COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 7.3.2007
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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated stability programme of Spain, 2006-2009

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. General background

The Stability and Growth Pact, which entered into force on 1 July 1998, 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. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that Member States have to submit, to the Council and the Commission, stability or convergence programmes and annual updates thereof (Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes). The first stability programme of Spain was submitted in December 1998. In accordance with the Regulation, the Council delivered an opinion on it on 15 March 1999 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. In accordance with the same procedure, updated stability and convergence programmes are assessed by the Commission and examined by the Committee mentioned above, while the Council may examine them.

2. Background for the assessment of the updated programme

The Commission has examined the most recent update of the stability programme of Spain, submitted on 22 December 2006, and has adopted a recommendation for a Council opinion on it (see box for the main points covered by the assessment).

In order to set the scene against which the budgetary strategy in the updated stability programme is assessed, the following paragraphs summarise:

(1) the economic and budgetary performance over the last ten years

(2) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the stability programme) and

(3) the Commission's assessment of the October 2006 national reform programme.

[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

2.1. Recent economic and budgetary performance

Spain seems to be enjoying a virtuous economic circle. Domestic demand, fuelled by private consumption and investment in construction, is at the origin of an intense job creation in housing and services, which, in turn, feeds domestic demand again, in a context of healthy public finances and negative real interest rates. However, a persistent inflation differential with the euro area, coupled with slow productivity growth, is deteriorating the external competitive position of a country whose comparative advantages are still based on low production costs rather than on products with a high technological content. Widening external deficits might jeopardise medium-term growth prospects. Furthermore, high households' indebtedness, largely explained by massive investment in dwellings, is increasing the vulnerability of a large hare of the population to a rise in interest rates. Prudent fiscal policies implemented by Spain have been appropriate against this background.

2.2. The assessment in the Council opinion on the previous programme

On 14 March 2006, the Council adopted its opinion on the previous update of the stability programme, covering the period 2005-2008. The Council was of the opinion that "overall, the budgetary position is sound and the budgetary strategy provides a good example of fiscal policies conducted in compliance with the Pact. Maintaining a strong budgetary position is important in the light of rising external imbalances". The Council invited Spain to "implement the envisaged measures to address the long-term budgetary implications of ageing populations".

2.3. The Commission assessment of the October 2006 national reform programme

The implementation report of the national reform programme of Spain, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 15 October 2006. Spain's national reform programme identifies as key challenges/priorities: budgetary stability; R&D strategy; a better environment for business; promoting competition; infrastructure development; a better functioning of the labour market; and better education and human capital.

The Commission’s assessment of this programme (adopted as part of its December 2006 Annual Progress Report[2]) showed that Spain is making good progress in the implementation of its National Reform Programme and the commitments agreed at the 2006 Spring European Council. Further implementation of new laws and measures across the seven key policy areas are now essential in order to increase employment and productivity and progress towards full GDP per capita convergence with EU-25.

Against the background of strengths and weaknesses identified, Spain was recommended to take action in the areas of competition; active labour market policies; life-long learning and education.

[2] Communication from the Commission to the Spring European Council, “Implementing the renewed Lisbon strategy for growth and jobs - A year of delivery” - COM(2006) 816, 12.12.2006.

Box: Main points covered by the assessment

As required by Article 5(1) (for stability programmes) and Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2006 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. The assessment of consistency with the broad economic policy guidelines is made against the broad economic policy guidelines in the area of public finances as included in the integrated guidelines for the period 2005-2008.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[3];
- the degree of integration with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[4], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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3 Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

4 "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.

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in accordance with the third paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated stability programme of Spain, 2006-2009

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[5], and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [27 March 2007] the Council examined the updated stability programme of Spain, which covers the period 2006 to 2009[6].

