

EXECUTIVE SUMMARY ON THE 2020 - 2021 STABILITY PROGRAMME UPDATE



EXECUTIVE SUMMARY

The Independent Authority for Fiscal Responsibility (AIReF) must report on the content of the 2020-2021 Stability Programme Update (SPU), both in terms of its macroeconomic projections and its fiscal scenario, in accordance with the mandate of articles 14 and 16 of Organic Law 6/2013 on the creation of AIReF.

After an initial analysis of the Government's macroeconomic forecasts, this report provides a comprehensive assessment of the SPU. On 30th April AIReF anticipated its endorsement of the macroeconomic scenario, enabling it to be included in the SPU for its referral to the relevant European institutions. With this comprehensive report on the SPU, AIReF has evaluated the Public Administrations' (PAs) initial budgets for 2020, which had been delayed due to the current exceptional situation and the fact that the 2020 General State Budgets haven't yet been presented and approved. However, uncertainty regarding the impact of the crisis on the Regions and the distribution of non-reimbursable funds announced by the Government has forced the individual reports for each of the Regions to be postponed.

The health crisis caused by COVID-19 is having a profound impact on both the Spanish and global economy, with indisputable negative effects on public accounts. Furthermore, this impact is subject to extreme uncertainty, which complicates the task of preparing economic and fiscal forecasts. This has led several institutions, including AIReF, to adapt their tools to the new reality.

AIReF has adapted its analysis framework and developed macroeconomic and fiscal scenarios in response to the current circumstances. Increased uncertainty means that a scenario-based analysis is preferable to traditional forecasts with confidence intervals. In the current context it is sensible to present scenarios based on different assumptions about factors that are subject to a high degree of uncertainty, such as the evolution of the pandemic or the speed of

economic recovery. These scenarios offer an overview of the main variables and help to identify the channels of transmission of the crisis. This is essential for designing measures and strategies without entering a fruitless debate about numbers or decimal places that are currently difficult to quantify.

AIReF has adopted a broader temporary view than the SPU and has also extended its quantitative fiscal analysis to 2021. Utilising the flexibility permitted by the European Commission, the SPU has limited the quantification of its fiscal prospects to cover 2020. Despite the existing uncertainty and the need to focus on the short-term response to this health, social and economic crisis, AIReF believes that we should not lose sight of a more long-term perspective and should also consider the medium-term sustainability of public finances. Both the crisis and the measures taken to tackle it have an impact that reaches beyond the year 2020. When short-term pressures have eased, AIReF believes that a focus on more long-term consequences of the crisis is needed. In the case of public finances, this requires the adoption of a fiscal strategy to ensure their sustainability.

In any case, the situation of extreme uncertainty means that the 2020-2021 estimates from both AIReF and other institutions, including those covered by the SPU, should be treated with greater caution than usual. These estimates should be subjected to continuous review, based on any new information that may become available.

Is the Government's macroeconomic scenario plausible?

AIReF considers the macroeconomic scenario of the Stability Programme Update to be reasonable against the backdrop of great economic uncertainty caused by the global spread of the new coronavirus.

On 30th April, AIReF endorsed the forecasts ([AIReF endorsement](#)) on the assumption that the Government's hypotheses on the evolution of the pandemic are accurate, and that the macroeconomic policy measures considered are those that are currently approved.

However, the high degree of uncertainty opens up several possible scenarios. AIReF believes that there are increased downside risks associated with the possibility of more adverse epidemiological scenarios. A further downside risk is the possibility of persistent damage to the economy's productive capacity and to employment, which would hinder the recovery of both demand and activity when restrictions end. AIReF has tried to reflect these risks by designing scenarios contingent on the duration of the pandemic.

Why has AIReF developed its own macroeconomic scenarios this year?

The coronavirus pandemic has, and continues to have, an extraordinary human and social cost, also resulting in extreme, global and synchronised economic disruption. This has increased uncertainty to unusual limits.

In this context, preparing macroeconomic forecasts and allocating probabilities to specific scenarios, as AIReF had done previously when assessing the macroeconomic scenario of the SPU, is a very complex task. The first element of uncertainty is the difficulty in determining the duration of the health crisis and the degree to which economic activity will return to normal once the epidemic has been controlled. In addition, there is a lack of sufficient indicators and benchmarks to help determine the economic impact of the pandemic. Furthermore, the models usually used to estimate and project the evolution of the economy using empirical regularities are less reliable in the face of such exceptional shocks.

