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Mistakes in the Fiscal Policy in Spain before the Crisis

Summary: The paper analyses the mistakes made in the management of the fiscal policy in Spain before the crisis. The authors argue that the low size of the public expenditures, the adoption of a procyclical expansionary fiscal policy the years before the crisis, and the lack of a correct coordination between the Spanish fiscal policy and the ECB's monetary policy, are key elements to understand the depth and length of the economic crisis and the current high fiscal imbalances in Spain.

Key words: Economic crisis, Fiscal policy, Macroeconomic policy, Spain, Stabilization policy.

JEL: E62, E65.

Before the onset of the financial crisis in the years 2007 and 2008, fiscal policies in most developed (and also emerging and developing) economies adopted a passive role in terms of its working as a tool of macroeconomic policy. Mainstream economics accepted as an axiom that only monetary policy could effectively influence the short-term temporary shocks that deviated the economic activity (driven by the demand factors in the short-run) from the potential output (driven by supply-side and institutional elements).

This consensus broke, at least partially, with the burst of the current crisis. A rising number of economists, including many of them that can be described as orthodox or mainstream economists, are now accepting that, in certain circumstances and under certain conditions, the fiscal policies can play an active role as an effective instrument to influence the economic activity offsetting the negative impact of the shocks affecting the economy (Jesús Ferreiro et al. 2011).

In this sense, this change of mind has been driven by two elements. The first of these elements are practical reasons, driven by the necessity of implementing extraordinary measures in an exceptional situation.

Table 1 shows the evolution of primary structural balances of general governments in the euro area since the year 2003. Since the beginning of the crisis until 2009-2010, Euro area countries adopt an expansionary stance, with a significant increase in the primary structural budget deficits, to offset the huge negative impact of financial and economic crisis.

Table 1 Primary Structural Balance of General Government in the Euro Area, 2003-2012 (Percent GDP)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Euro area	0,0	0,1	0,4	0,8	0,9	0,1	-1,7	-1,6	-0,5	1,0
Belgium	4,3	3,4	3,5	2,7	2,5	1,7	-0,1	0,1	0,0	0,5
Germany	-0,3	-0,1	0,6	1,1	1,9	1,9	1,8	0,2	1,6	2,8
Estonia	0,6	1,6	0,2	-1,0	-1,4	-4,3	-0,9	-1,0	-0,5	0,3
Ireland	1,6	2,8	2,8	3,2	-0,8	-6,2	-7,8	-5,9	-4,4	-3,8
Greece	-0,6	-2,7	-0,4	-2,3	-2,8	-4,5	-9,6	-2,9	1,8	4,1
Spain	1,6	2,4	2,6	3,1	2,5	-2,9	-6,8	-5,5	-4,8	-2,5
France	-1,8	-1,9	-1,8	-1,4	-1,8	-1,3	-3,7	-3,4	-2,0	-1,0
Italy	-0,4	-0,5	-0,9	0,3	1,4	1,3	0,4	0,8	1,2	4,0
Cyprus	-4,6	-1,6	0,5	2,0	5,5	2,0	-3,9	-3,5	-4,2	-3,6
Luxembourg	1,0	-0,6	0,1	0,9	1,9	3,0	1,4	0,3	0,8	0,5
Malta	-2,7	-2,6	-0,8	0,0	-0,3	-3,1	-0,8	-1,6	-0,5	-1,0
Netherlands	0,9	1,7	3,0	2,8	1,2	1,6	-1,9	-2,1	-1,7	-0,8
Austria	2,1	2,2	1,7	1,1	1,0	0,8	0,1	-0,7	0,3	1,1
Portugal	-2,8	-3,0	-3,4	-1,5	-0,7	-1,4	-5,8	-6,0	-2,5	0,2
Slovenia	-0,9	-1,0	-0,5	-1,4	-1,5	-3,3	-3,0	-3,0	-2,8	-0,6
Slovakia	0,0	-0,3	-0,4	-2,0	-2,3	-2,8	-5,8	-5,8	-3,7	-2,3
Finland	5,1	4,2	4,4	4,6	4,1	3,9	2,0	0,6	1,3	0,7

Source: Annual macro-economic database (AMECO).

However, we cannot deny that a certain change of mind have occurred in the economic profession, and that the development of recent empirical research that challenges the principles guiding the orthodox fiscal policy, exemplified in the recommendations and guidelines set by the hypothesis of the expansionary fiscal consolidation, give theoretical and empirical underpinnings to the active fiscal policies implemented by public authorities.

Thus, we can emphasize among these findings the following ones:

- The value of public spending multiplier is above one (Cristina D. Romer and David H. Romer 2010; Lawrence Christiano, Martin Eichembaum, and Sergio Rebelo 2011; Philip Arestis 2012; Arestis and Malcolm Sawyer 2012; Alan J. Auerbach and Yuriyi Gorodnichenko 2012; Nicoletta Batini, Giovanni Callegari, and Giovanni Melina 2012; International Monetary Fund 2012; Derek Anderson et al. 2013). Consequently, fiscal adjustments are not expansionary, and the negative impact of fiscal consolidations based on cuts in public spending is higher than that of fiscal consolidations based on tax hikes.

- The impact of fiscal policy depends on the relationship between monetary and fiscal policies. Thus, public expenditures multipliers are well above 1 in the presence of an accommodative monetary policy (Charles Freedman et al. 2009; Christiano, Eichembaum, and Rebelo 2011; Anderson et al. 2013).
- The value of the fiscal multipliers depend on the phase of the business cycle when the fiscal policy is implemented: the value of multipliers change with the business cycle, with fiscal multipliers being higher during downturns and (big) recessions (Romer and Jared Berstein 2009; Auerbach and Gorodnichenko 2012; Batini, Callegari, and Melina 2012; Anja Baum, Marcos Poplawski-Ribeiro, and Anke Weber 2012). Consequently, fiscal consolidations, mainly frontloaded adjustments (Batini, Callegari, and Melina 2012; Lukascz Rawdanowicz 2012; Olivier Blanchard and Daniel Leigh 2013), can have a strong negative impact if they are implemented during a downturn.
- The negative economic impact of fiscal adjustments reduces the capacity of fiscal adjustments to cut the debt-to-GDP ratio in the short-term (Luc Eyraud and Anke Weber 2013).
- Expansionary fiscal consolidations episodes are not a generalized phenomenon, and their existence depends on the existence of other (domestic and/or external) measures adopted in parallel to the fiscal adjustment (International Monetary Fund 2010; Arjub Jayadev and Mike Konczal 2010; Roberto Perotti 2011; Batini, Callegari, and Melina 2012; Huixin Bi, Eric M. Leeper, and Campbell B. Leith 2012; Sebastien Dullien 2012; Gennaro Zezza 2012).
- The size of public sector also works as an automatic stabilizer (Antonio Fatás and Ilian Mihov 2001; Young Lee and Taeyoon Sung 2007; Javier Andrés, Rafael Doménech, and Fatás 2008; Xavier Debrun, Jean Pisani-Ferry, and André Sapir 2008): countries with a high size of the public sector facing a downturn have a decline in the economic activity smaller than that registered in the countries with a small public sector. Moreover, countries with big public sectors facing a downturn also have a worsening in the situation of their public finances (that is a higher fiscal deficit) smaller than that registered in the countries with a small public sector.

The above arguments reinforce the voices of those economists that, from a non-mainstream perspective, support the need of an active role of the fiscal policy as an effective tool to stabilize the business cycle and criticize the implementation of fiscal austerity (Arestis 2011; Yiannis Kitromilides 2011; Eckhard Hein and Achim Truger 2012-2013). Fiscal policy would be a feasible and effective instrument of stabilization policy. Its effectiveness would be higher in economies, that like those being members of a monetary union, that lose the capacity to manage autonomously some instruments of the stabilization policy, like the monetary policy or the exchange rate. This fiscal activism would come with a discretionary management by the public authorities of the fiscal policy, who would set in each case the required stance of the fiscal policy.

However, this view assumes the existence of an effective and efficient management of the budgetary variables by the public authorities. That is, policy-makers would always manage fiscal variables following only macroeconomic stabilization reasons. This involves that the discretionary management of the fiscal policy can on-

ly be the solution to a problem, but never its cause. By proceeding this way, we are opposing to the invisible hand the figure of the benevolent and omniscient dictator (or the economist-technician not contaminated by political-electoral reasons).

In this sense, the Spanish experience with the management of the fiscal policy in the years immediately before the crisis proves the weakness of that argument. Thus, the wrong management of the fiscal crisis before the crisis is a key element to explain the deep intensity of the consequences of the crisis burst in the years 2007-2008 in Spain, in general and the elements that led to the public finances crisis that lashes the Spanish economy in the recent years.

According to recent data from the AMECO database (June 2013), the net lending of the Spanish general government amounted 10.6 percent GDP, the highest public deficit in Europe, well above that registered in the whole euro area (3.7 percent GDP). Part of this huge fiscal deficit can be explained by the joint effect of the impact of the economic crisis on the Spanish public finances and by the rescue to a significant part of the Spanish banking system. However, these elements do not entirely explain the strong deterioration in the public finances. In the paper, we will argue that a significant part of the worsening in the situation of the public finances is the result of mistakes in the fiscal policy implemented in Spain in the years before to the crisis.

In earlier papers (Felipe Serrano 2010; Ferreiro and Serrano 2012a, 2012b) we have developed the mistakes in the management of the public finances in Spain before and during the current crisis. In this paper, we will focus on the period before the crisis. We argue that the deep economic impact of the current crisis and the huge fiscal deficit of the Spanish public finances can be, partially, explained, by three elements related to the role played by the fiscal policy in Spain in the years immediately prior the burst of the crisis of 2007-2008: the small size of the public sector in Spain (compared to that existing in other European countries), the procyclical stance of the discretionary fiscal policy adopted in the last years of the expansion, and, finally the lack of coordination between the fiscal policy adopted by the Spanish public authorities and the ECB's monetary policy.

The paper structures as follows. After the introduction, Section 1 analyzes the size of the public expenditures in Spain before the crisis, and its effects on the economic growth and the situation of the public finances after the crisis. The second Section analyzes how the fiscal policy in Spain adopted during the last years of the crisis a procyclical stance. The third Section focuses on the lack of coordination between the fiscal and the monetary policies. The final Section concludes.

1. The Size of the Public Sector Was too Small to Stabilize the Economy

From the macroeconomic stabilization perspective, the main objective of the fiscal policy is to correct the impact on the economic activity resulting of the domestic and/or external shocks, thus smoothing the evolution of the aggregate demand in the short-run. This objective can be reached either through the discretionary management of the fiscal instruments or through the working of the automatic built-in stabilizers.

In this sense, as pointed out in the previous section, the size of the public sector, measured as the public expenditures-to-GDP ratio, works like an automatic stabilizer.

Figure 1 shows the size of public expenditures in Europe in two periods: 1995-1997 and 2005-2007. In the years prior to the crisis the size of the public expenditures in Spain was lower than in most European countries. But, this gap in the years 2005-2007 was even higher than that existing one decade before. In the period 1995-1997, the size of public expenditures in Spain was 6.9 percentage points of the GDP lower than in the European Union (27 countries) and 7.8 percentage points of the GDP lower than in the Euro area (17 countries). A decade later, this difference was 7.5 and 8 percentage points GDP, respectively. In other words, the capacity of the Spanish public sector to work as an automatic stabilizer was not only lower than in other European countries, but is was also lower than that existing in Spain ten years before.

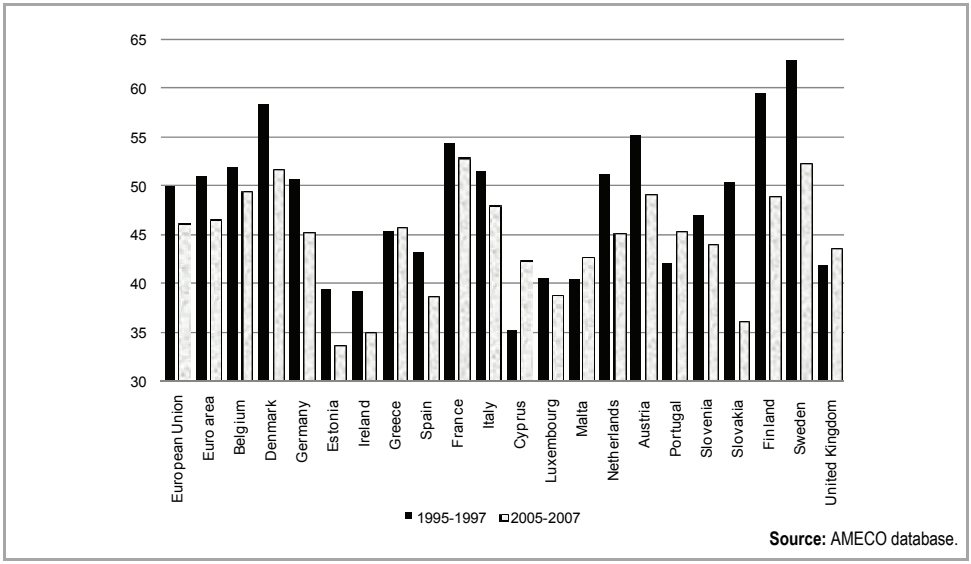


Figure 1 Public Expenditures (Percent GDP)

The low (and declining) size of the public sector is one of the elements that help to understand the depth and length of the current economic crisis in Spain and, also, the strong deterioration in the public finances. The reason is that if the size of the public sector has worked as an effective automatic stabilizer helping to (partially) offset the impact of the crisis, this smoothing effect of the size of the public sector, should have led to a smaller impact of the crisis in terms of the decline in the growth of the GDP (and the consequent lower need of a countercyclical fiscal measures), and, consequently, and to a smaller deterioration of public finances in countries with the highest sizes of public sector.

This hypothesis is clearly detected in the Figure 2. In the horizontal axis of the figure we show the average size of the public expenditures of general governments in the euro area countries before the crisis: the period 2005-2007. In the vertical figure we show the fall in the GDP rate of growth registered before the crisis (the 3-years period 2005-2007) and since the burst of the crisis (the period 2008-2012).

The figure shows a negative relationship between the size of the public sectors before the crisis and the impact of the crisis. Focusing on Spain, public expenditures were before the crisis 8 percentage points of the GDP lower than the euro area average. According to the simple regression included in the Figure 2, if Spain had had a public spending equivalent to 46.7 per cent of the GDP (the eurozone average), instead of the 38.7 percent, the fall in the GDP rate of growth in the period 2008-12 would have been 0.5 percentage points lower, 4.1 percentage points. This would mean that instead of the average rate of growth of -0.8 percent, Spain would have registered a negative GDP rate of growth of -0.3 percent.

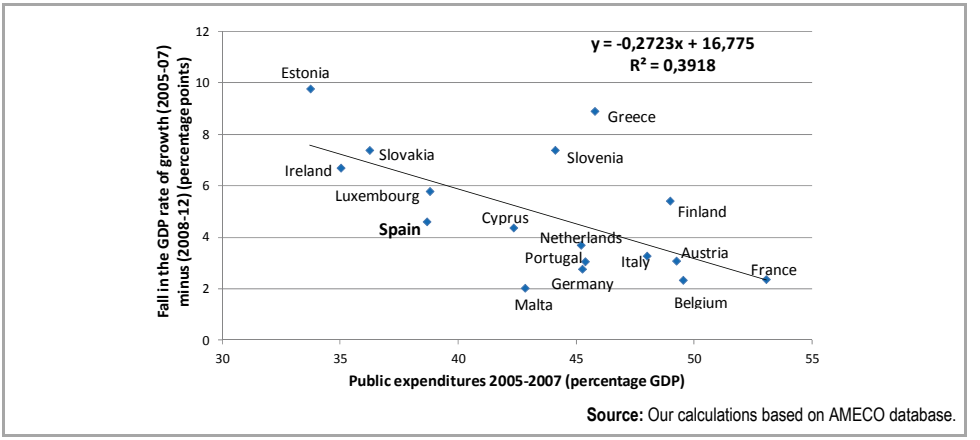


Figure 2 Decline in the Economic Growth during the Crisis, and Size of Public Expenditures before the Crisis in the Eurozone Countries

In the Figure 3 we focus on the impact of the crisis on the potential GDP rate of growth, which would be a proxy of the rate of growth that can be registered in the short and medium-term.

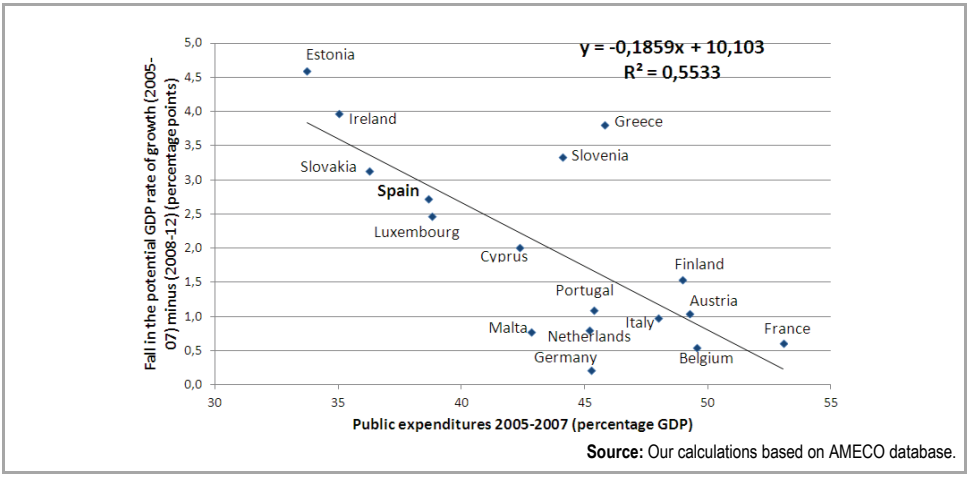


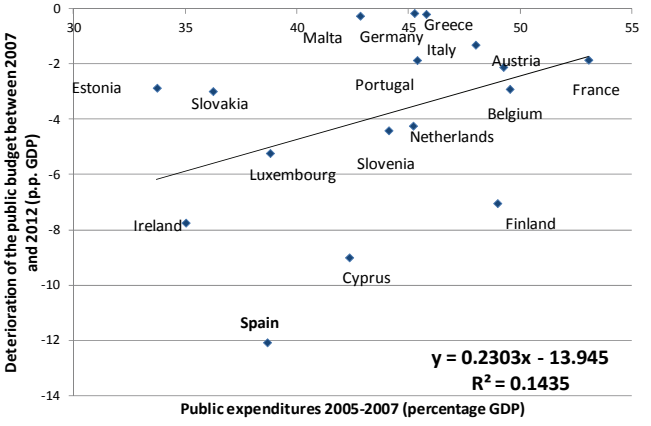
Figure 3 Decline in the Potential Economic Growth during the Crisis, and Size of Public Expenditures before the Crisis in the Eurozone Countries

Now, the relationship between the size of the public expenditure before the crisis and the impact of the crisis on the potential economic growth is even more evident. Focusing our attention in Spain, in the period 2005-2007 the potential GDP rose in Spain at an average rate of 3.2 percent per year. However, in the period 2008-2012, this potential GDP grew annually at a substantially lower rate: 0.5 percent. This means that the fall in the average potential GDP rate of growth was 2.9 percent (only below the falls registered in Estonia, Ireland, Greece, Slovenia and Slovakia).

Again, according to the regression included in the Figure 3, if Spain had had before the crisis a public sector similar to the average of the euro area (46.7%), the annual average rate of growth of the potential GDP in Spain would have been in 2008-2012 of 1.8 percent. This means that the rate of growth of the potential GDP would only have fallen in 1.4 percentage points.

As we mentioned in the previous section, a higher size of the public spending would have generated a higher smoothing effect, a lower decline in the economic activity, and a smaller deterioration in the public finances. This improvement in the public finances would come, first, from a lower cyclical balance and, second, from a lower intensity of the discretionary measures adopted.

The Figure 4 shows the validity of this hypothesis. In the horizontal axis we show the average size of the public spending in the euro area member states before the crisis, in the 3-years period 2005-2007. In the vertical axis, we show in percentage points of the GDP the deterioration of the public finances between the years 2007 and 2012. Figure 4 shows that the highest worsening in the situation of the public finances in the euro area has taken place in the countries with the lowest sized of the public expenditure before the crisis.



Source: Our calculations based on AMECO database.

Figure 4 Evolution of Public Finance Balances during the Crisis, and Size of Public Expenditures before the Crisis in the Eurozone Countries

In the case of Spain, in 2007 the Spanish public finances showed a surplus amounting 1.9 percent of the GDP. In the year 2012, according to the data from AMECO database, the deficit of the general government amounted 10.2 percent of

the GDP. That means a worsening in the public finances since 2007 equivalent to 12.1 percentage points of the GDP. A public sector 8 percentage points of the GDP higher, would have involved a deterioration of the GDP equivalent to 3.3 percent of the GDP. The above figure of the Spanish public deficit in 2012 includes the financial assistance to the Spanish financial system approved in this year. This assistance amounts 3.4 percent of the GDP. Thus, excluding this stock-flow adjustment, if Spain had had a public spending similar to the euro area average, the fiscal deficit in 2012 would have been 5.6 percent of the GDP.

2. Fiscal Policy Should Have Adopted a Countercyclical Stance during the Expansion before the Crisis

A basic lesson of the functional finances is that fiscal policy must always adopt a countercyclical stance, being expansionary during downturns but also being restrictive during downturns. Procyclical stances must be avoided regardless the phase of the business cycle. A procyclical fiscal policy during expansions must be avoided to remove the problems that an expansionary fiscal policy could cause in the form of overheating the economy (increasing internal and external disequilibria) and reducing the fiscal space to implement expansionary fiscal policies when needed (in recessions). In this sense, countries with strong public finances during expansions are able to avoid high and unsustainable fiscal deficits during recessions (for a study of the Swedish public finances, see Michael Bergman 2011). Actually, this is one of the main problems that the Spanish economy faced the years prior the burst of the crisis, when the fiscal policy adopted an expansionary stance in the last years of the expansion.

Table 2 Budget Balance of General Government in Spain (1999-2012)

	Output gap (%)	Budget balance (% GDP)	Change in the budget balance (% GDP)
1999	1.4	-1.2	1.8
2000	2.6	-0.9	0.3
2001	2.5	-0.5	0.4
2002	1.4	-0.2	0.3
2003	0.9	-0.3	-0.1
2004	0.7	-0.1	0.2
2005	1.0	1.3	1.4
2006	1.8	2.4	1.1
2007	2.1	1.9	-0.4
2008	0.5	-4.5	-6.4
2009	-4.1	-11.2	-6.7
2010	-4.7	-9.7	1.5
2011	-4.0	-9.4	0.2
2012	-4.5	-10.2	-0.7

Source: Our calculations based on AMECO database.

As Table 2 shows, during the first years of the boom of the first decade of the century, the Spanish public finances improved its public finances, reaching a surplus in the year 2005. If we define the existence of an expansion or recession using the sign of the output gap, then fiscal policy adopted a restrictive countercyclical stance until 2006, when a fiscal surplus of 2.4 percent of the GDP was reached. However, fiscal stance started to change this year. A set of fiscal measures adopted in the years 2006 and 2007 removed this fiscal surplus, and thus in the year 2008, when the Spanish economy was still in a expansionary phase of the business cycle (at least until the end of the year), a fiscal deficit amounting 4.5 percentage points of the GDP was registered. Actually, as the last column of the Table 2 shows, this involved a deterioration of the public balance (a fiscal impulse) in one year equivalent to 6.4 percentage points of the GDP (around 65,000 million euro).

This huge deterioration of the Spanish public finances just before the crisis made that only in 2009 Spain could implement a countercyclical expansionary fiscal policy. Actually, in 2010 and 2011 the fiscal policy had to adopt a procyclical restrictive fiscal policy to reduce the huge and unparalleled fiscal deficit.

The previous analysis can be influenced by the impact of the changes in the economic activity on the situation of the public finances. Consequently, in the Table 3 we will show the evolution of the primary cyclically adjusted public balance, a better measure of the discretionary fiscal policy and of the fiscal impulse adopted by the Spanish public authorities.

Table 3 Discretionary Fiscal Policy in Spain

	Output gap (%)	Cyclically adjusted budget balance (% GDP)	Interest burden (% GDP)	Primary cyclically adjusted budget balance (% GDP)	Change in the primary cyclically adjusted budget balance (% GDP)	Fiscal policy stance	
1999	1.4	-1.7	3.5	1.8	1.3	Restrictive	Countercyclical
2000	2.6	-1.9	3.2	1.3	-0.4	Expansionary	Procyclical
2001	2.5	-1.7	3.1	1.4	0.0	Restrictive	Countercyclical
2002	1.4	-0.9	2.7	1.8	0.5	Restrictive	Countercyclical
2003	0.9	-0.8	2.4	1.6	-0.2	Expansionary	Procyclical
2004	0.7	-0.5	2.0	1.6	0.0	Expansionary	Procyclical
2005	1.0	0.8	1.8	2.6	1.0	Restrictive	Countercyclical
2006	1.8	1.5	1.6	3.2	0.6	Restrictive	Countercyclical
2007	2.1	0.9	1.6	2.5	-0.6	Expansionary	Procyclical
2008	0.5	-4.7	1.6	-3.1	-5.7	Expansionary	Procyclical
2009	-4.1	-9.2	1.8	-7.4	-4.3	Expansionary	Countercyclical
2010	-4.7	-7.4	1.9	-5.5	1.9	Restrictive	Procyclical
2011	-4.0	-7.5	2.5	-5.1	0.4	Restrictive	Procyclical
2012	-4.5	-8.0	3.0	-5.0	0.0	Restrictive	Procyclical

Source: Our calculations based on AMECO database.

Since 1999 until 2004, the Spanish general government registered a cyclically adjusted fiscal deficit. This cyclically adjusted deficit, with the exception of the year 2000, had a declining trend. However, once we exclude the interest payments, we can see that the primary cyclically fiscal balance remained nearly unchanged, with a surplus oscillating between 1.3 and 1.8 percent GDP. This means that the fall in the interest burden is the main determinant of the improvement in the cyclically adjusted public balance. Consequently, if we measure the fiscal policy stance by the change in the primary cyclically adjusted budget balance, we can see that, despite the existence of an expansion (a high and positive output gap), the discretionary fiscal policy did not adopt a countercyclical stance along this period: between 2000 and 2004 the primary cyclically adjusted public finance merely improved in less than 0.2 percent GDP, despite the fact that in this period the real GDP increased 23.3 percent.

This situation changed in 2005 and 2006, when during an expansion, the cyclically adjusted public balance improved in 2 percentage points of the GDP. In these years, the size of interest payments fell 0.4 percent GDP, and the primary cyclically adjusted deficit improved in 1.6 percent GDP. In other words, the discretionary fiscal policy was the responsible of the 80 percent of the improvement in the Spanish public finances. As a result, in these two years, the Spanish fiscal policy adopted a clear countercyclical (restrictive) stance.

As Table 3 shows, since 2005 the discretionary primary fiscal balance is positive, showing the existence of a cyclically adjusted surplus, and, therefore, given the positive output gap, the implementation of a countercyclical fiscal policy.

However, as a result of the fiscal measures adopted in the years 2006 and 2007, the stance of the fiscal policy changed, despite the fact that the Spanish economy was still in an expansion (between 2006 and 2008 the economy grew 8.7 percent). In 2007 and 2008, the primary cyclically adjusted budget balance changed from a surplus of 3.2 % GDP in 2006 to a deficit of 3.1 % GDP in 2008, that is, a discretionary fiscal impulse of 6.3 percent GDP. As a result the Spanish fiscal policy adopted a procyclical stance the years immediately prior the crisis.

The size of this fiscal impulse was so large, that if the primary cyclically adjusted public balance in the year 2008 had remained at the level registered in 2006, in the year 2012, with the fiscal impulses adopted since the onset of the crisis (2009), Spain would have registered a primary cyclically adjusted surplus (1.3 percent GDP). As a result, the strong fiscal adjustment registered since 2010 could have been much more limited, giving more room to the implementation of an expansionary countercyclical fiscal policy during the crisis, something that could only be implemented in the year 2009.

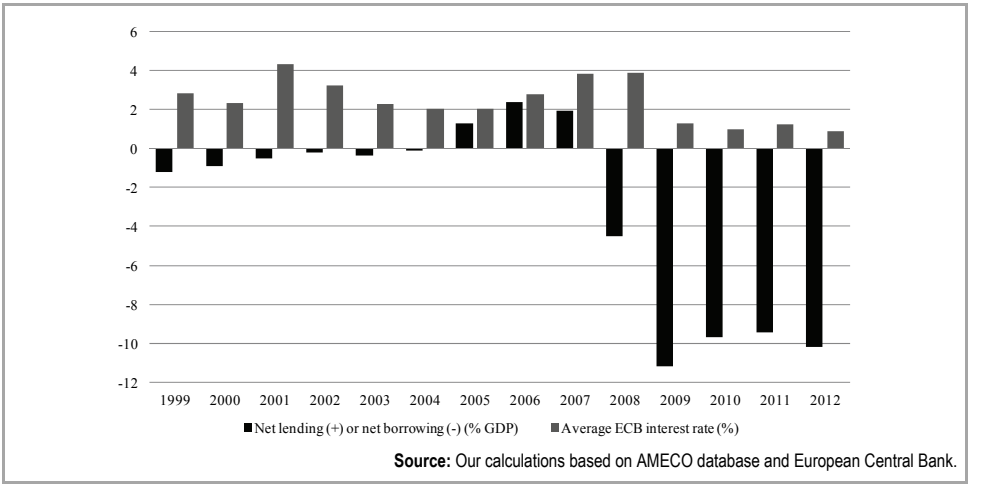
3. Fiscal and Monetary Policies Were Not Coordinated

As showed in the first section, empirical studies conclude that fiscal multipliers are low (below one, close to zero or even negative) when the monetary policy reacts rising interest rates to shocks that presumably have an inflationary impact, like fiscal impulses. Higher interest rates provoke a fall in the private consumption and investment, offsetting (partially or totally) any positive impact of the fiscal impulse on the economic activity. On the contrary, fiscal multipliers are higher (above 1) when there

is an accommodative monetary policy that does not increase interest rates and in an environment of interest rates close to zero. Therefore, an expansionary fiscal policy is ineffective if, simultaneously, monetary policy adopts a restrictive stance.

These results emphasize the relevance of an appropriate coordination between fiscal and monetary policies to achieve the desired objective. This is not something new. The traditional Keynesian economics stressed the need of implementing a mix of fiscal and monetary policies (and, also, incomes policies) to achieve the desired result of a full employment economic activity (Arestis and Sawyer 2013).

Precisely, the lack of coordination between the fiscal policy implemented in Spain in the years immediately before the crisis and the monetary policy adopted in those years by the European Central Bank explains why that expansionary fiscal implemented in the years 2006 to 2008 did not have a positive and significant impact on the economic activity, despite the size of the fiscal impulse.



Source: Our calculations based on AMECO database and European Central Bank.

Figure 5 Spanish Budget Balance (Percent GDP) and European Central Bank Interest Rates (Percent), 1999-2012

Figure 5 shows, for the period 1999-2012 the evolution of the Spanish general government budget balance (as a percentage of the GDP) and the evolution of the European Central Bank interest rate. The annual ECB interest rate has been calculated as the average for the whole year of the daily current interest rates of the main refinancing operations. Since 2006, the Spanish fiscal policy adopted an expansionary stance in a context characterized by the increase in the interest rates. Between June 2003 and December 2005, the European Central Bank set the interest rate at 2 percent. Between December 2005 and July 2008, the ECB increased its interest rate 9 times, setting it at 4.25 percent in July 2008, and only in October 2008 the European Central Bank decided to cut interest rates setting them at 2.5 percent in December. It is precisely in this context of rising interest rates when the Spanish fiscal policy adopted an expansionary stance.

The lack of coordination between the Spanish fiscal policy and the monetary policy of the European Central Bank can be better analyzed using the data of Table 4.

The second column of the table shows the change (as a percentage of the Spanish GDP) in the primary cyclically adjusted budget balance of the Spanish general government. We use this variable as a measure of the discretionary fiscal policy adopted by the Spanish authorities. The third column shows the change registered in the annual average European Central Bank interest rates: A positive sign means an increase in the interest rates, and vice versa.

The fourth and the fifth columns show, respectively, the stances of the Spanish fiscal policy and of the monetary policy of the European Central Bank. We identify a restrictive fiscal policy with an increase in the primary cyclically adjusted budget balance (a positive sign) and an expansionary fiscal policy with a fall in the primary cyclically adjusted fiscal balance (a negative sign). A restrictive monetary policy is identified with an increase in the ECB interest rates (a positive sign in the third column) and an expansionary monetary policy with a fall in the ECB interest rates (a negative sign).

With the objective to analyze whether fiscal and monetary policies adopted a procyclical or countercyclical stance, we have included in the sixth column the output gap.