(2) The macroeconomic scenario underlying the programme envisages that real GDP growth will decrease from 3.8% in 2006 to 3.3% on average over the rest of the programme period. Assessed against currently available information, this scenario appears to be based on plausible growth assumptions. The programme's projections for inflation also appear realistic. The projected inflation differential with the euro area, although decreasing, is still significant. While there may be some upside risks in the short term, there might also be some downside risks to this scenario associated to the imbalances of the economy, namely the increasing household indebtedness and the widening current account deficit. Furthermore, less buoyant growth in the medium term than foreseen in the programme is a distinct possibility, notably if the extended residential construction boom came to an end.

(3) For 2006, the Commission services' autumn 2006 forecast estimated the general government surplus at 1.5% of GDP, fully in line with the updated stability

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5 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

6 The update was submitted 3 weeks beyond the 1 December deadline set in the code of conduct.

programme, but against a target of 0.9% of GDP set in the previous update of the stability programme. This positive outcome is the result of higher-than-expected revenues stemming from strong job creation and buoyant corporate profits, which are estimated to have boosted direct tax revenues well above nominal GDP growth.

(4) The update aims at (i) maintaining macroeconomic and budgetary stability and (ii) fostering productivity by increasing infrastructure, human and technological capital. The general government surplus is envisaged to decline from 1.4% of GDP in 2006 to about 1% in 2009. The time profile of the primary surplus is similar, falling from 3% of GDP in 2006 to 2¼% in 2009. While revenues should decline by 0.2% of GDP over the programme period, primary expenditures should increase by around 0.5% of GDP, partly offset by a decline in the interest burden. The previous update projected smaller surpluses against a broadly similar macroeconomic outlook. The difference between the two updates is to be found in a much better 2006 surplus outcome than projected one year earlier, which is projected to have favourable carryover effects over the programme period.

(5) The structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to marginally decline from around 1¾% of GDP in 2006 to 1½% at the end of the programme period. As in the previous update of the stability programme, the medium-term objective (MTO) for the budgetary position presented in the programme is a balanced position in structural terms, which the programme plans to maintain by a large margin throughout the programme period. As the MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1¼% of GDP, achieving it should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The MTO lies within the range indicated for euro-area and ERM II Member States in the Stability and Growth Pact and the code of conduct and is more demanding than implied by the debt ratio and average potential output growth in the long term.

(6) The risks to the budgetary projections in the programme appear broadly balanced. The macroeconomic scenario underlying the update is plausible and revenue projections seem to reflect cautious assumptions. On the expenditure side, there is a risk of some expenditure overruns (at the level of regional authorities) if past trends in education and health care are confirmed.

(7) In view of this risk assessment, the budgetary stance seems sufficient to maintain the MTO throughout the programme period, as envisaged in the programme. In addition it provides a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations in every year. The fiscal policy stance implied by the programme is in line with the Stability and Growth Pact.

(8) Government gross debt is estimated to have declined to 40% of GDP in 2006, well below the 60% of GDP Treaty reference value. The update projects the debt ratio to further decline by 8 percentage points over the programme period.

(9) The long-term budgetary impact of ageing in Spain is well above the EU average, mainly as a result of a relatively high increase in pension expenditure as a share of GDP over the coming decades. The initial budgetary position, improved compared with 2005, contributes to easing the projected long-term budgetary impact of ageing

populations, but is not sufficient to fully cover the substantial increase in expenditure due to the ageing of the population. Maintaining high primary surpluses over the medium term and implementing further measures aimed at curbing the significant increase in age-related expenditures would contribute to reducing risks to the sustainability of public finances. Overall, Spain appears to be at medium risk with regard to the sustainability of public finances.

(10) The stability programme contains a qualitative assessment of the overall impact of the October 2006 implementation report of the national reform programme within the medium-term fiscal strategy. However, it provides no systematic information on the direct budgetary costs or savings of the main reforms envisaged in the national reform programme, although its budgetary projections seem to take into account the public finance implications of the actions outlined in the national reform programme. The measures in the area of public finances envisaged in the stability programme seem consistent with those foreseen in the national reform programme. In particular, both programmes envisage the gradual increase of public R&D expenditures and of infrastructure investments.

