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Abstract: *This paper examines the fiscal strategy followed by the Spanish government in order to stop the fall of aggregate demand induced by the financial crisis. The Spanish economy provides the best example among the countries of the European Monetary Union of the contradictions between the discretionary fiscal policy in the crisis and the fiscal rules. The intensity of the crisis and some initial badly designed fiscal stimulus shortened the fiscal space, raising the deficit over the limit established in the Stability and Growth Pact. As a consequence of the enforcement of the rule, the Spanish administration has to apply a restrictive fiscal policy without having left the recession, while keeping one of the lowest indebtedness levels in the euro zone countries.*

Key words: *fiscal policy, fiscal rules, Spain.*

In a recent article, Auerbach indicated that "the current recession provides compelling circumstances for renewed fiscal policy activism. But the strong support for fiscal policy intervention reflects a renewed belief in policy activism that had already appeared before the present crisis" (2009, p. 548). It is true that during the last years, we have observed the theoretical rediscovery of the advantages of the fiscal policy to control aggregate demand. This new interest, though, is not generalized and has not been able to provide enough "inputs" for the design of new fiscal strategies.

The claims for an active fiscal policy have always been one of the distinct features of Post Keynesian thought, which has considered fiscal policy as a more powerful instrument than monetary policy (Arestis and Sawyer, 2003). However, as Arestis and Fontana point out, "it is really

astonishing that the journals that typically publish contributions within
the Post Keynesian tradition have few or no papers dealing with the sta-
bilization role of discretionary fiscal policy" (2009, p. 547). The recent
theoretical recovery of fiscal policy is also associated, paradoxically, with
the "new macroeconomics consensus." Its new models of equilibrium
rediscover fiscal policy (for "normal times") when combining the rigid-
ity on prices and wages with the presence of non-Ricardian consumers
(Galí et al., 2007).[1] These new models, however, are still being devel-
oped, and they are not a distinctive feature of the new macroeconomics
consensus.

The present use of the fiscal policy is pragmatic. The core idea is that
not all countries can apply expansionary fiscal policy and not all countries
can apply it with the same intensity (Spilimbergo et al., 2008). The fiscal
possibilities depend on the fiscal space that is available. This space ends
when the maintenance of deficits faces a problem of sustainability.[2] The
concept of sustainability is ambiguous in its definition. There does not
exist an unambiguous definition of sustainability and of the limits that
should define the corresponding implicit fiscal rule—that is, a limit to
the total deficit, to the primary deficit, or to public debt.

Fiscal policy has been used because the crisis has weakened the tradi-
tional monetary transmission mechanisms. But, simultaneously, fiscal
rules, at least in the European Monetary Union (EMU), are maintained,
although a degree of flexibility in their interpretation is accepted. The
concern about keeping down the growth of public deficits behaves as an
implicit restriction, both in the design and in the intensity with which a
fiscal stimulus is executed. The constant appeal to the effects of popula-
tion aging on public expenditure in the following decades is presented
as a burden to the implementation of fiscal stimulus in the present situa-
tion. All things considered, in the reports of the International Monetary
Fund (IMF), Organization for Economic Cooperation and Development

[1] In these models, individuals do not participate in financial markets. Their con-
sumption is supposed to be equal to their disposable income; therefore, they do not
lend or borrow resources.

[2] "The fiscal response to the crisis was to increase government spending, lower
taxes, and accept much larger fiscal deficits. Given the collapse of private demand, and
the inability to reduce interest rates below zero, governments clearly chose the right
response. But large deficits lead to rapid increases in debt, and, because debt levels
were already high in many countries, such increases cannot go on for long. As large
deficits continue, debt sustainability comes increasingly into question. And with this
comes the risk of higher long-term interest rates, both because of anticipated crowd-
ing out of private borrowers by government borrowers and because of a higher risk of
default" (Blanchard, 2009, p. 10).

(OECD), and the European Commission, there is a predominant conviction that the best guarantee for the economic growth is associated with narrow margins of fiscal discretion.

The aim of this paper is to show how incoherently the fiscal policy is being carried out, taking Spain as a case study. The Spanish economy provides the best example among the countries of the European Union to describe that incoherence. At the beginning of the crisis, Spanish public finances were among the soundest in the European Union. The intensity of the crisis and some initial badly designed fiscal stimulus reduced the fiscal space (set by the fiscal rules of the Stability and Growth Pact), raising the deficit over the limit established by the rules. As a consequence of the enforcement of the rules, the Spanish administration will have to apply a restrictive fiscal policy while there is still a recession, while keeping one of the lowest indebtedness levels in the euro zone countries.

