIRF considers that the risk exists that the ARs and LGs prepare their budgets with the sole reference to the budgetary balance, but without taking into account that part of the revenue they will receive under the financing system in 2024 is temporary, which would mean they undergo growth in primary spending net of revenue measures, without the RTRP and without REACT, of around 7% and 9% respectively. This very high margin for growth in spending in 2024 without the existence of the limitation that may derive from the expenditure rule could compromise the fiscal path in the future and mean that spending is strictly contained, which is hard to implement in practice.

AIRF also reiterates three recommendations, of which two are live. It reiterates the recommendation made in the Report on the Endorsement of the General State Budget (GSB) for 2023 (published on October 4<sup>th</sup>, 2022), on the need for the Ministry of Economic Affairs and Digital Transformation to also consult AIRF before issuing the Report on the Situation of the Spanish Economy. It should also consult the Bank of Spain and take into account the forecasts of the European Central Bank and the European Commission. It also maintains live the recommendations on the need to regulate the endorsement process by means of an agreement between the parties and to provide more information on the measures of a budgetary and fiscal nature included in the macroeconomic scenario with a view to making the endorsement process more thorough.