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Economic Outlook

November 2022

SPECIAL REPORT: "Assessment of the new EU fiscal rules"

Overview

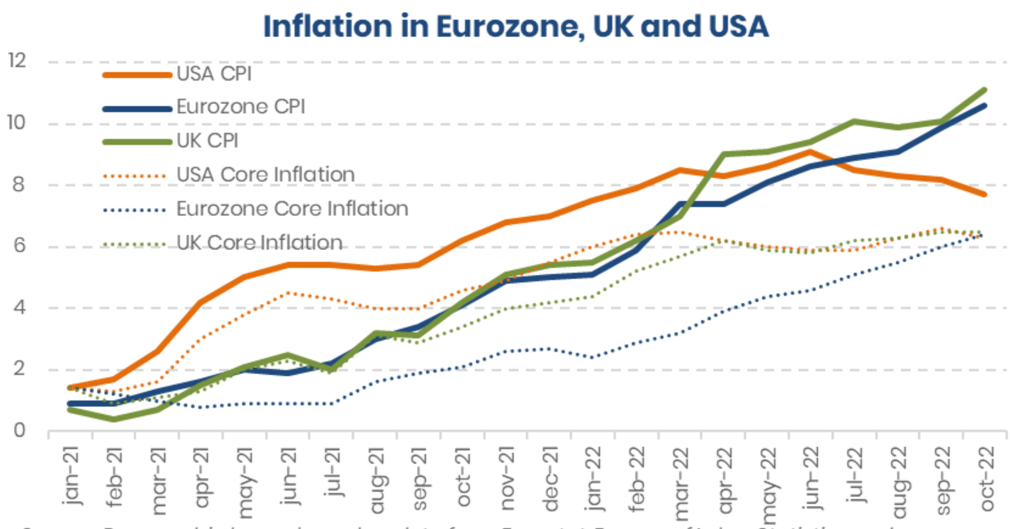
- **The main Western central banks continue to tighten monetary policy to fight inflation.**
- **Prices continue to rise in Europe, while they show signs of slowing down in the United States.**
- **The European Commission also revises down its growth forecasts for 2023, while it raises its inflation forecasts.**
- **PMI indices anticipate a slowdown in the global economy.**
- **The European Commission is the latest agency to confirm that the outlook for the Spanish economy in 2023 is marked by a low growth scenario (1%) and a certain moderation in inflation (4.8%).**
- **The Spanish economy slowed down significantly in Q3 and the outlook for the coming quarters points to lower growth.**
- **The LFS results confirm that job creation eased in Q3 and this trend is expected to continue throughout the final stretch of 2022.**
- **Inflation slowed down in October to 7.3% due to the lower increase in energy prices, although food prices continue to push upwards.**
- **Up to September and in National Accounting terms, the State's public deficit stands at -1.2% of GDP, compared to -4.8% of GDP in 2021. The public administrations as a whole are likely to end the year with a lower public deficit than the -5% of GDP estimated by the Government.**

The International Scenario

The main Western central banks continue to raise interest rates to fight inflation

Between the end of October and the first days of November, the main Western central banks raised their interest rates by 75 basis points, bringing them to 2.0% in the case of the ECB, 3.0% in the case of the Bank of England and between 3.75% and 4.0% in the case of the Federal Reserve. Thus, central banks continue to show their firm commitment to controlling inflation, which is still very high, despite signs of a slowdown in the economy and the possibility of a contraction in activity in the short term.

Meanwhile, inflation continues to rise in Europe. In the Eurozone, it stood at 10.6% in October, the highest in its historical series and, in the United Kingdom, it was set at 11.1% in October, the highest level since 1981. By contrast, in the United States, where inflationary pressures and interest rate hikes began earlier, some moderation is already noticeable, with the reading for October (7.7%) being the fourth consecutive decline. Nevertheless, price pressures are becoming more widespread and are being transferred to an increasing number of goods and services, which is reflected in underlying inflation reaching very high rates, namely 6.3% in the United States, 6.4% in the Eurozone and 6.5% in the United Kingdom.



Source: Prepared-in house based on data from Eurostat, Bureau of Labor Statistics and Office for National Statistic

In this context of persistently high inflationary pressures and a slowdown in activity, the European Commission has revised its growth forecasts downwards for 2023. At the same time, it has increased its forecasts for 2022, due to the good performance of the economy in the first half of the year. These estimates foresee very modest growth for Europe in 2023, 0.3% for the EU and the Eurozone, with contractions in Germany and also in the UK. A modest recovery is expected for 2024, with GDP growth of 1.5% in the Eurozone, 1.6% in the EU as a whole, and only 0.9% in the UK.