This is why AIReF has decided to prepare its own scenarios, to be better able to assess the macroeconomic scenario of the SPU.

What macroeconomic scenarios does AIReF present and what are the main results?

AIReF has established two Gross Domestic Product evolution scenarios, based on assumptions about i) the duration of the pandemic, which will determine the initial impact on the added value of the sectors considered in the scenarios; and (ii) information to be able to form opinions about the influence that certain structural characteristics of the economy exert on its ability to recover. The scenarios also include the macroeconomic impact of the economic policy measures implemented so far. AIReF's quarterly model is used to ensure the consistency of all these elements.

The first scenario, based on simulation models, established the hypothesis that the epidemiological findings would allow restrictions to begin to be relaxed in mid-May. But a more adverse second scenario was also considered, in which the measures to confine the population and restrict economic activities would carry on for a further month.

Quantifying the impact of these assumptions on GDP is based on an initial calculation on the impact that the period of confinement and economical hibernation has had on the added value of different sectors. AIReF's calculations suggest that control measures could subtract 0.8 points from GDP growth for each week of strict confinement and 1.5 points for each week of non-essential activity restrictions. This calculation is based on a hypothesis on the degree of

impact on the added value of each sector. This reflects the fact that the various sectors' activities have different characteristics that mean that containment measures have a very heterogeneous impact on them. These assumptions lead to an estimated fall in production, in terms of supply, of -8.7% in the more benign scenario and -12.8% in the more adverse scenario.

IMPACT OF SOCIAL DISTANCING MEASURES IN TERMS OF SUPPLY (STARTING POINT OF THE ESTIMATE FOR AIREF'S SCENARIOS)

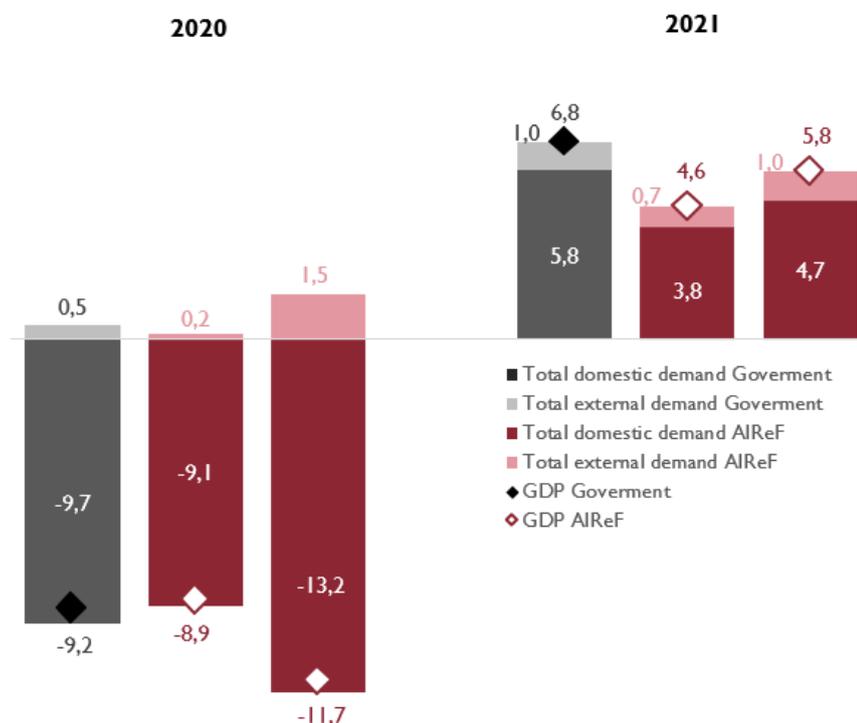
	Consensus Estimate Previous to COVID-19 Outbreak	Initial State of Alarm (15-mar 27-mar)	Essential Activities (28-mar 14-apr)	State of Alarm (14-apr 15-may)	Additional Impact on Tourism Sector Rest of 2020	Additional Impact after 15th May in the rest of Sectors Rest of 2020	Estimated Initial Impact
Scenario 1	1,6	-1,6	-3,1	-4,0	-1,6		-8,7
Scenario 2	1,6	-1,6	-3,1	-4,0	-1,6	-4,0	-12,8

Source: AIReF.