(11) The budgetary strategy in the programme is broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008.

(12) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and most of the optional data[7].

The overall conclusion is that the medium term budgetary position is sound and the budgetary strategy provides a good example of fiscal policies conducted in compliance with the Stability and Growth Pact. A strong budgetary position is important in the light of rising external imbalances and the existing inflation differential with the euro area.

In view of the above assessment and in particular the projected increase in age-related expenditure, Spain is invited to further improve the long term sustainability of public finances with measures to contain the future impact of ageing on spending programmes.

[7] In particular, the data on HICP as well as on general government expenditure by function are not provided.

Comparison of key macro economic and budgetary projections

		2005	2006	2007	2008	2009
Real GDP (% change)	**SP Dec 2006**	**3.5**	**3.8**	**3.4**	**3.3**	**3.3**
	COM Nov 2006[7]	3.5	3.8	3.4	3.3	n.a.
	SP Dec 2005	*3.4*	*3.3*	*3.2*	*3.2*	n.a.
HICP inflation[6] (%)	**SP Dec 2006[6]**	**3.4**	**3.5**	**2.7**	**2.6**	**2.5**
	COM Nov 2006	3.4	3.6	2.8	2.7	n.a.
	SP Dec 2005[6]	*4.2*	*3.5*	*3.3*	*3.2*	n.a.
Output gap (% of potential GDP)	**SP Dec 2006[1]**	**-0.9**	**-0.9**	**-1.2**	**-1.5**	**-1.6**
	COM Nov 2006[5]	-0.8	-0.9	-1.1	-1.3	n.a.
	SP Dec 2005[1]	*-0.5*	*-0.8*	*-1.1*	*-0.7*	n.a.
General government balance (% of GDP)	**SP Dec 2006**	**1.1**	**1.4**	**1.0**	**0.9**	**0.9**
	COM Nov 2006	1.1	1.5	1.1	0.9	n.a.
	SP Dec 2005	*1.0*	*0.9*	*0.7*	*0.6*	n.a.
Primary balance (% of GDP)	**SP Dec 2006**	**2.9**	**3.0**	**2.5**	**2.3**	**2.2**
	COM Nov 2006	2.9	3.1	2.7	2.3	n.a.
	SP Dec 2005	*2.8*	*2.6*	*2.2*	*2.0*	n.a.
Cyclically-adjusted balance (% of GDP)	**SP Dec 2006[1]**	**1.5**	**1.8**	**1.5**	**1.6**	**1.6**
	COM Nov 2006	1.5	1.9	1.6	1.4	n.a.
	SP Dec 2005[1]	*1.2*	*1.2*	*1.2*	*0.9*	n.a.
Structural balance[2] (% of GDP)	**SP Dec 2006[3]**	**1.5**	**1.8**	**1.5**	**1.6**	**1.6**
	COM Nov 2006[4]	1.5	1.9	1.6	1.4	n.a.
	SP Dec 2005	*1.2*	*1.2*	*1.2*	*0.9*	n.a.
Government gross debt (% of GDP)	**SP Dec 2006**	**43.1**	**39.7**	**36.6**	**34.3**	**32.2**
	COM Nov 2006	43.1	39.7	37.0	34.7	n.a.
	SP Dec 2005	*43.1*	*40.3*	*38.0*	*36.0*	n.a.

Notes:

[1] Commission services calculations on the basis of the information in the programme.
[2] Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.
[3] One-off and other temporary measures taken from the programme.
[4] One-off and other temporary measures taken from the Commission services' autumn 2006 forecast.
[5] Based on estimated potential growth of 3,9%, 3,8%, 3,6% and 3,6% respectively in the period 2005-2008.
[6] Private consumption deflator instead of HICP.
[7] According to first estimates, growth was 3.9% in 2006. The Commission services' interim forecast of 16 February 2007 projects growth of 3.7% in 2007.

Source:
Stability programme (SP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations