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COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 24.3.2009
SEC(2009) 561 final

Recommendation for a

COUNCIL DECISION

on the existence of an excessive deficit in Spain

EXPLANATORY MEMORANDUM

1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn. Several factors are at play. First, the economic downturn brings about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be timely, targeted and temporary and differentiated across Member States, with more room for manoeuvre for those Member States that have achieved sustainable public finance positions and improved their competitive positions. The Plan also called for structural reforms that support demand and promote resilience in the short term, while paying special attention to actions in the four priority areas of the Lisbon Strategy. Finally, several countries have taken measures to stabilise the financial sector, some of which impact on the debt position or constitute a risk of higher deficits and debt in the future, although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to initiate the excessive deficit procedure (EDP) whenever the deficit of a Member State exceeds the 3% of GDP reference value. The amendments to the Stability and Growth Pact in 2005 aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation, and thereby ensuring long-term sustainability of public finances.

2. PREVIOUS STEPS IN THE EXCESSIVE DEFICIT PROCEDURE

Article 104 of the Treaty lays down an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure"[1], which is part of the Stability and Growth Pact.

According to Article 104(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is

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1 OJ L 209, 2.8.1997, p. 6. Account is also taken of the Opinion of the Economic and Financial Committee on the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005, available at: http://ec.europa.eu/economy_finance/other_pages/other_pages12638_en.htm.

only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 104(3) stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. This report also has to “take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State”.

On the basis of the budgetary data included in the January 2009 update of the stability programme of Spain and taking into account the Commission services’ January 2009 interim forecast, the Commission adopted a report under Article 104(3) for Spain on 18 February 2009[2].

Subsequently, and in accordance with Article 104(4), the Economic and Financial Committee formulated an opinion on the Commission report on 27 February 2009.

3. THE EXISTENCE OF AN EXCESSIVE DEFICIT

According to the January 2009 update of the stability programme, Spain's general government deficit is estimated to have reached 3.4% of GDP in 2008, thus exceeding the 3% of GDP reference value. The Commission report under Article 104(3) considered that the deficit was close to the 3% of GDP reference value but that the excess over the reference value cannot be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. In particular, it did not result from an unusual event or a severe economic downturn in 2008. According to the Commission services’ January 2009 interim forecast, real GDP growth in Spain is estimated to have decelerated markedly in 2008 to 1.2%, but the output gap remained positive at 1% of GDP. Furthermore, the excess over the reference value cannot be considered temporary. According to the Commission services’ January 2009 interim forecast, the general government headline deficit will increase to 6.2% of GDP in 2009, including deficit-increasing one-off measures worth over ½% of GDP. The forecast was based on a projected GDP contraction by 2% as well as on a prudent assessment of both the 2009 Budget Law and the fiscal package announced by the Spanish authorities on 27 November 2008. Based on the customary unchanged policies assumption, the 2010 deficit is projected at 5.7% of GDP. Therefore, the deficit criterion in the Treaty is not fulfilled.

General government gross debt remains well below the 60% of GDP reference value and stood at 39.5% of GDP in 2008. However, according to the Commission services’ January 2009 interim forecast, the general government debt-to-GDP ratio is projected to increase significantly reaching 53% in 2010.

In line with the provisions in the Treaty and the Stability and Growth Pact, the Commission also analysed in its report “relevant factors”. According to the Stability and Growth Pact, these can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the deficit satisfies the double condition of closeness and temporariness. In

[2] All EDP-related documents for Spain can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2.

the case of Spain, the double condition is not met. Considered on their own merit, the relevant factors in the current case on balance seem to be relatively favourable.

The opinion of the Economic and Financial Committee in accordance with Article 104(4) of the Treaty is consistent with the assessment in the Commission report under Article 104(3).

The Commission, having taken into account its report under Article 104(3) and the opinion of the Economic and Financial Committee under Article 104(4), is of the opinion that an excessive deficit exists in Spain. This opinion, adopted by the Commission on [24 March] 2009, is herewith addressed to the Council according to Article 104(5). The Commission recommends that the Council shall decide accordingly, in conformity with Article 104(6). In addition, the Commission is submitting to the Council a recommendation for a Council recommendation to be addressed to Spain with a view to bringing the situation of an excessive deficit to an end according to Article 104(7).

4. RECOMMENDATIONS TO END THE EXCESSIVE DEFICIT SITUATION

According to Article 3(4) of Council Regulation (EC) No 1467/97, the Council recommendation under Article 104(7) has to establish a deadline of six months at most for effective action to be taken by the Member State concerned as well as a deadline for the correction of the excessive deficit, which "should be completed in the year following its identification unless there are special circumstances". Article 2(6) of the Regulation implies that the "relevant factors" considered in the Commission report under Article 104(3) of the Treaty have to be taken into account in deciding whether special circumstances exist. Article 3(4) of the Regulation specifies that the Council has to recommend that the Member State achieves a "minimum annual improvement of at least 0.5% of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation".