In addition to the intensity of the downturn in 2020, another fundamental element in defining the two scenarios is the projected speed of recovery. In this area, AIReF has incorporated two nuances into its scenarios. Firstly, AIReF makes an assumption that, in both cases, the Spanish economy presents some structural features that will make recovery slow and gradual, meaning that it will take several quarters to recover the previous level of GDP. These features are mainly related to its specialisation in manufacturing, the segmentation that continues to exist in the labour market and the high proportion of micro- and small companies that are, in principle, more vulnerable to financial constraints. Secondly, the more adverse scenario is based on the assumption that a longer lasting pandemic will lead to increased financial hardship for companies and households and lower world trade growth, which is only implemented in this scenario through an additional shock in employment, investment and exports.

The scenarios' main results are presented in the following figure, compared to the Government's sole macroeconomic scenario.

GROSS DOMESTIC PRODUCT AND CONTRIBUTIONS TO THE GROWTH OF NATIONAL AND EXTERNAL DEMAND



Source: *Ministerio de Asuntos Económicos y Transformación Digital* (Ministry of Economic Affairs and Digital Transformation) and AIReF's estimates.

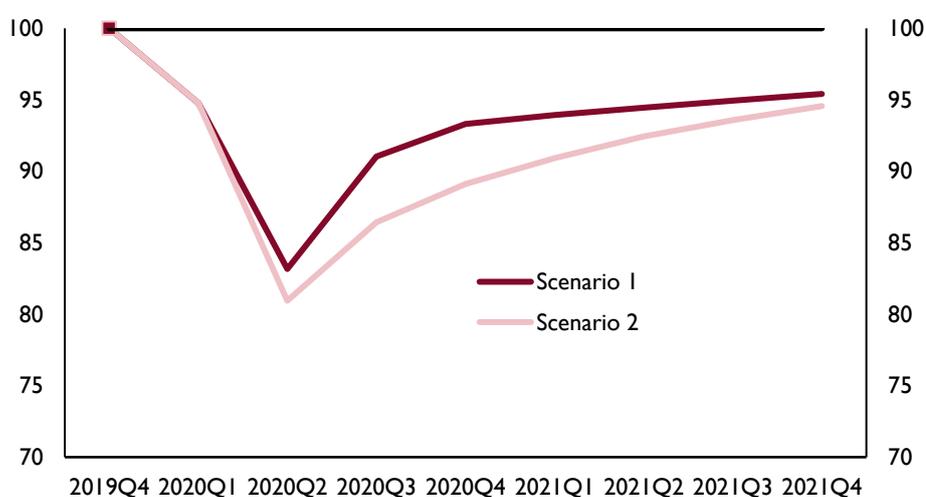
Based on its scenarios, under the assumption that the SPU's pandemic containment timeline is accurate, AIReF considers the scenario envisaged for 2020 to be reasonable. In fact, the SPU's forecasted GDP contraction (-9.2%) is similar to that of AIReF's most positive scenario (-8.9%), which broadly incorporates common assumptions on the duration of the pandemic. The SPU fairly reflects the decrease in domestic demand and employment caused by social distancing measures and the paralysis of some economic activities, along with a fall in exports against the backdrop of a global recession. However, the breakdown by components analysed in the report reveals notable discrepancies in public consumption estimates, which increases at a much lower rate in the SPU. This contrasts with the increased spending on medical equipment and the staff hires needed to cope with the public health threat posed by the coronavirus.

All in all, in the event of more adverse epidemiological scenarios, the contraction in activity and employment could be more intense in 2020. According to AIReF's estimates, GDP could decline by about 12% in 2020 if the containment measures continue for one more month.

Beyond 2020, AIReF considers that the SPU's recovery path is subject to significant downside risks, even if its hypotheses on the epidemic are accurate. More specifically, the SPU predicts an "asymmetric V" shaped

recovery. This would mean that the economy's gross domestic product would recover to almost the level recorded prior to the crisis by the end of 2021. In other words, the income level would recover within just six quarters. AIReF identifies downside risks with this path. Its scenarios predict that GDP would be around 5 points below pre-crisis levels at the end of 2021. The very rapid recovery of investment and employment included in the SPU is especially notable in the current context of uncertainty.

