The euro area sovereign debt crisis made it clear how, when the cycle turns down, the absence of sound public finances may exacerbate budgetary difficulties, the correction of which may ultimately require the adoption of fiscal adjustment measures which deepen the recession. With a view to the creation of budgetary headroom to mitigate these risks and ensure the long-term sustainability of Member States' public finances, the EU Stability and Growth Pact (SGP) establishes procedures for the supervision of national budgetary policies.[1] The purpose of this Box is to describe how compliance with these procedures affects the Spanish fiscal policy stance in the current economic situation.

There are two tools in the SGP framework which allow follow-up of Member States' public finances according to their situation. First, if the budget deficit is above 3% of GDP and/or public debt exceeds 60% of GDP and GDP is not being reduced to the relevant threshold at a sufficient pace,[2] the so-called "corrective component" is applied and the economy is said to be subject to an excessive deficit procedure. Second, when the government deficit and debt are not considered excessive under the aforementioned criteria, Member States become subject to the requirements of the so-called "preventive component" of the SGP. The latter aims to ensure that the fiscal policies of EU countries generate sufficient budgetary headroom for them to avoid excessive deficits. This means that Member States have to achieve budgetary balance in terms of the structural deficit net of temporary measures, with certain adjustments to take into account two factors which differ across countries: the need to reduce the public debt ratio below 60% of GDP and the size of the expected impact of population aging.[3] This materialises in a medium-term objective (MTO) which, in the case of the Spanish economy, is set at 0% of GDP.

Spain has been subject to an excessive deficit procedure (EDP) since 2009 because of a budget deficit exceeding the limit of 3% of GDP. At the cut-off date of this Box, the European authorities confirmed that Spain qualified to exit this procedure (which will be repealed by the EU Council in early July), because in 2018 the general government deficit was below the 3% threshold (specifically, 2.5% of GDP) and this situation was judged to be sustainable in the future.[4] Spain will exit the "corrective arm" and simultaneously enter the "preventive arm".

On the available estimates, the structural deficit in 2018 stood above 2% of GDP (see Chart 1). Spain was thus still a long way from the medium-term structural budget balance objective (MTO), which, as mentioned above, has been set at 0% of GDP. Therefore, within the SGP "preventive component" framework, two requirements intended to ensure sufficient progress towards that objective will be activated.

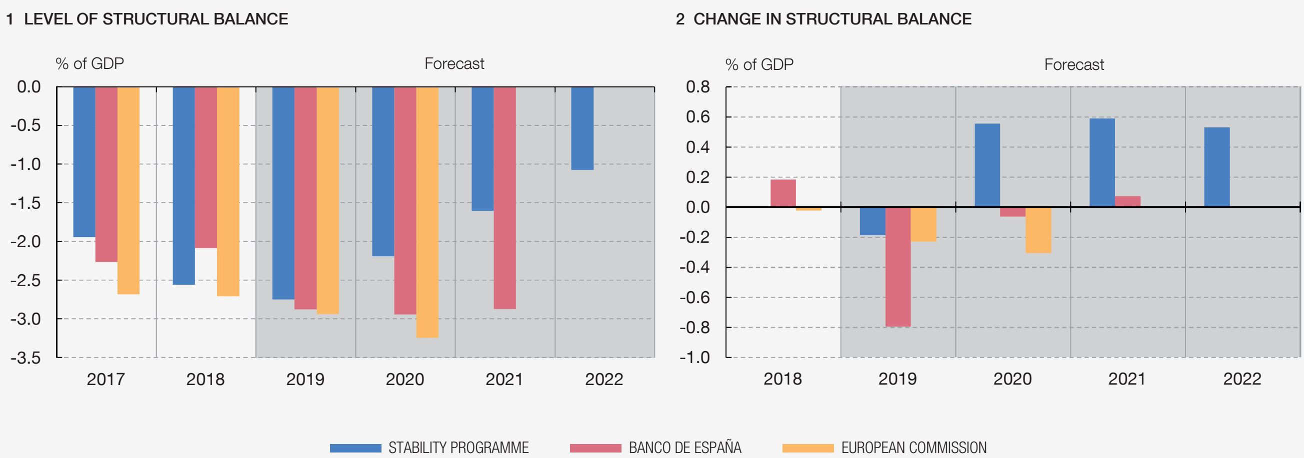
1 For more details, see García-Perea and Gordo (2016) "Los mecanismos de supervisión presupuestaria de la UEM", *Boletín Económico* of the Banco de España, 47-60.

2 See Vade Mecum on the Stability and Growth Pact – 2019 Edition.

3 It should be taken into account that the structural budget deficit is an unobservable variable and thus has to be estimated. For the purpose of the European procedure, it is estimated as the difference between the observed budget deficit and the cyclical deficit, stripping out the effect of temporary and exceptional factors. The cyclical deficit is calculated by applying the government revenue and spending elasticities to the output gap. The output gap is estimated using a methodology developed by the European Commission in conjunction with the Member States (see Havik et al. (2014) "The production function methodology for calculating potential growth rates and output gaps", Economic Papers, 535, European Commission).

4 Recommendation for a Council decision abrogating Decision 2009/417/EC on the existence of an excessive deficit in Spain.

Chart 1
STRUCTURAL BALANCE OF GENERAL GOVERNMENT



SOURCES: 2019-2022 Stability Programme Update, spring forecast of the EC (May 2019) and Spanish economic forecast of the Banco de España (June 2019).