In the case of Spain, special circumstances are considered to exist, warranting an extension of the deadline for the correction of the excessive deficit beyond 2010. In particular, the rate of economic growth has decreased sharply in 2008 to 1.2% from 3.7% in 2007 and, according to the Commission services' January 2009 interim forecast, GDP is expected to decline by 2% in 2009 and by 0.2% in 2010. This downturn in economic activity is accompanied by a decline also in potential output growth on account of a series of mutually reinforcing structural factors, including a sizeable downsizing of the construction sector to more sustainable levels of activity, which entail a medium-term growth rate well below that observed in the years preceding the recession. With potential GDP growth projected to average around 1% in 2009/2010 in the Commission services' January 2009 interim forecast, the output gap is projected to fall to -3% on average over the same period. The government deficit is projected to further widen in 2009, to 6.2% of GDP, before improving moderately in 2010 to reach 5.7% of GDP. Bringing the government deficit below the 3% of GDP reference value in 2010 would require an improvement of the headline deficit by over 3% of GDP from 2009. All in all, in view of the current sharp economic downturn and the size of the required budgetary correction special circumstances as meant in the Stability and Growth Pact exist.

Against this background, it is appropriate to consider the correction of the excessive deficit in a medium-term framework in accordance with the path for deficit reduction as specified in the January 2009 stability programme – on which the Council gave its opinion on 10 March 2009 – with a deadline for the correction of 2012. A credible adjustment path would require the

Spanish authorities to stick to the fiscal targets as spelled out in the January 2009 update of the stability programme of Spain up to 2011. This means, first, implementing rigorously the plans for fiscal policy for 2009 as outlined in the January 2009 update of the stability programme of Spain, which reflects also the fiscal impulse package presented in the context of the European Economic Recovery Plan. Second, additional annual fiscal efforts might be necessary so as to achieve a government deficit targets up to 2011 if downside risks to the budgetary targets were to materialize. Finally, it will require ensuring the additional effort in 2012 so as to achieve a government deficit below 3% in that year in a credible and sustainable manner. In order to limit risks to the medium-term fiscal adjustment, Spain should stick to the binding nature of its medium-term budgetary framework as well as closely monitor adherence to the budgetary targets for the various levels of the government sector throughout the year. Finally, enhanced surveillance under the EDP, which seems necessary in view also of the extension of the deadline for the correction of the excessive deficit, will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy. In this context, a separate chapter in the updates of the Spanish stability programme which will be prepared between 2009 and 2012 could usefully be devoted to this issue.

The budgetary strategy outlined in the January 2009 update of the stability programme of Spain aims at gradually reducing the government deficit in 2010 and 2011 after a fiscal expansion in 2009. However, the deficit would remain above the 3% of GDP reference value by the end of the programme period in 2011. Specifically, the programme targets government deficits of 5.8% of GDP in 2009, 4.8% in 2010 and 3.9% of GDP in 2011. This fiscal path is assumed to be achieved against a macroeconomic scenario where GDP contracts by 1.6% in volume terms in 2009 and grows by 1.2% and 2.6% in 2010 and 2011 respectively. In structural terms, this would imply a fiscal expansion in 2009 on account of the significant fiscal impulse implemented in this year as a response to the economic downturn and in line with the European Economic Recovery Plan, which would be completely reversed in 2010, and an improvement in the cyclically-adjusted balance net of one-off and temporary measures slightly over ½% of GDP in 2011. In its opinion of 10 March 2009 on the Spanish stability programme, the Council stated that the budgetary targets are subject to downside risks throughout the programme period. First, downside risks pertain to the growth assumption in the underlying macroeconomic scenario, which appears to be favourable. Second, the adjustment path in the programme is not fully backed up with concrete measures. Besides the risks to the fiscal targets highlighted by the Council, delaying much fiscal consolidation would affect negatively the government debt ratio, which even if still below 60% of GDP is foreseen to increase markedly in the coming years, adding to the high risks to the long-term sustainability of public finances.

Enhanced surveillance under the EDP, which seems necessary in view also of the relatively long period for the correction, will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy to ensure the correction of the excessive deficit.

Key macroeconomic and budgetary projections

		2007	2008	2009	2010	2011
Real GDP (% change)	**SP Jan 2009**	**3.7**	**1.2**	**-1.6**	**1.2**	**2.6**
	COM Jan 2009	3.7	1.2	-2.0	-0.2	n.a.
Output gap[1] (% of potential GDP)	**SP Jan 2009**	**1.4**	**0.3**	**-2.6**	**-3.2**	**-2.7**
	COM Jan 2009[2]	1.5	0.8	-2.3	-3.4	n.a.
General government balance (% of GDP)	**SP Jan 2009**	**2.2**	**-3.4**	**-5.8**	**-4.8**	**-3.9**
	COM Jan 2009	2.2	-3.4	-6.2	-5.7	n.a.
Primary balance (% of GDP)	**SP Jan 2009**	**3.8**	**-1.9**	**-4.1**	**-2.9**	**-1.9**
	COM Jan 2009	3.8	-1.8	-4.6	-4.0	n.a.
Cyclically-adjusted balance[1] (% of GDP)	**SP Jan 2009**	**1.6**	**-3.5**	**-4.7**	**-3.4**	**-2.8**
	COM Jan 2009	1.6	-3.7	-5.2	-4.2	n.a.
Structural balance[3,4] (% of GDP)	**SP Jan 2009**	**1.6**	**-3.5**	**-4.7**	**-3.4**	**-2.8**
	COM Jan 2009	1.6	-3.3	-4.6	-4.2	n.a.
Government gross debt (% of GDP)	**SP Jan 2009**	**36.2**	**39.5**	**47.3**	**51.6**	**53.7**
	COM Jan 2009	36.2	39.8	46.9	53.0	n.a.

Notes:
[1] Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.
[2] Based on estimated potential growth of 3.0%, 1.8%, 1.0% and 0.9% respectively in the period 2007-2010.
[3] Cyclically-adjusted balance excluding one-off and other temporary measures. No one-offs are included in the most recent programme. One-off and other temporary measures are below ½% of GDP in 2008 and above ½% in 2009, all deficit-increasing, are included in the Commission services' January 2009 interim forecast.
[4] Using the recalculated cyclically-adjusted balance, based on the information in the programme, and the definition of one-offs and other temporary measures applied by the Commission services, the structural balance would be - 3.1% of GDP in 2008, -4.1% of GDP in 2009, and -3.4% of GDP in 2010.

Source:
Stability programme (SP); Commission services' January 2009 interim forecasts (COM); Commission services' calculations.

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(6) thereof,

Having regard to the recommendation from the Commission,

Having regard to the observations made by Spain,

Whereas:

(1) According to Article 104 of the Treaty Member States shall avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) The excessive deficit procedure (EDP) under Article 104, as clarified by Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure[3] (which is part of the Stability and Growth Pact), provides for a decision on the existence of an excessive deficit. The Protocol on the excessive deficit procedure annexed to the Treaty sets out further provisions relating to the implementation of the EDP. Council Regulation (EC) No 3605/93[4] lays down detailed rules and definitions for the application of the provision of the said Protocol.

(4) The 2005 reform of the Stability and Growth Pact sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. It aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

(5) Article 104(5) of the Treaty requires the Commission to address an opinion to the Council if the Commission considers that an excessive deficit in a Member State exists or may occur. Having taken into account its report in accordance with Article 104(3)

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[3] OJ L 209, 2.8.1997, p. 6.
[4] OJ L 332, 31.12.1993, p. 7.

and having regard to the opinion of the Economic and Financial Committee in accordance with Article 104(4), the Commission concluded that an excessive deficit exists in Spain. The Commission therefore addressed such an opinion to the Council in respect of Spain on 24 March 2009[5].

(6) Article 104(6) of the Treaty states that the Council should consider any observations which the Member State concerned may wish to make before deciding, after an overall assessment, whether an excessive deficit exists. In the case of Spain, this overall assessment leads to the following conclusions.

(7) According to the January 2009 update of the stability programme, Spain's general government deficit is estimated to have reached 3.4% of GDP in 2008, thus exceeding the 3% of GDP reference value. The deficit was close to the 3% of GDP reference value but the excess over the reference value cannot be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. In particular, it did not result from an unusual event or a severe economic downturn in 2008. According to the Commission services' January 2009 interim forecast, real GDP growth in Spain is estimated to have decelerated markedly in 2008 to 1.2%, but with the output gap remaining positive at 1% of GDP. Furthermore, the excess over the reference value cannot be considered temporary. According to the Commission services' January 2009 interim forecast, the general government headline deficit will increase to 6.2% of GDP in 2009, including deficit-increasing one-off measures worth over ½% of GDP. The forecast was based on a projected GDP contraction by 2% as well as on a prudent assessment of both the 2009 Budget Law and the fiscal package announced by the Spanish authorities on 27 November 2008. Based on the customary unchanged policies assumption, the 2010 deficit is projected at 5.7% of GDP. Therefore, the deficit criterion in the Treaty is not fulfilled.

(8) General government gross debt remains well below the 60% of GDP reference value and stood at an estimated 39.5% of GDP in 2008 according to the January 2009 stability programme. However, according to the Commission services' January 2009 interim forecast, the general government debt-to-GDP ratio is projected to increase significantly reaching 53% in 2010.

(9) According to Article 2(4) of Council Regulation (EC) No 1467/97, "relevant factors" can only be taken into account in the steps leading to the Council decision on the existence of an excessive deficit in accordance with Article 104(6) if the double condition - that the deficit remains close to the reference value and that its excess over the reference value is temporary - is fully met. In the case of Spain, this double condition is not met. Therefore, relevant factors are not taken into account in the steps leading to this decision.

HAS ADOPTED THIS DECISION:

Article 1

From an overall assessment it follows that an excessive deficit exists in Spain.

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5 All EDP-related documents for Spain can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2.

Article 2

This decision is addressed to the Kingdom of Spain.

Done at Brussels,

For the Council
The President