VARIATION IN THE LEVEL OF GDP COMPARED TO FOURTH QUARTER OF 2019

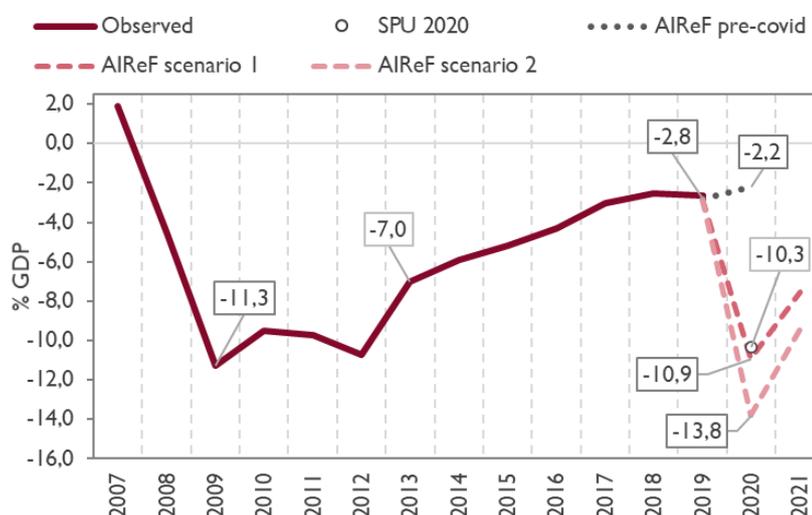


Source: *Instituto Nacional de Estadística* (National Statistics Institute - INE) and AIReF's calculations

How will COVID-19 impact public accounts?

AIReF estimates that the public deficit will be between 10.9% and 13.8% GDP in 2020, depending on which scenario arises. In this financial year, the COVID-19 crisis would trigger an increase in the public deficit of between 8.8 and 11.6% GDP compared to its pre-pandemic forecast, which AIReF estimated at 2.2% GDP.

NET LENDING/BORROWING CAPACITY OF PAs (%GDP)



This impact on the deficit is broken down into three factors: the denominator effect that is the result of a notable decline in GDP; the effect of the Government's measures to alleviate the pandemic and its effects on the economy; and the macroeconomic effect of the increase in expenditure and decrease in revenue caused by reduced economic activity during the pandemic.

Firstly, the denominator effect entails a deficit increase of 0.9-1.4% GDP due to the increase in expenditure over of 5.6-7.4% GDP, offset by the increase in revenue of 4.7-6.0% GDP.

Secondly, according to AIReF's estimates, the measures taken to date represent an increase in the deficit of 3.3-4.2% GDP. According to AIReF's preliminary estimates based on information provided by some administrations, the COVID-19 health crisis will result in an increase in healthcare expenditure of 0.6-0.9% GDP. On the other hand, income replacement measures, such as those related to the *Expedientes de Regulación Temporal de Empleo* (Temporary Redundancy Plans - ERTE) or the benefit granted to self-employed workers who have had to stop working, represent the greatest discretionary impact on public accounts, with an estimated cost of 2.4-2.9% GDP. Measures to defer and postpone tax obligations and social security payments have also been taken, although most of these would not have a direct impact on the 2020 public accounts, only changing the monthly revenue profile. In addition, measures supporting the liquidity of companies and individuals are not calculated as deficit, although they generate

contingent liabilities that require appropriate and transparent management.

Most of the measures adopted (around 95%) are temporary and will revert automatically, therefore not resulting in additional expenditure in coming years. Meanwhile, the permanent measures adopted so far will have a limited impact on the deficit.

Finally, the impact of the COVID-19 crisis on economic activity, excluding the effect of measures, will increase the deficit by 4.6-6.0% GDP, depending on which scenario occurs. The decrease in economic activity will lead to a 5.9-9.1% reduction in revenue compared to 2019; the pre-pandemic scenario expected an increase of 5%. Therefore, revenue will fall by €30,000-45,000 million compared to 2019 in nominal terms, despite the measures taken. For some taxes, such as Personal Income Tax (PIT) and Corporate Income Tax (CIT), the 2020 decrease will be partially offset by the annual declarations, which involve the liquidation of tax periods prior to the crisis. Meanwhile, other taxes such as VAT or social contributions reflect current economic developments more accurately.

The impact on expenditure is expected to be lower, with an increase of 3.3% in the pre-crisis scenario rising to 4.4-4.8%, essentially due to unemployment levels. In this sense, the measures taken and the action of automatic stabilisers clearly complement one another in the case of unemployment benefits, meaning that the measures are absorbing part of the increase in expenditure.

As a result, AIReF estimates that revenue will be 39.5-39.4% GDP in 2020. Both these predictions are below the SPU's prediction of 41.2%. For its part, expenditure is expected to increase to 50.4-53.2% GDP, with the SPU's estimate of 51.5%, falling between the two scenarios.

Despite the temporary nature of the health crisis, AIReF estimates that the public deficit will be 7.5-9.4% in 2021. The recovery of economic activity in 2021 will not be enough to reverse the macroeconomic impact of the crisis on public accounts. In contrast to the effects of most of the measures, collection and unemployment benefits will not be able to recover to the levels seen before the crisis in 2021. In this case, the annual PIT and CIT declarations in 2021 will still be recovering from the impact of the pandemic, thereby limiting the growth of collection.

How will the crisis affect each sub-sector of the PAs?

All sub-sectors' fiscal balance will deteriorate, although the *Administración Central* (Central Government - CG) and *Fondos de la Seguridad Social* (Social Security Funds - SSF) will experience the greatest impact. On the one hand, the CG suffers more from the

reduction in revenue resulting from a drop in economic activity, an effect that is exacerbated by the decision to not adapt the instalment payments of the territorial administrations' financing system to a more realistic revenue estimate. This allows Regions under the common tax regime to partially offset the deficit increase, primarily due to the health expenditure increase caused by the crisis. However, this will mean that payments will decline significantly in 2021; while in 2022 there will be increased liquidation in favour of the State due to the difference in instalment payments in 2020 and actual revenue.

Meanwhile, the deterioration of SSF accounts is mainly explained by the measures adopted, but also by a decrease in social security contributions in line with the loss of employment. Although the impact is lower for the Local Governments (LGs), the surplus obtained in recent years may disappear, or even fall into a deficit.

However, the distribution of the deficit between sub-sectors will ultimately depend on the transfers between PAs. On the one hand, the CG has announced a non-refundable transfer of €16,000 million to the Regions. Along with lack of update to instalment payments, this will mean that the sub-sector will be nearly balanced in 2020 and there will be a sharp decrease in revenue in 2021. On the other hand, the deficit of the State Public Employment Service (SEPE) is financed by transfers from the CG, although none have been announced to date. Both extremes would lead to a greater deficit for the CG and lower deficit for the SSF and the Regions.

PUBLIC ADMINISTRATIONS' DEFICIT IN THE 2 SCENARIOS (%GDP)

	2019	Scenario 1		Scenario 2	
		2020	2021	2020	2021
PAs	-2,8	-10,9	-7,5	-13,8	-9,4
CG	-1,3	-4,5	-2,5	-5,6	-3,0
SSF	-1,3	-5,0	-3,1	-6,1	-3,9
Regions	-0,5	-1,5	-1,8	-2,0	-2,3
LGs	0,3	0,0	-0,1	-0,1	-0,2

Is the SPU's macroeconomic and fiscal scenario consistent?

The SPU's fiscal forecasts do not seem completely consistent with the SPU's macroeconomic scenario. On the expenditure side, the macroeconomic scenario reflects a 4.8% growth in public consumption, which is lower than and apparently incompatible with the growth estimated for compensation of employees (6.1%), intermediate consumption and social transfers in kind (8.6%), which are its main components. On the revenue side, AIRcF's models have estimated that the revenue level that would be achieved based on the SPU's macroeconomic assumptions would create a revenue level of

40% GDP, lower than the SPU's predicted 41.2%. Therefore, if the SPU's macroeconomic scenario materialises, the PAs' deficit would be greater.

What are the implications in terms of the sustainability of public finances?

AIReF predicts a 20-27% increase in the debt-to-GDP ratio in 2020, with an additional 2% increase in 2021. This means the debt-to-GDP ratio will be 115-122% GDP in 2020 and 117-124% GDP in 2021. Primary deficit accumulation will be the factor that most contributes to this increase.

The SPU only presents a projection of the debt-to-GDP ratio for 2020, placing it at 115.5% GDP. This estimate is in line with AIReF's most positive scenario.

Although current economic prospects are surrounded by an unprecedented uncertainty, its high impact on debt levels is certain. The spread of COVID-19 will cause a sharp and, in principle, temporary, increase in the public deficit, which in turn will lead to a permanent increase in the debt-to-GDP ratio.

The starting fiscal position represents an added difficulty in meeting the challenges posed by the crisis. AIReF's simulations indicate that in order to keep the 2021 debt level stable in 2030, a fiscal consolidation exercise similar to the one carried over the past decade will have to be carried out over the coming decade, to reach budgetary balance in 2030. In addition, budgetary balance would have to be maintained for almost another decade in order to fully digest the consequences of this crisis and return to the previous debt-to-GDP ratio of 95.5% in 2038.

What are AIReF's recommendations?

The national and European fiscal framework allows flexibility for this exceptional situation. The European Union has already made use of this flexibility, and Spain should follow suit. In March, ECOFIN backed the activation of the EU's general escape clause, created for situations of severe economic recession within the euro zone or the EU. For countries in a preventive situation (currently all countries), its activation allows for temporary deviations from the medium-term budgetary objective, or from the adjustment path towards this. The Spanish Government indicated in the SPU that it will initiate procedures to declare an extraordinary situation, once the Commission's pronouncement and proposal for guidelines and recommendations have been published.

There is no doubt that the short-term requirements to protect against the effects of COVID-19 on health, society and the economy require unprecedented measures at both the national and European level. This short-term response now takes precedence over other considerations.

However, both the national and European fiscal frameworks are not losing sight of the impact on the sustainability of public finances. At the European level measures are expected to be timely, temporary and selective. Activation of the escape clause facilitates a coordinated and temporary deviation. It also allows the Commission and Council to take their guidance into account, considering the impact of measures on both the response to the consequences of the pandemic and the medium-term sustainability of public finances. Nationally, there is also the possibility of temporary deviation without jeopardising medium-term fiscal sustainability. The formulation of a Rebalancing Plan is expressly recommended.

From AIReF's perspective, the current priority is to respond to the crisis, but without losing sight of the medium-term effects of the pandemic. For this reason, it recommends to utilise the fiscal margins permitted by regulations and, in particular, to activate the national escape clause. On the other hand, it also recommends to start preparing a fiscal exit strategy, which by law requires a Rebalancing Plan, that takes the European context into account. For these reasons, AIReF recommends:

- That the Government should activate the exceptionality clause referred to in article 11.3 of Organic Law 2/2012 on Budgetary Stability and Financial Sustainability.
- That the Government should start work to establish a Rebalancing Plan, which will serve as medium-term fiscal guidance and ensure the realistic and credible financial sustainability of the PAs. This requires the participation and joint responsibility of all levels of the Administration and, therefore, the fiscal reality in terms of each sub-sectors' resources and competencies to be taken into account. As far as possible, this plan should be consistent with the schedule and approach that may be determined at the European level.
- To carefully plan any permanent measures, particularly considering their financing, with the aim of preserving the sustainability of public accounts. These permanent measures should be included in the Rebalancing Plan.
- To closely monitor the measures that do not have an immediate impact on the public deficit, but that generate contingent liabilities. These must be included and considered in the Rebalancing Plan. It is also recommended that sufficient information be sent to AIReF on a quarterly basis in order to be able to assess the impact on sustainability.

In relation to the preparation of the SPU, AIReF reiterates the following recommendations:

- That the information provided to AIReF by the Government in order to issue the reports referred to in article 14.1 of Organic Law 6/2013 should include a fiscal scenario and a no-policy-change scenario that details

and quantifies the impact of the measures taken or planned and their translation to the final macroeconomic scenario.

- That, in line with standard practice in surrounding countries in the interaction between the Government and the National Independent Fiscal Institution, the flow and schedule of information exchange should be regulated through a convention or "memorandum of understanding".