In the case of inflation, the revisions have been upward for both 2022 and 2023. For the former, inflation forecasts for the Eurozone have increased by nine tenths to an annual average of 8.5%, while, for next year, a significantly higher increase of 2.1 points is expected, which would set average inflation at 6.1%. A more notable moderation in prices is not foreseen until 2024, with average inflation for the Eurozone expected to stand at 2.6%, a rate that is much closer to the ECB's targets.

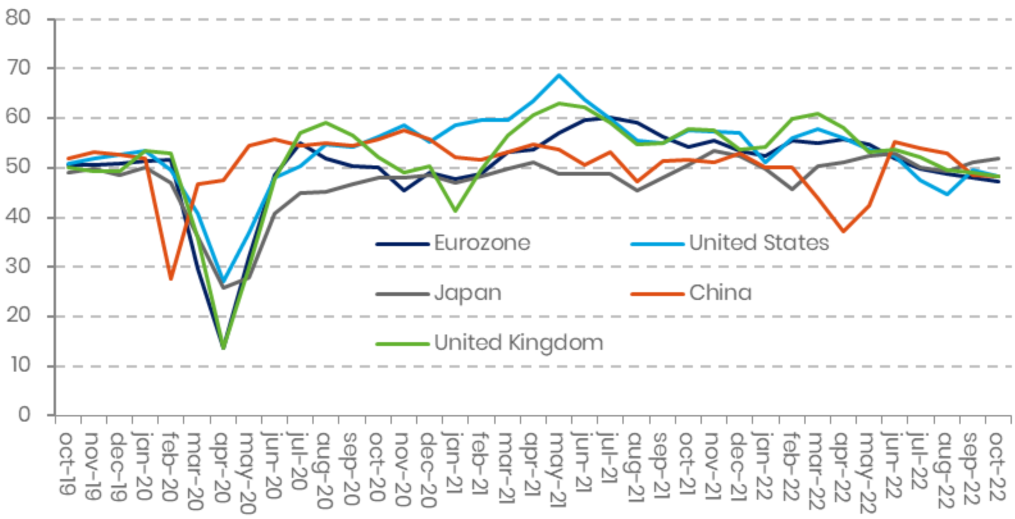
European Commission forecasts (November 2022)

	GDP			Inflation		
(y-o-y rate)	**2022**	**2023**	**2024**	**2022**	**2023**	**2024**
World	3.1	2.5	3.1			
United States	1.8	0.7	1.7	7.9	3.4	2.3
China	3.4	4.5	4.7			
Japan	1.7	1.6	1.2	2.5	3.1	1.8
United Kingdom	4.2	-0.9	0.9	7.9	7.5	2.9
European Union	3.3	0.3	1.6	9.3	7.0	3.0
Eurozone	3.2	0.3	1.5	8.5	6.1	2.6
Germany	1.6	-0.6	1.4	8.8	7.5	2.9
France	2.6	0.4	1.5	5.8	4.4	2.2
Spain	4.5	1.0	2.0	8.5	4.8	2.3
Italy	3.8	0.3	1.1	8.7	6.6	2.3

Source: European Commission

Meanwhile, PMI indicators show a slowdown in activity worldwide. For example, the global composite PMI index for October stood at 49 points, the lowest since June 2020, and the third consecutive month below 50, indicating a decline in growth. All the indices for the major economies are showing signs of a slowdown, except for Japan, which shows accelerating growth. However, the labour market continues to show positive behaviour and signs of resilience despite the economic slowdown.

Composite PMI Index



Source: Markit Economics

In contrast to the deterioration in the PMI indices that has been occurring since July, GDP results for Q3 are surprisingly positive, with growth in the United States of 0.6% quarter-on-quarter, after two quarters of negative growth. In October, the US labour market continued to perform favourably, with the creation of 261,000 jobs, although at a slower pace than in previous months. In contrast, the unemployment rate rose by two tenths to 3.7%. Nevertheless, the strength of the labour market and inflationary pressures are making it easier for the Federal Reserve to continue raising interest rates. In November, it raised them for the sixth consecutive meeting, to between 3.75% and 4.0%, and Fed Chairman, Jerome Powell, stated that rates will continue to rise to higher levels than previously expected.

Although there has been a slowdown in the Eurozone, with GDP growth of 0.2% in Q3 versus 0.8% in Q2, it is worth noting that it continues to report positive growth, in spite of the difficulties derived from the war in Ukraine. The main surprise was Germany, which grew by 0.3% when it was expected to contract in Q3. On the other hand, inflation continues to set record highs, which led the ECB to implement its third consecutive rate hike; this is the second time it has raised rates by 75 basis points, bringing the benchmark rate to 2.0%. The lending and deposit facility also rose by 75 basis points, to 2.25% and 1.5%, respectively.

The higher inflation in the Eurozone in comparison to the United States anticipates a possible easing in the pace of rate hikes in the US, which is why the euro has appreciated in the last few days (going from 0.97 dollars per euro, a 20-year low, to around 1.04 dollars per euro). On the other hand, the Eurozone has a greater energy dependence and more economic and political risks in the short and medium term, so the current appreciation of the euro will be limited, and the possibility of losing parity against the dollar cannot be ruled out.

China also showed a notable improvement in Q3, with year-on-year growth of 3.9% versus 0.4% in Q2, benefiting from fewer restrictions than in previous quarters. In addition, the Chinese government has announced that it will slightly relax its zero-tolerance policy on COVID. However, the problems being experienced by its real estate sector are a risk for the country's growth, which, according to the latest forecasts by the IMF and the European Commission, is expected to be set at between 3.2% and 3.4% in 2022, the lowest in more than four decades if we exclude 2020.

For Q4, the weakness in the global economy is expected to be more pronounced, given the persistence of high inflation and the greater repercussions that the monetary policy tightening is likely to cause, such as the impact it will have on consumption and investment, as well as on the financing of sovereign debts, which are at very high levels. In addition, labour constraints in some labour markets and problems in supply chains, which are still lingering, will be other factors that will condition the evolution of activity in the coming months.

As for raw materials, prices in September continued on a moderate downward trend in most cases, after the peaks reached in April. Oil prices in October remained at very similar levels to September's, at $95.1/barrel on average, although in year-on-year terms they are up 13.4% in dollars and 33.9% in euros. Prices are facing mixed pressures. On the one hand, the production cut agreed by OPEC+ countries favours the rise, but on the other, the high level of uncertainty and signs of a slowdown in the global economy are working in the opposite direction. Some volatility was observed in the first days of November, as China's announcement to ease its zero COVID policy to stimulate activity and energy demand boosted crude oil prices. In contrast, the increase in cases in the Asian country, along with the cut in crude oil demand forecasted by the IEA and OPEC, put downward pressure on prices. Meanwhile, futures continue to point to a downward trend.

The Spanish Economy

Significant moderation in activity and employment (according to the LFS) in Q3

GDP and LFS data for Q3 both point to a moderation in activity and employment. GDP grew by 0.2% quarter-on-quarter, but this was due to the foreign sector and not to domestic demand, given that consumption and investment in capital goods showed notable growth. As for the LFS, it is worth noting the meagre increase in employment in the summer season (77,700 people, below the average for the Q3s in the 2014-2019 period). All in all, the labour market continues to show remarkable resilience, with an outstanding increase in permanent hiring and registrations with the Social Security in October, which contrasts with the prevailing environment of uncertainty, rising business costs and loss of activity.

Inflation has begun to slow down in the final stretch of the year (7.3% in October), leaving behind the highs reached in July (10.8%), albeit heavily conditioned by specific measures to reduce energy and transport costs. Although it is too early to know the exact intensity of the slowdown, forecasts point to inflation at year-end set between 6% and 7%.

The European Commission is the latest agency to confirm that the outlook for the Spanish economy in 2023 is marked by a low growth scenario (1%) and a certain moderation in inflation (4,8%), although at rates far from what is considered price stability (around 2%). The public deficit will remain high in 2023 (-4.3% of GDP) with the current account still in surplus (0.8% of GDP), while the unemployment rate will not rise (12.7%), thus consolidating the resilience of the Spanish labour market.

In 2024, according to this institution, inflation and the public deficit will return to levels more in line with macroeconomic stability (2.3% and -3.6%, respectively), GDP growth will be 2%, but the unemployment rate will barely fall (12.6%). In other words, by then, the crisis will presumably be over, growth rates will be recovering, and the main imbalances will be on the correction path, except for public debt, which will remain at very high levels (above 110% of GDP). In this regard, it is worth mentioning the European Commission's proposal for new fiscal rules, which is described and assessed in the special report included at the end of the present outlook document.

Demand and activity

Activity slows significantly in Q3, and the forecast for 2023 worsens

As already anticipated in previous outlooks, the Spanish economy suffered a significant slowdown in Q3. Thus, the Quarterly National Accounts preliminary data show a notable deceleration in Spanish economic growth, pointing to a 0.2% increase quarter-on-quarter. In year-on-year terms, the rate of growth slowed to 3.8%, versus 6.8% in Q2.

Activity was less dynamic in Q3 due to the decreased contribution of external demand, which accounted for 3 points vs. 4.9 points in the previous quarter.

Within the domestic demand components, it is worth highlighting the good performance of consumption in Q3, despite inflation having reached record highs, and of investment in capital goods. Investment, measured in terms of GFCF, slowed significantly due to the deterioration of its construction component, which fell by -0.1% quarter-on-quarter, while investment in capital goods posted a rise.

An analysis by sector shows a generalized moderation. The largest quarter-on-quarter increase was recorded in the manufacturing industry (0.8% quarter-on-quarter), followed by the service branches (0.7% quarter-on-quarter), mainly in those sectors that suffered the greatest deterioration during the crisis, such as artistic, recreational, and other services activities (7.6% quarter-on-quarter).

Another noteworthy result included in the Quarterly National Accounts for Q3 is the increase in inventories with respect to the previous quarter, which could be explained by a “preventive effect”, as certain goods were accumulated to face possible supply difficulties during the winter.

Rising financing conditions, high inflation, bottlenecks (although they are gradually being corrected) and the consequences of the energy crisis in Europe leave no room for optimism in the coming months, and the Spanish economy is expected to continue to decelerate.

With regard to the evolution of consumption in the coming quarters, the rise in inflation and the increase in interest rates have intensified uncertainty and damaged consumer confidence, reducing households' intention to make major purchases. Moreover, these factors imply a decline in household purchasing power, which will not be offset by increased job creation, and private consumption will, therefore, slow down in comparison to 2022. On the other hand, the savings accumulated by households since the beginning of the COVID crisis may partially cushion the effect of the rise in prices and interest rates, although part of these savings will also be used for other purposes, such as reducing debt or investing in housing.

There is also a clear deterioration of expectations in confidence indicators in most sectors. Industrial activity is being further impacted by the increase in the price of raw materials, both energy and non-energy, together with problems in supply chains and the decline in incoming orders. Thus, manufacturing PMIs have posted contractionary figures since July and, in October, they stand at their lowest level since 2020. Meanwhile, the services PMI also fell below the 50 level in September and is still posting contractionary levels in October, although it has improved slightly.

From the point of view of the external sector, the information available for the first eight months of the year shows a much more dynamic evolution of good imports than exports, resulting in a trade deficit 4.5 times higher than in the same period of 2021. Likewise, the Balance of Payments data show that, in the first eight months of the year, the surplus of the current account balance reached 1.0 billion, compared to a surplus of 4.7 billion in the same period of the previous year. This balance is due to the notable deterioration in the balance of non-tourist goods and services, which has been offset by the notable increase in the surplus of the balance of tourist services.

The latest available data regarding the tourism sector show how the inflow of international tourists already began to slow its pace of recovery in August and September, standing at around 87% of the 2019 figures, while in July it had reached 92%.

Looking ahead to the coming quarters, it is foreseeable that both exports and imports will suffer a slowdown in view of the growth forecasts in our main issuing countries, where household spending could be further eroded by inflation and lower activity; or, even, recession. Likewise, international tourist arrivals could suffer a decline in the coming quarters and throughout 2023.

The Labour Market

Job creation has slowed down in recent months and this trend is expected to continue in the final stretch to 2022

In the second part of the year 2022, job creation is slowing down, in contrast to the remarkable dynamism it showed in the first half of the year. This deceleration is more intense if we consider the figures recorded in the Labour Force Survey on to the number of employed workers than if we look at the number of people registered with the Social Security. Thus, the labour market is showing that it is not immune to the greater difficulties that companies are facing in the current context of greater uncertainty, inflation and downside risks to growth, although job creation has not yet experienced a sharp decline as a result of the slowdown in economic growth.

The outlook for the labour market in 2022 and 2023 will be significantly affected by the performance of economic activity. Thus, CEOE forecasts that employment in LFS terms will grow by 3.1% in 2022, one tenth more than in 2021. On the other hand, job creation will slow down significantly in 2023, to 0.6%, as a result of the lower GDP growth forecast. Meanwhile, the unemployment rate, after having reached 14.8% in 2021, will fall further in 2022, to 12.9%. In 2023, the unemployment rate will increase by one tenth to 13.0% due to lower expected job creation.

The LFS results for Q3 reflect the loss of dynamism in economic activity. In a traditionally positive quarter for the labour market, employment increased by 77,700 people, well below the average for the third quarters of the 2014-2019 period. Much of the job creation was in the public sector, which accounted for two out of every three newly employed, which means that the private sector only generated one out of every three new jobs. In addition, the year-on-year employment growth rate slowed considerably, from 4.0% in Q2 to 2.6% in Q3. Meanwhile, the seasonally adjusted quarter-on-quarter rate for the number of employed workers was negative in Q3, at -0.06%, marking the first decline since Q2 2020. Meanwhile, the number of unemployed increased by 60,800, an unfavourable reading compared to the declines in unemployment usually seen in Q3s. In addition, the unemployment rate increased by two tenths to 12.7% of the labour force, resulting in a total of 2,980,200 people unemployed. On a positive note, the temporary employment rate in the private sector is at an all-time low (17.5%), which is almost half of the public sector rate (30.7%).

With regard to the most recent evolution of the labour market, October's results were better than expected, even in a more unfavourable economic environment than a few months ago. October registered an increase of 103,499 in Social Security registrations, a higher figure than the average recorded for this month in the 2014-2019 period. The public sector added 34,507 workers, while the private sector generated 68,992 new jobs. On a negative note, it should be pointed out that, in seasonally adjusted terms, registrations grew moderately in October, specifically by 16,095 persons, which is the lowest increase so far this year, with the exception of July.

The Ministry of Inclusion, Social Security and Migration estimates that in November there could be a slight increase, of about 1,000 people, in Social Security registrations, which would be a more favourable figure than the average decline recorded in the 2014-2019 period (-23,219 people). In seasonally adjusted terms, the Ministry forecasts an increase of around 80,000 people registered with the SS, which would imply a notable upturn compared to the last few months. If these estimates are met, the year-on-year rate of registrations would continue its slowdown, to stand at 2.7% in November, after 3.0% in October, and in contrast to 5.1% in April. Meanwhile, the number of workers under furlough schemes has remained slightly above 20,000 in recent months, with an average of 22,997 people from November 1 to 17.

Registered unemployment surprised positively in October, posting a reduction of 27,027 people, a figure that contrasts with the typical increases during this month due to seasonal factors. It is likely that the changes resulting from the labour reform may have contributed to this more favourable result than in other years. Specifically, there has been a notable boost in permanent contracts for intermittent work, coupled with a lower use of temporary contracts. The worker with a permanent contract for intermittent work appears as a registered employed worker with the Social Security system during periods of work activity, while his/her registration is cancelled during periods of inactivity. When a worker with a permanent contract for intermittent work is not working, he/she may decide to register with the National Employment Services (SEPE) as a job seeker. However, he/she will not be considered unemployed, but will be included in the category of employed job seeker. Therefore, foreseeably, those workers who prior to the labour reform had a temporary contract for a seasonal activity and now have a permanent contract for intermittent work will be considered as employed job seekers when they finish their period of employment, instead of being considered as registered unemployed, as was previously the case. In October, the category of employed job seekers increased by 123,463 people, to 960,599 people. However, it is impossible to know how many of them are workers with a permanent contract for intermittent work, because this category also includes others, such as workers under furloughs and employed workers looking for a better job.

Inflation

Inflation decelerated in October due to lower energy prices, although food prices continue to push upwards

In October, inflation decelerated to 7.3%, after having reached 8.9% in September, helped by the lower increase in energy prices. Processed and unprocessed food prices are the main inflationary element, since their notable increase is coupled with the significant weight they account for in the basket of products on which the CPI is based.

In October, the underlying CPI remained unchanged at 6.2% in year-on-year terms. Within the core component, Services prices accelerated their year-on-year rate by one tenth to 3.9%; Industrial Goods prices excluding energy products decreased by five tenths to 4.8%; and Processed Food, beverages and tobacco accelerated their year-on-year rate by six tenths to 13.4%.

Non-processed food prices increased by 1.5 points to 15.3% year-on-year. It is worth noting the increase in the prices of basic products such as pulses, cereals, milk, and eggs, all of which grew by more than 20%. Practically all food items recorded rates above 10%.

Energy product prices significantly eased their year-on-year rate to 8.0%, compared to 22.4% in September or 37.4% in August, due to the lower increase in the price of energy raw materials. The price of Brent crude oil in October remained stable compared to the previous month, averaging $95.1/barrel, which represents a 13.4% increase in dollar terms and 33.9% in euros, due to the strength of the US currency. In the first days of November, prices averaged $97.8/barrel, which, if sustained, will lead to increases of 19% in dollar terms and almost 39% in euros. A progressive moderation of prices is expected in the coming months.

The ongoing war in Ukraine may continue to affect the evolution of the prices of certain raw materials, such as gas, fuels, cereals, and oils, which in turn have an impact on the price composition of many other products. Inflation will therefore remain high in the short term, although it will continue to moderate.

The Public Sector

The State's public deficit through September stands at -1.2% of GDP

Up to September, and in National Accounting terms, the State's public deficit is estimated at €16.269 billion, 72.2% lower than in the same period of 2021. In terms of GDP, the public deficit has gone from -4.8% in 2021 to -1.2% this year. Excluding interest, the primary surplus is 0.3% of GDP, which contrasts with the primary deficit of -3.4% of GDP recorded up to September 2021. Therefore, it is feasible for the general government as a whole to end the year with a public deficit lower than -5% of GDP, which is the Government's forecast.

The negative balance of the State in 2022 is shrinking sharply due to the strong growth in resources (27%) and a slight drop in uses (-0.4%). State resources continue to gain weight in terms of GDP, standing at 14.8% (two points higher than in the same period of 2021), while uses reduce their weight by one and a half points to 16.1% of GDP.

In the disaggregated analysis of the resources, the performance of the different taxes continues to stand out, with VAT collection increasing by 19.8%, personal income tax by 37.2% and corporate income tax by 21.9%. In other words, tax collection as a whole will set new historical records in 2022. In addition, it is worth mentioning the 7.9% increase in the Hydrocarbon Tax, the Tax on Tobacco Products, which increased by 7.4%, and the auctions of greenhouse gas emission rights, up by 45.3%. There are also taxes whose collection decreased, such as the revenues linked to the suspension of the collection of the Tax on the Value of the Production of Electric Energy (IVPEE) and the Tax on Electricity, mainly as a consequence of the reduction of the tax rate from 5.1% to 0.5%, as of September 2021.

On the expenditure side, the decrease is mainly due to the recording in 2021 of an expense of just over €4 billion for the total forecast of defaults arising from the standardized guarantees linked to the guarantee lines granted by the State since 2020 and which did not apply in 2022. The resources allocated to the Social Security and the Regional Administration are also reduced. The rest of the items are up across the board, among which accrued interest (18.4%), social transfers in kind (65.8%) and to the Local Administration (10.0%), and also those related to aid to households and sectors as a result of the rise in energy prices stand out.

Forecasts

Economic forecasts for Spain (last update: November 2022)						
Annual rates of change, unless otherwise indicated	2018	2019	2020	2021	2022	2023
GDP	2.3	2.0	-11.3	5.5	4.6	0.8
Private consumption expenditure	1.8	0.9	-12.4	6.0	2.1	0.8
Government consumption expenditure	2.3	1.9	3.5	2.9	-1.6	0.5
Gross fixed capital formation	6.3	4.5	-9.7	0.9	5.7	4.8
-Tangible fixed assets	7.5	5.3	-11.1	0.1	5.4	5.1
Construction	9.5	7.2	-10.2	-3.7	4.4	4.6
Equipment and cultivated assets	4.6	2.4	-12.6	6.5	7.0	5.9
-Intangible fixed assets	1.1	0.6	-2.5	4.7	6.9	3.5
Domestic demand (*)	2.9	1.6	-9.1	5.3	1.5	1.0
Exports	1.7	2.2	-19.9	14.4	17.8	4.3
Imports	3.9	1.3	-14.9	13.9	9.2	4.5
External demand (*)	-0.6	0.4	-2.2	0.3	3.1	-0.2
GDP current prices	3.5	3.4	-10.1	7.8	8.1	2.0
GDP deflator	1.2	1.4	1.2	2.3	3.5	1.2
CPI (average annual rate)	1.7	0.7	-0.3	3.1	8.5	4.3
CPI (Dec/Dec)	1.2	0.8	-0.5	6.5	6.1	4.6
Core CPI (average annual rate)	0.9	0.9	0.7	0.8	5.1	4.5
Employment (Quarterly National Accounts)(**)	2.2	3.3	-6.8	6.6	3.5	0.5
Employment (LFS)	2.7	2.3	-2.9	3.0	3.1	0.6
Unemployment rate (LFS) (% active population)	15.3	14.1	15.5	14.8	12.9	13.0
Productivity	0.1	-1.3	-4.8	-1.0	1.1	0.3
Compensation per employee	1.8	2.4	2.5	-0.8	1.5	2.8
Unit labour cost (ULC)	1.7	3.8	7.7	0.2	0.5	2.6
Current Account Balance (% of GDP)	1.9	2.1	0.8	0.9	0.7	0.0
General government net lending (+) / net borrowing (-) (% of GDP)	-2.5	-2.9	-10.3	-6.9	-4.8	-4.4
Interest rates USA (Dec)	2.50	1.75	0.25	0.25	4.50	5.00
Interest rates Eurozone (Dec)	0.00	0.00	0.00	0.00	2.75	3.50
Brent Oil ($)	70.9	64.8	41.5	71.1	104.9	88.1

Source: CEOE, INE (National Statistics Institute), Banco de España, Eurostat

(*) Contribution to GDP growth

(**) Full-time equivalent jobs

Assessment of the new European fiscal rules

1. **New framework for European fiscal rules**

The EU's economic governance framework and, more specifically, **the fiscal policy framework, has helped to create conditions that would foster economic stability, ensuring the sustainability of Member States' public finances** and thus promoting economic and social progress. **This framework is constantly evolving** to address any weaknesses identified in its practical implementation over the course of the successive economic shocks and budgetary realities that have taken place. In this regard, as the European Commission acknowledges, "not all instruments and procedures have withstood the test of time".

One of the major general shortcomings of the current application of the Stability and Growth Pact, which has been widely pointed out by the main studies and analyses, and which, moreover, has tended to intensify over time, **has been the high complexity of the procedures established,** subject to a myriad of indicators, standards and specifications.

Another major problem has been the European Commission's lack of capacity to enforce this pact, especially with regard to debt. It is worth recalling that the Excessive Deficit Procedure (hereinafter EDP) may be initiated if either of these 2 infringements is present: failing to meet the deficit rules and failing to meet the debt rules. In this regard, we should note that an EDP has never been opened for excessive public debt. Despite the fact that several countries had failed to comply with the public debt reduction criteria, they have always ended up finding a way to avoid opening an EDP on these grounds. The most recent example has been Italy in 2018 and 2019.

However, EDPs have been opened for public deficit violations in many countries, and these have ultimately led to a reduction in this deficit. Nonetheless, along the way, various breaches of the requirements prescribed in the procedures have taken place but, still, have not led to the imposition of the sanctions provided for. Thus, despite these sanctions being clearly stipulated, they have never been applied.

In addition to all of the above, the pandemic has also led to an increase in deficits and, most importantly, in public debt, especially in those countries that are routinely " bordering " the established fiscal rules. At the end of 2021, public debt to GDP in Greece was close to 195%, in Italy it exceeded 150%, and in Spain it was close to 120%. This highlights the difficulty of tackling debt reduction within the framework of the current fiscal criteria, especially if we consider that they have been systematically breached.

This is the context underpinning the European Commission's proposal, which seeks to address precisely the problems described above**. Thus, the aim is to reinforce compliance with the current debt criterion, which has been routinely overlooked, and which is difficult to meet under the current circumstances. The proposed changes are related to the simplification of the requirements, given the widely admitted complexity, as well as to a greater flexibility in the reduction path to make it feasible and realistic, depending on the situation of each**

Member State. However, at the same time, the incentives for this actual compliance are increased, through increased supervision and a system of penalties with lower amounts but more extensive consequences (these being not only financial but also "reputational"), and with more frequent **and, in principle, more rigorous application of these sanctions.**

2. Description of the rules

The proposal is to move to a transparent and risk-based EU monitoring framework **that distinguishes between countries, taking into account their public debt challenges**. To this end, the 1992 Maastricht Treaty targets of 3% of GDP for government deficit and 60% of GDP for government debt, will remain in place. However, the rule of having to reduce excess public debt by one-twentieth each year will be replaced by more flexible reduction paths that take into consideration each country's initial situation

Consequently, there will be **national medium-term budgetary and structural plans**, which are the cornerstone of the framework proposed by the Commission, and they will integrate budgetary, reform and investment objectives, including those aimed at addressing macroeconomic imbalances where appropriate, into a single comprehensive medium-term plan.

Member States will have greater leeway in setting their fiscal adjustment plan, strengthening national ownership of their budgetary paths.

The idea is to use a single operational indicator, namely net primary expenditure (nationally financed)**,** which is defined as expenditure net of discretionary revenue measures and excluding interest expenditure and cyclical unemployment expenditure. In other words, **it would be the expenditure controlled by the Public Administration.** This indicator **would serve as the basis for setting the budget adjustment track**.

Functioning:

- **The Commission would present a baseline fiscal adjustment path covering a four-year period.** This baseline adjustment path should ensure that **the debt of Member States with large or medium-sized debt challenges is set to follow a credible downward path** and that the deficit is plausibly kept below the 3% of GDP reference value as set out in the Treaty.

- **Member States would then submit plans outlining their medium-term budgetary path**, as well as priority commitments for reforms and public investments. **Member States could propose a longer adjustment period, extending the fiscal adjustment path by up to another three years when there is an accompanying set of reform and investment commitments that support debt sustainability and** respond to common EU priorities and objectives.

- **As a third step, the Commission would evaluate the plans and issue a** positive **assessment** if the debt is on a downward path or remains at prudent levels, and the budget deficit is credibly kept below the 3% of GDP reference value over the medium term. **The Council would approve the plans after a positive assessment by the Commission.**

- **Finally, the Commission would continuously monitor the implementation of the plans. Member States would submit annual reports** on the implementation of the plans to enable effective monitoring and ensure transparency.

Independent fiscal institutions could play an important role in monitoring compliance with national fiscal and structural plans, in support of national governments. This would also trigger more debate at the national level and a higher degree of political acceptance.

In addition, **enforcement mechanisms would be strengthened**: the use of lower **financial penalties would be considered**, which would be more effective. **Stricter reputational penalties would also be imposed** (e.g., a minister would have to explain before the European Parliament the measures to be taken to redress the deviation from the targets set). Macroeconomic conditions for the Structural Funds and for the Recovery and Resilience Mechanism would be applied with a similar intent, that is, **EU funding could also be suspended if Member States fail to take effective action to correct their excessive deficits.**

The deficit-based EDP would remain in place, while the debt-based EDP would be reinforced. It would be triggered when a Member State with a debt above 60% of GDP deviates from the agreed spending path.

3. Implications for Spain

The new fiscal rules plan being proposed by the European Commission directly affects Spain, given that our country currently has a public deficit that exceeds 3% of GDP (the Government expects it to reach 5.0% in 2022) and a public debt that almost doubles the reference level of 60% of GDP (the Government's forecast is that it will reach 115.2% in 2022).

The implementation of the plan by the European Commission implies a country-specific debt reduction path, depending on its starting point and circumstances. This would be a significant stimulus for the fiscal consolidation of Spain's public accounts, for which we, at CEOE, have advocated so strongly.

Our country, with a high level of public debt, would be one of the possible beneficiaries of applying softer and more progressive debt reductions than those established in the previous framework**. But it also implies a clear restriction on any discretionary spending measures** that do not take into account the structural component and medium-term impact on the achievement of this fiscal consolidation. In other words, **a new budgetary discipline is reinstated, something that has not been in place in recent years in which fiscal rules were under suspension**.

On the other hand, the possible non-compliance with the agreed paths, in addition to the resulting penalties, could also have additional negative effects on the financing of our country. In this regard, it is worth recalling that, in July, **the ECB approved the Transmission Protection Instrument (TPI)**, a tool that enabled them to buy additional debt in the secondary market from countries suffering a deterioration in their financing conditions that was not justified by their economic fundamentals. However, **to be eligible for such purchases, countries had to meet a series of requirements**, including the absence of serious macroeconomic imbalances and **not being under an excessive deficit procedure**. It should be borne in mind that, **for States with a substantial public debt problem, deviations from the agreed fiscal path would, by default, result in the opening of an EDP**.

4. CEOE's assessment

The new European governance scheme on fiscal rules is more transparent and simpler. The public debt and deficit targets remain unchanged, i.e. -3% of GDP and 60% of GDP, respectively. The main indicator to be monitored is primary public expenditure, i.e. excluding interest and cyclical unemployment, since it is the one that depends entirely on the policies of each government**. This simplifies the scheme, because it is easier to measure than the structural deficit and places the spotlight on a public spending indicator.**

These rules adapt to a greater extent to the specific conditions of each country. This provides greater flexibility by taking into account the economic and fiscal situation of each member state, which, as we have seen over the last few years, has been quite different across many European countries. In addition, each country can set clear objectives and steer its fiscal and budgetary policies so that they can be met, making them **more realistic**. In this regard**, we, at CEOE, have defended that the consolidation of public finances should always place the focus on gaining efficiency in spending and not on raising taxes.** We should bear in mind that, in 2022, Spain has already reached a tax burden similar to the European average and, in the specific case of the corporate tax rate, we are well above the EU average.

This new scheme is more integrated with other policies, so, at first sight, the approach is more comprehensive and coordinated. In fact, it takes into account the requirements established for the Next Generation EU funds, such as structural reforms and investment policies. It is also integrated with the Macroeconomic Imbalance Procedure to identify potential future economic risks.

We welcome the fact that the fiscal authorities of each Member State have a greater role in monitoring and controlling fiscal plans and structural policies affecting the public sector.

One of the keys for this system to work is for penalties to be enforced and for these, given that they imply lower amounts, to be implemented rigorously and on an ongoing basis.

Finally, the most important implication for Spain is that budgetary discipline mechanisms are reinstated and, consequently, that there must be greater justification for those discretionary policies that increase our structural spending and hinder the achievement of stable public finances.