The starting point is to show that there was enough initial fiscal space as a result of the previous fiscal performances. Then I proceed to explain the policies developed and, finally, provide empirical evidence and some reflections that show that the end of the fiscal space depends on the future monetary policy carried out by the European Central Bank (ECB).

The fiscal space

Table 1 shows the evolution of Spanish fiscal policy in the last years. As can be seen, public expenditure (cyclically adjusted) shows a stability path in the years prior to the crisis, around 39 percent of gross domestic product (GDP). Fiscal revenues (also cyclically adjusted) show a growth path until 2007, when they reached the maximum value of that period (40.5 percent of GDP). The result of this evolution of revenues and expenditure was a correction of the needs for financing of the public sector that led to the surge in the budget surplus. From a deficit equivalent to 1.5 percent of GDP (cyclically adjusted) in 2000, Spain reached a surplus in the three years preceding the crisis. The public debt, for its part, decreased twenty-three percentage points of the current GDP between 2000 and 2007. In 2007, it represented 36.2 percent of GDP, one of the lowest rates in the European Union. This fall in the extent of the debt, combined with the decrease of the interest rate boosted by the ECB from the beginning of the decade, considerably reduced the expenditure earmarked for the settlement of the debt. In 2007, financial expenditure for this concept was equivalent to 1.6 percent of GDP.

Therefore, Spain had a considerable fiscal space to correct the negative impact on aggregate demand induced by the financial crisis. The level

Table 1
Fiscal policy in Spain (2000–2010)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009*	2010*
Total revenue											
Actual data											
Ratio as a percent of GDP	38.1	38	38.4	38.2	38.5	39.4	40.5	41	36.6	36.6	37.3
Change in ratio from previous year	−0.3	−0.1	0.4	−0.2	0.4	0.9	1.1	0.5	−4.4	−0.1	0.7
Cyclically adjusted data											
Ratio as a percent GDP	37.6	37.6	38.4	38.3	38.7	39.5	40.3	40.5	36.3	37.5	38.7
Change in ratio from previous year	−0.7	0	0.8	0	0.4	0.8	0.7	0.2	−4.2	1.2	1.2
Total expenditure											
Actual data											
Ratio as a percent of GDP	39.1	38.6	38.9	38.4	38.9	38.4	38.5	38.8	40.5	45.2	47.1
Change in ratio from previous year	−0.8	−0.5	0.3	−0.5	0.5	−0.4	0	0.4	1.6	4.7	1.9
Cyclically adjusted data											
Ratio as a percent of GDP	39.2	38.7	38.9	38.4	38.8	38.4	38.5	38.9	40.5	45	46.9
Change in ratio from previous year	−0.7	−0.5	0.2	−0.5	0.5	−0.4	0.1	0.4	1.6	4.5	1.8
Net lending (+) or net borrowing (−)											
Actual balance (as a percent of GDP)	−1.0	−0.6	−0.5	−0.2	−0.3	1.0	2.0	2.2	−3.8	−8.6	−9.8
Cyclically adjusted balance (as a percent of GDP)	−1.5	−1.1	−0.5	0.0	−0.1	1.1	1.8	1.6	−4.2	−7.5	−8.2
Government debt (as a percent of actual GDP)	59.2	55.3	52.3	48.7	46.2	42.9	39.6	36.2	39.5	52.0	—

Source: European Commission (2009a) and author's elaboration.

* Forecast.

of indebtedness was low, as was the financial expenditure generated by the debt. And the surplus of the public accounts was far from the fiscal deficit level (3 percent) fixed in the Stability and Growth Pact.

This capacity could have been slightly higher if, in the years before 2008, an active fiscal policy had been performed with the aim of smoothing the economic cycle. From the beginning of the decade, the Spanish economy maintained a solid growth path until 2009. Between the years 2003 and 2008, the economy grew at an annual average rate of 3.2 percent. The peaks of maximum growth were reached in 2006 and 2007 with a positive output gap equivalent to 0.6 percent and 1.4 percent, respectively, of the potential GDP. The unemployment rate fell from 11.37 percent in 2003 to 8.26 percent in 2007.[3] The working population rate rose 3 points, from 56 percent in 2003 to 59 percent in 2007. This growth was encouraged by a strong credit expansion induced by negative real interest rates (see Ferreiro et al., 2007). The household indebtedness rate rose from 80 percent of their disposable income in 2003 to 130 percent in 2008. The level of the debt in nonfinancial corporations, measured as a percentage of the gross operating surplus, increased from 400 percent to 700 percent in the same period (Bank of Spain, 2009).