First, based on its level of debt (above 60% of GDP) and its cyclical position (positive output gap), Spain will have to make an annual adjustment in structural deficit terms of 0.65 percentage points of GDP in 2019 and 2020.[5] Second, this structural adjustment must be compatible with the primary public spending growth rate below 0.6% and 0.9% in 2019 and 2020, respectively.[6]

Additionally, holding public debt above the 60%-of-GDP threshold makes it necessary to reduce GDP at a sufficient pace to prevent Spain returning to the "corrective arm", this time due to excessive debt (see Chart 2). Specifically, for a debt-to-GDP ratio exceeding 60% not be considered excessive, the general rule is that this ratio must be reduced annually at one-twentieth of the difference from 60%. However, in the three years following the repeal of the EDP (i.e. 2019-2021 in this case), Spain will remain in a transitional period which endows a certain degree of flexibility regarding the debt rule. This is because a minimum adjustment of the structural deficit is required, which ensures compliance with the debt criterion at the end of the transitional period.[7] In particular, the minimum annual structural adjustment required of Spain for 2019 would be 0.5 pp of GDP.[8]

However, on the Government's latest estimates sent to the European Commission in April as part of the 2019-2022 Stability Programme Update, the structural balance for 2019 is expected to worsen by -0.2 pp of GDP (see Chart 1), as compared with the required improvements of +0.65 pp under the preventive arm and of 0.5 pp under the debt rule. Meanwhile, compared with the maximum allowed growth rate of eligible public spending of 0.6%, the projected growth of this variable for 2019 in the Stability Programme Update is 3.9%.

In this respect, although the Council should not make any statement on the Spanish fiscal policy stance until spring 2020, once the 2019 data have been published,[9] the EU's recent recommendation emphasised that, for the current year, there is a significant risk of deviation from the established requirements. Should this deviation materialise, the Council would recommend that Spain adopt the necessary adjustment measures, non-compliance with which could even lead to a requirement to make a deposit of 0.2% of GDP.

5 See the Recommendation for a Council recommendation on the National Reform Programme of Spain and delivering a Council opinion on the 2018 and 2019 Stability Programmes of Spain.

6 With a view to complying with the rule, public expenditure is defined excluding the interest burden and non-discretionary spending on unemployment benefits. Also excluded is EU programme expenditure which is fully offset by revenue from EU funds. Also, given its variability, government investment is not included at its annual amount, but rather as the average expenditure over four years.

7 This adjustment is known as the minimum linear structural adjustment (MLSA). Chart 2.1 shows various public debt paths for Spain in the period 2019-2021, including: that resulting from projections by the Directorate General Economics, Statistics and Research of the Banco de España, that compatible with the minimum structural adjustment (calculated from the EU's 2019 spring projections) and that resulting from application of the general rule.

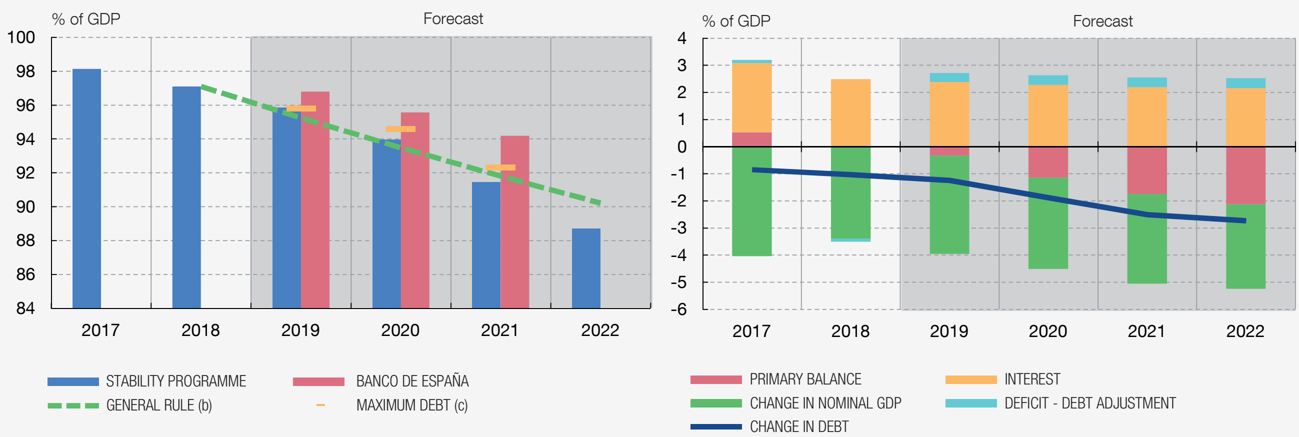
8 See Assessment of the 2019 Stability Programme for Spain.

9 Compliance with the Council recommendations under the SGP "preventive component" is determined by an ex-post check, i.e. based on the data published after year-end (see "Vade Mecum on the Stability and Growth Pact – 2019 Edition").

Chart 2
GENERAL GOVERNMENT DEBT

1 DEBT

2 BREAKDOWN OF CHANGE IN DEBT (a)



SOURCES: 2019-2022 Stability Programme Update and Spanish economic forecast of the Banco de España (June 2019).

a 2019-2022 Stability Programme Update.
b Annual reduction by one-twentieth of the difference from 60%.
c Estimate of the maximum debt compatible with the requirements of the transition period.

Compliance with the fiscal rules set in the European budgetary governance process is a requirement which all member countries must meet in order to contribute to maintaining the macroeconomic stability of the euro area. But it also constitutes a desirable objective from the national standpoint, insofar as it helps to endow each country's public finances with the resilience needed to withstand possible future downturns and ensure their long-term sustainability.