This situation demanded a more restrictive fiscal policy than the one observed,[4] which in 2007 had an expansive profile as the cyclically adjusted expense and revenue growth rates showed (see Table 1). The absence of this countercyclically fiscal policy caused a serious deterioration of the external balance, which reached 10.1 percent of GDP in 2007. The most significant thing, though, is that the fiscal policy, which the central and regional governments designed for the fiscal year 2008, had an expansionary bias for electoral reasons. Besides, this bias was reinforced by the effects brought about with the fiscal reforms (to be dealt with later on) that came into force during 2007. The combination of this procyclical policy (see Table 1) with the change of expectations that took place in 2008 has brought about a loss of that initial fiscal space. However, this loss is more apparent than real, as we will see below.

[3] This rate of unemployment may be considered as the long-run rate of unemployment.

[4] During a large part of the last decade, the Spanish economy was growing over its potential, which generated obvious tensions about prices. During the whole decade, price rises in Spain were approximately 1.3 percentage points higher than the average for the euro zone.
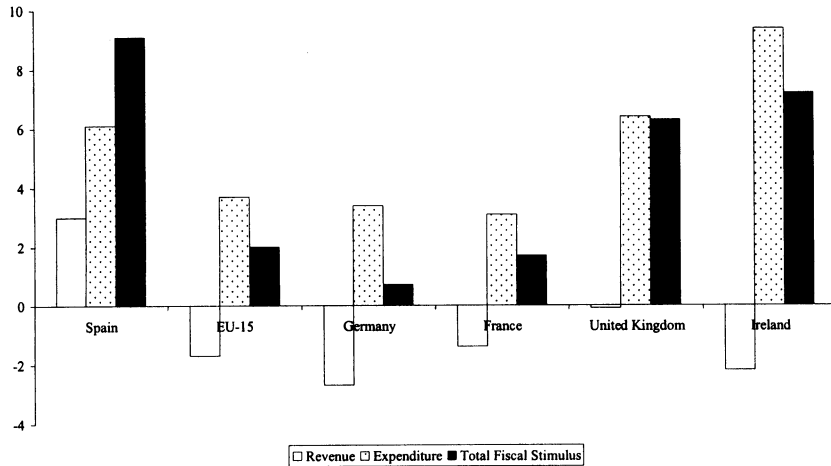
The fiscal stimulus

Figure 1 shows the discretionary fiscal stimulus in 2008 plus the one estimated for 2009 (as well as its distribution between taxes and expenses) by the Spanish economy and some of the most important economies of the European Union. The discretionary fiscal stimulus with the changes in the cyclically adjusted data of revenues and expenditures is identified.[5] Thus, in Figure 1, a positive value means a rise in the cyclically adjusted expenditures and a fall in the cyclically adjusted revenues. Consequently, a negative value involves a fall in the cyclically adjusted expenditures or a rise in the cyclically adjusted revenues.

The correct reading of the data requires some explanation. The estimation of public balances adjusted for the cycle, and especially the estimation of public revenues, shows some methodological problems that cause an overvaluation of the structural component and, as a corollary, an undervaluing of the cyclical element (Larch and Turrini, 2009). In the case of public revenues, there are two kinds of problems. The first has to do with the estimation of the economic cycle and the corresponding output gap, because this is not an observable variable. Besides this source of uncertainty, we have to add the one linked to the response of the fiscal income to the cycle.[6] In the case of expenditures, the only cyclical component is unemployment benefits. The information currently available at the time of writing does not permit making out the structural component of the expenditure from the cyclical component. For this reason, in the information provided by the European Union on cyclically adjusted balances, the cyclical component takes a value of zero in most countries. Therefore, the structural component of the expenditure is likely to be upwardly biased. In conclusion, the intensities of the fiscal effort reflected in Figure 1 must be interpreted cautiously. In any case, and with the information available, it is possible to draw some relevant conclusions for the analysis.

[5] From here onward, I identify a fiscal stimulus with a discretionary fiscal stimulus—that is, the result of the change in the cyclically adjusted position of public budget.

[6] For example, in the Spanish case, it has been observed that the structural component of fiscal revenues is lower than the estimated one (De Castro et al., 2008), because the estimation method of the balance attributes a part of the extra incomes generated as a consequence of the housing boom as structural income. The fiscal boost of 4.2 percent, shown in Table 1 for 2008, is very likely to be lower than that which has actually taken place. The loss of tax collection caused by the bursting housing bubble may be imputed to that value.

Figure 1 Discretionary fiscal stimulus in European countries, 2008–2009 (percent of GDP)

□ Revenue □ Expenditure ■ Total Fiscal Stimulus

Source: European Commission (2009a) and author's elaboration.

As can be observed in Figure 1, the fiscal stimulus engaged by the Spanish government during 2008–9 is equivalent to 9 percentage points of GDP. This stimulus is the result of a rise in the public expenditure equivalent to 6 percent of GDP together with a tax decline of 3 percent of GDP.

The rest of the countries have concentrated their fiscal stimulus exclusively on expenditure. The Irish economy has a more intense initial stimulus, equivalent to 9.4 percentage points of GDP. This stimulus, though, can be reduced due to the increase of taxation that took during 2009 and which can be equivalent, as the European Commission estimates, to 2.8 percentage points of GDP. For this reason, the total fiscal stimulus shown in Figure 1 is lower (in a percentage equivalent to the estimated raises in taxes) than the stimulus induced through expenditure increase.

France and Germany are in a similar situation, though their fiscal stimulus is lower than that of Spain, Ireland, and the United Kingdom. France and Germany have concentrated the increase in public expenditure in the fiscal year 2009 with increases, respectively, of 2.8 and 3.6 percentage points of GDP. For these two countries, the European Commission estimated a fiscal contraction in 2009 equivalent to 1.5 and 3 percentage points, respectively, of GDP, derived from a discretionary increase of the total revenues.

In the United Kingdom, total fiscal stimulus is similar to the increase of public expenditure—6.4 percentage points of GDP. In 2009, the European Commission estimated that the British government might introduce a fiscal stimulus through a decrease of public revenues equivalent to 1.4 percentage points of GDP. This decline would compensate for the rise in 2008. For this reason, Figure 1 does not show any variation in total revenues.

At the time this paper is being written, it is impossible, due to the lack of information, to make an adjusted and measurable assessment of the adequacy of the fiscal effort intensity to boost the respective aggregate demand of the selected countries. Nevertheless, and if we accept as a working hypothesis that such intensity should keep a relation with the observed evolution of the reality, the Spanish case is very interesting. In 2008, GDP in Spain grew 1.2 percent, whereas Ireland had a negative rate of 2.3 percent and the United Kingdom had a positive rate of 0.7 percent. The intensity of fiscal stimulus encouraged by the Spanish government that year (5.8 percentage points of GDP) was higher than what Ireland (5 percentage points) and the United Kingdom (3.7 percentage points) achieved. Apart from the difference in intensity, most of the Spanish fiscal stimulus came from a decrease in taxes (4.2 percentage points), whereas in Ireland and the United Kingdom the stimulus was implemented by means of expenditure, with an increase of 5 and 3.7 percentage points of GDP, respectively. Apparently, then, from these data, a certain success of the Spanish government (following a better selection of the fiscal instrument) in curbing the economic deterioration in 2008 could be inferred (at least as a working hypothesis). However, a more detailed analysis of the effects of this stimulus reveals that such a hypothesis cannot be true.

The effectiveness of fiscal stimulus depends on multiple factors, but especially on two. On one hand, it depends on the coefficient of the multipliers associated to public expenditure and to revenue. On the other hand, it depends on the moment chosen by the government for intervention and, more particularly, on the possible tensions (or compatibilities) that such stimulus may produce with the monetary policy.

Fiscal multipliers differ between economies, showing, for example, different degrees of external opening or different structural relationships. On the other hand, the multiplier coefficients do not necessarily remain stable over time, among other reasons because of the changes that may take place in the monetary policy, in the agents' expectations, or in the structural relations that characterize an economy. Moreover, its measurement is not easy due to the problems of endogeneity generated. Fiscal policy is at the same time the result and the cause of the cycle, which makes it difficult to separate the discretionary component from

the automatic stabilizers.[7] The present financial crisis has also provoked a high level of uncertainty, and, consequently, existing estimates of fiscal multipliers are less reliable and informing about which measure will be more effective.

Another source of uncertainty comes from monetary policy. The theory suggests that the effectiveness of fiscal stimulus increases if the monetary policy is accommodating. The present uncertain situation, even in a lax monetary policy framework in most economies, can be contributing to diminish the value of multipliers and, therefore, to limit the effectiveness of fiscal policy. This can be particularly relevant in economies where households have a high level of debt, such as the Spanish case. Fiscal stimulus, and especially stimulus induced through tax reductions, may be accelerating processes of debt repayment rather than an expansion of consumption.[8]

Taking into account the above-mentioned difficulties, the information (De Castro, 2005) available in Spain before the crisis on fiscal multipliers is as follows: accumulated multipliers of public expenditure (with short-term interest rates) were higher than 1 in the two first years—1.14 in the fourth quarter and 1.04 in the eighth quarter. From the third year, the values were negative. Multipliers increased significantly if the estimation was made with long-term interest rates. The multiplier value in the first and second year rose to 1.5 and remained positive during the third year. "Gross fixed capital formation" had higher multipliers and lasted longer—2.42 the first year and 3.40 the second and third. "Intermediate consumption" also had a positive multiplier, though it was lower than the one on investment, and it lasted less. The maximum value (2.15) was reached the second year. "Compensation of employees" had a negative multiplier which increased over time. Net tax multipliers (with short-term interest rates) were substantially lower than those of expenditure—0.09 the first year and 0.42 the second and third. If the estimation was made with long-term rates, multipliers (contrary to expenditure multipliers) decreased—0.05 the first year and 0.39 the second and third.

[7] In Spilimbergo et al. (2009), there is a relation of the different estimations carried out of the multiplier's value for different countries.

[8] The last estimations carried out by the OECD point to a decrease of the fiscal multipliers' values as a consequence of the increase of uncertainty:

> In the current conjuncture the propensity of households and businesses to save has probably increased, so reducing multipliers, particularly for tax cuts. For the average OECD country, such multipliers suggest that the level of support from discretionary stimulus to GDP both in 2009 and 2010 will be of the order of ½ per cent. Only for the United States and Australia will the estimated multiplier effect clearly exceed 1% of GDP. (2008, p. 106)

The main body of fiscal stimulus that the Spanish government developed in 2008 was through direct tax decreases. A part of that stimulus was designed and implemented during that year with the aim of curbing the plummeting of demand. However, the most important part of that stimulus comes from the corporation tax reform and from the income tax changes that came into force during 2007. When these reforms were designed, they had a clear procyclical bias, because they were oriented to increase the disposable income of families and companies. The change of cycle, though, turned them into anticyclical at the time they became operative. The same can be said about the stimulus through public expenditure (1.6 percent of GDP). The increase in wages and salaries of public servants is the component that best explains this expansion.

The fiscal impact of those tax cuts with permanent effects on public finances is estimated to be 2 percentage points of GDP. The impact of the rest of tax cuts with temporary effects on public finance would be equivalent to 0.8 percentage points of GDP.[9]

If we assess these measures bearing in mind the values of the coefficients mentioned above, the conclusion is obvious: the fiscal stimulus the Spanish economy received in 2008 is the one with lower multipliers and, therefore, its effects on the economy could have been minimal. There are partial indicators that reinforce this assessment. The most significant is the household saving behavior. As a result of the tax decrease, a 3.8 percent increase of their disposable income in 2008 was observed. However, their consumption grew only 0.1 percent. The result was an increase of the saving rate of almost 3 points, rising from 10.3 percent in 2007 to 13 percent in 2008 (National Institute of Statistics, 2009). In conclusion, fiscal stimulus moved toward saving in a context of great uncertainty and high interest rates. The ECB kept a rising interest rate policy, which was not relieved until the last quarter of 2008.

In 2009, fiscal policies were reoriented toward expenditure and, especially, toward public investment and the increase of transfers to unemployed workers. Nowadays, it is not possible to estimate the fiscal costs of all the fiscal measures implemented. The programs supporting certain productive sectors, and a wide range of subsidies, were approved without a precise budget. Nonetheless, the two special investment funds approved were specifically designed and implemented to support aggregate demand (Fondo Estatal de Inversión Local and Fondo Especial para la Dinamización de la Economía y el Empleo) and amounted to 1 percent

[9] These estimations were made considering all reforms implemented in 2008 and 2009, according to the information provided by the Bank of Spain (2009).

of GDP. New tax cuts were adopted, though they were less important. On the other hand, during 2009, some of the above-mentioned tax cuts continued exerting effects. At the time this paper is being written, there is not enough information to assess the impact of these new measures. Nevertheless, and regarding the effects of tax reductions, they are very likely to have been moved toward saving. Partial indicators of the household saving behavior during the first quarter of this year seem to confirm this fact (National Institute of Statistics, 2009).

Tax reductions, on the other hand, can have indirect negative effects in the fiscal rule framework imposed by the Stability and Growth Pact. The loss of income caused by this reduction is permanent in such a way that its effects on public deficit remain. Its negative contribution to the budget balance is reinforced, in a moment of crisis, by the tax collection fall, automatically caused by the cycle. Therefore, the fiscal space, whose limits are marked by the fiscal regulations of the Pact, ends faster than with temporary interventions through the expenditure. In the Spanish case, the income reductions as well as the expenditure increase (both discretionary and automatic) increased public deficit six percentage points of GDP in 2008, turning from a 2.2 percent surplus to a 3.8 percent deficit. The last forecast for 2009 points to a deficit of around 10 percent of GDP.

In February 2009, the European Commission began to follow the procedure of excessive deficit for those countries whose deficit exceeded 3 percent of GDP in 2008—France, Spain, Italy, Greece, and Malta. In the case of Spain, the Commission argued that the excess over 3 percent could not be considered exceptional because it had not happened in a context of economic deceleration. The limit imposed on Spain is for the correction of the deficit to be made by 2012, which implies an annual average fiscal constraint effort equivalent to 1.25 percent of GDP, according to the new Stability Programme (Spanish Ministry of Economics, 2009). Then, the Spanish economy will have to modify its fiscal policy radically: from fiscal year 2010, such policy will become procyclical when the economic situation demands that fiscal stimulus should continue. The forecasts (European Commission, 2009b) for 2010 show a negative growth rate of 1 percent, with an unemployment rate of about 20 percent.

The level of government debt

The evolution of the public debt in Spain followed a strong decreasing trend during the whole decade (see Table 1). Between 2000 and 2007, the level of indebtedness dropped thirty-three percentage points of GDP, from 59.2 percent to 36.2 percent. Fiscal stimulus of 2008 and 2009, though, in

addition to breaking that trend, increased the level of indebtedness sixteen percentage points of GDP since 2007 (see Table 1). The last forecasts (European Commission, 2009b) predict the level of debt at 62.3 percent of the GDP[10] for 2010—that is, slightly higher than the 60 percent limit imposed by the Stability and Growth Pact. The IMF (2009), on its part, increases that rate to 69.2 percent of GDP in 2014.[11]

However, the Spanish indebtedness level is still slightly lower than that of the group of countries of the euro zone, which rose 11.7 percentage points between 2007 and 2009, from 66 percent of GDP to 77.7 percent. For 2010, the prospects of the Commission (European Commission, 2009b) raise this ratio up to 83.8 percent. If the comparison is established among the countries of the zone, the indebtedness ratio of the Spanish economy is one of the lowest. Only Sweden and Finland, with an indebtedness ratio of 46 percent of GDP for 2010, and Denmark, with a 33.7 percent ratio, have lower levels than Spain. For Italy and Belgium, the prospects show ratios higher than 100 percent. The forecast for France is 85 percent and 78.7 percent for Germany. Ireland, which together with Spain and the United Kingdom, has boosted the strongest fiscal stimulus, is predicted to reach a level of indebtedness of around 80 percent in 2010.

Certainly, the indebtedness capacity of a country does not depend on whether it has become more indebted than its neighbors but on the future sustainability expectations of its deficits. For a process of indebtedness to be sustainable, the following restriction has to be fulfilled:

$$\Delta d_{t+1} = \beta_t d_t + (g_t - t_t),$$

[10] The part of this indebtedness increase attributable to rescue operations and support of the financial system is not too high at the moment. It is estimated at no more than 3 points of GDP. Besides, the amortization of this debt will not be difficult. The Spanish financial system has not been under as much pressures as the financial systems in the United States or the United Kingdom. The operations supporting the financial system have consisted in the provision of liquidity to provide the Spanish banking system with the refund of credits incurred in international markets. In this way, it was possible to avoid a possible problem of mismatch in the balances of some banks. The assets transferred as collateral by the banks are nontoxic assets. Nevertheless, the Spanish government is preparing a new rescue plan in order to capitalize saving banks, whose definite impact, in terms of debt, is not known at the moment. In the worst of the hypothesis—that is, considering a full use of the fund—the debt could rise 6 additional points of GDP.

[11] Distribution of competences between the central government and regional and local governments limits their capacity of indebtedness. The central government issued the most debt. Distribution of circulating debt is as follows: 78 percent of the whole debt belongs to the central government, 16 percent to autonomous governments, and 6 percent to local governments.

where

$$\beta_t = r_t - p_t / 1 + p_t.$$

In this formula (all expressed as a proportion of GDP), d represents the debt volume in the respective periods, $(g_t - t_t)$ is the primary fiscal balance, and β_t represents the net increase of the net debt due to the difference between the ex post real interest rate (r_t) and the real growth rate (p_t). Sustainability, then, depends on primary balances, economic growth rate, and interest rate. The first two variables, in turn, are connected by automatic stabilizers. The higher the economic growth rate, the faster the primary balance can improve, for the effect it has on both the expenditure and the revenue. In a situation of recession such as the present one, the relationships act in the opposite direction. The influence of interest rates is, however, the most determinant variable, because of the effect it has on the economic growth rate as well as on the debt cost. If β_t, for instance, took negative values, the deficit process would not face any fiscal sustainability problem. It would be enough with a monetary policy acting as an economic growth booster, at least, for some time. And that depends on the decisions of the ECB.

There are multiple simulations that can be made on the sustainability of the current deficits, depending on whether we consider different values for the relevant variables. The IMF (2009) has conducted this simulation exercise for both advanced and emerging economies. The interest of this exercise does not lie so much on the result it produces in each country as on the information it provides on the relative position each of them occupies.

The simulation sets an (arbitrary) indebtedness rate equivalent to 60 percent of GDP as a goal for 2029 (for those countries that in 2014 are likely to exceed it). Then the problem to be solved is to estimate the growth of primary balances, which would be necessary, considering the differential between the real interest rate and the economic growth rate is 1 percent. In the case of the Spanish economy, it is estimated that the primary balance should be 1.2 percent of GDP from 2014.[12] This primary balance is lower than that estimated for Germany (2.8 percent), France (2.7 percent), Belgium (4.2 percent), Ireland (5.3 percent), or the United

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[12] At this time, the hypotheses handled by the IMF (2009) to estimate that growth rate are not confirmed. The Spanish economy growth rate is negative, prices are also increasing at a negative annual rate, and the last debt issues are being made at a weighed average interest rate of about 3 percent. In other words, sustainability, with all these data, would need a primary balance slightly over the 1.2 percent estimated by the IMF for the following years.

Kingdom (2.6 percent). In other words, the future fiscal effort, which most economies of the euro zone will have to make, will be slightly higher than that of the Spanish economy.

The Spanish economy has already experienced a similar situation to the present one. In 1996, the indebtedness rate was 66.8 percent of GDP, three percentage points less than that estimated by the IMF for 2014. Eleven years later, this rate had decreased to 36.2 percent. This came as a combined result of several factors. The first was a fiscal consolidation process, which began in the second half of the last decade and which led to a significant primary surplus (see Table 1). The most significant thing is that this process had no important real costs. This means contracyclical fiscal policies fostered by that process did not affect the economic growth rate negatively. The second element was the ECB monetary policy. The real interest rates in Spain were very low, or even negative, during this period because of the higher than EU average Spanish inflation rate. This monetary policy has promoted economic growth and has also contributed to reduce the debt financial costs. The difference between real interest rates of the debt (10-year bonds) and the real growth rate of the economy (β_t) shows a negative sign since 1998 (see Figure 2).

Consequently, sustainability of current Spanish public deficits will depend greatly on the tone and intensity of the monetary policy during the following years. Yet this restriction affects the euro zone economies equally, in such a way that sustainability of public deficits of all euro zone countries will depend, fundamentally, on the monetary policy the ECB will follow.

Fiscal and monetary policy

The fiscal rule, which imposes a 3 percent limit to the deficit growth, is an arbitrary rule. The arguments used to fix the limit in that value are unknown (should there be any). This fiscal rule was established to subordinate the fiscal policy to a monetary policy oriented to price stability.[13] Consequently, the fiscal space is not determined either by the initial fiscal conditions or by its future sustainability, but by a rule developed to constrict inflationist tensions in "normal times." Its application in

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[13] The rule, on the other hand, is asymmetric—that is, it only works when there is a situation of deficit. Nevertheless, inflationist tensions can also arise with procyclical fiscal policies, without governments incurring deficits. The Spanish economy provides a paradigmatic example in this regard. A fiscal rule, then, with the aim of constraining inflationist tensions, should also have fixed some surplus objectives (Uxó González and Arroyo Fernández, 2008).

Figure 2 β values for Spain (1996–2008)
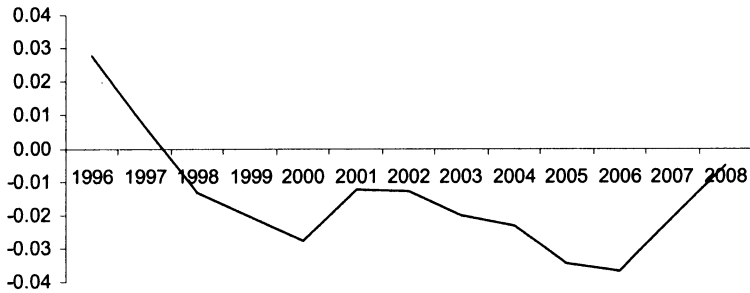
Source: Bank of Spain (2009) and author's elaboration.

times of crisis induces procyclical policies when the economy is still in a recession phase.

   As was mentioned at the beginning of this paper, current fiscal policy strategies are conditioned by the economic theory conceived in the past two decades. These strategies are generating obvious contradictions when putting limits to fiscal policy. The reasoning behind the current economic policy strategy could be defined in this line: governments are facing the choice of intervention or no intervention. Both actions have additional costs: in the first case increasing the indebtedness levels, and in the second, prolonging the recession. The predominant idea at the moment is that no intervention may have greater costs than intervention. However, the latter has some limits, which are identified with a debt surge or with an arbitrary fiscal rule. What is beyond these limits is an implicit conviction: preserve the independence of central banks to fulfill a monetary policy focused on price stability once the crisis is over. If the exit from the crisis results in swollen public deficits, pressures from governments on their respective central banks will probably increase (in order to maintain an accommodating orientation of the monetary policy), which would put their independence in jeopardy. However, the lower the deficits are, the fewer the difficulties to preserve that independence. Therefore, there is no evidence that the present commitment to fiscal policy will have "strong support," as Auerbach (2009) suggests, in the new theoretical convictions about fiscal activism.

   The financial crisis, on the other hand, has revealed the limits that the model for monetary integration of the European Union has to face. The monetary and fiscal rules with which they have been supported can delay the exit from the crisis or slow the growth during the following

years. The need to tackle a deep reconsideration of the model is urgent. This reconsideration should begin with an explicit acknowledgment of the stabilizing role of the fiscal policy. Post Keynesian theory has stated (Sawyer, 2009) the advisability of articulating intervention strategies by means of a monetary and fiscal policy combination. The former should be growth oriented rather than price control oriented, and the latter should be focused on the control of the economic activity level. Yet the change of model demands a change of prevailing paradigm. The crisis has generated the necessary conditions for this change to take place. We will have to wait and see whether they are enough.

Summary and conclusions

This paper has two goals. The first is to present the fiscal strategy followed by the Spanish government in order to stop the fall of aggregate demand induced by the financial crisis. The second is to show the contradictions that the application of the EU fiscal rules generates in a situation of economic recession. Regarding the first objective, the main conclusion drawn from its analysis is that such a strategy was not successful, above all, in 2008. Fiscal stimulus was focused on the increase of the disposable income by means of tax reductions. That stimulus, combined with a high level of uncertainty and with the restrictive monetary policy followed by the ECB most of the year, was moved toward saving. The impact of automatic stabilizers on public expenditure, together with the drop of tax collection due to that stimulus, raised the public deficit over the 3 percent limit fixed by the Stability and Growth Pact of the European Union. With regard to the second objective, the most relevant conclusion is that the application of the fiscal rule shortens artificially the initial fiscal space the Spanish government had, forcing them to implement restrictive fiscal policies without having been able to exit from the recession. The general conclusion reached, from the experience of the Spanish situation, is that present fiscal policies are not boosted by a renewed belief in the possibilities of fiscal policy but by an implicit strategy to preserve the leading role of the monetary policy in the future.

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