Table 4 Fiscal and Monetary Policy Stances in Spain, 2000-2012

	Change in the Spanish primary cyclically adjusted budget balance (percent GDP)	Change in the average ECB interest rate (percentage points)	Fiscal policy stance	Monetary policy stance	Output gap (%)	Fiscal policy stance	Monetary policy stance
2000	-0.44	-0.49	Expansionary	Expansionary	2.6	Procyclical	Procyclical
2001	0.01	1.99	Restrictive	Restrictive	2.5	Countercyclical	Countercyclical
2002	0.46	-1.07	Restrictive	Expansionary	1.4	Countercyclical	Procyclical
2003	-0.21	-0.96	Expansionary	Expansionary	0.9	Procyclical	Procyclical
2004	-0.02	-0.26	Expansionary	Expansionary	0.7	Procyclical	Procyclical
2005	1.01	0.02	Restrictive	Restrictive	1.0	Countercyclical	Countercyclical
2006	0.57	0.76	Restrictive	Restrictive	1.8	Countercyclical	Countercyclical
2007	-0.62	1.07	Expansionary	Restrictive	2.1	Procyclical	Countercyclical
2008	-5.69	0.05	Expansionary	Restrictive	0.5	Procyclical	Countercyclical
2009	-4.31	-2.61	Expansionary	Expansionary	-4.1	Countercyclical	Countercyclical
2010	1.95	-0.28	Restrictive	Expansionary	-4.7	Procyclical	Countercyclical
2011	0.43	0.25	Restrictive	Restrictive	-4.0	Procyclical	Procyclical
2012	0.04	-0.37	Restrictive	Expansionary	-4.5	Procyclical	Countercyclical

Source: Our calculations based on AMECO database and European Central Bank.

With the only exception of the year 2002, fiscal and monetary policies in Spain adopted a similar stance until 2007. However, this does not mean that the both policies worked in a stabilizing way. Actually, in the years 2000, 2003 and 2004 both adopted a procyclical stance, being expansionary during the expansion. Since the

monetary policy of the ECB is designed according to the economic situation of the whole euro area, the Spanish fiscal policy should have adopted in these years a restrictive stance, in order to avoid the exacerbation of the domestic (inflation) and external imbalances (external deficit) of the Spanish economy.

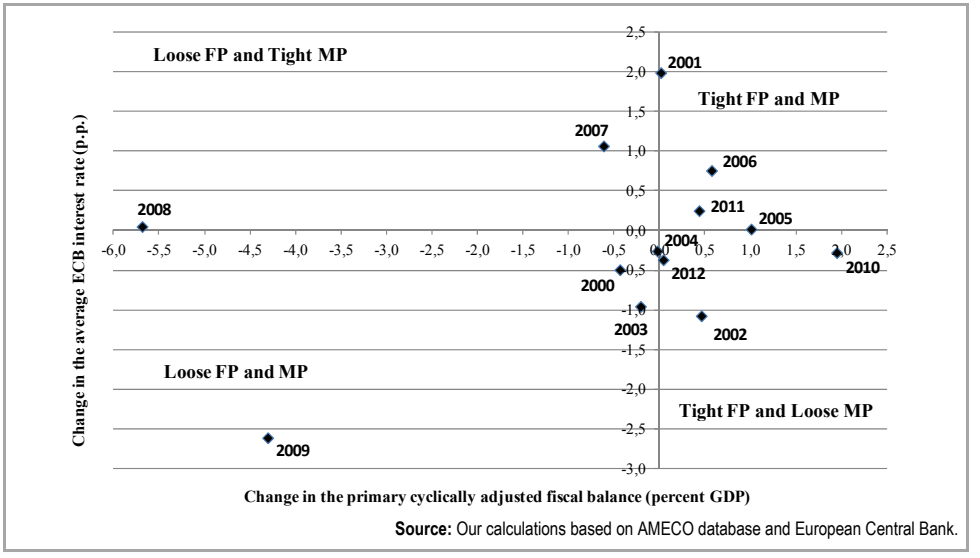


Figure 6 Fiscal and Monetary Policies Stances

In the years 2007 and 2008, however, whilst monetary policy adopted a restrictive countercyclical stance, fiscal policy adopted an expansionary procyclical stance. Figure 6 shows the stance of the macroeconomic policy in Spain in the period 2000-2012. This figure gives us a clear idea of the intensity of tightness or looseness of the monetary and fiscal policies. Thus, between 2006 and 2008 the ECB increased the interest rates in 1.9 percentage points, whilst the Spanish authorities adopted a fiscal impulse equivalent to 5.7 percent GDP. The combination of both discretionary opposite fiscal and monetary measures explain the null effectiveness of the macroeconomic policy in Spain, and the generation before the crisis of a excessive fiscal imbalance that led to an unsustainable fiscal situation when the crisis shock dramatically Spain in the years 2009 and 2010, forcing to a restrictive procyclical fiscal policy since 2010.

4. Conclusions

The current economic crisis has made evident the need of fiscal policy as a useful tool of macroeconomic policy to face the consequences on the economic activity generated by domestic or external shocks. However, we cannot infer from this statement that fiscal policy will always be effective.

The Spanish case shows that the management of fiscal policy can, in some cases, be a source of disturbances, affecting negatively to the economic activity and to the capacity of fiscal (and monetary) policy to offset economic shocks. Thus, (at

least) three conditions must be fulfilled for an effective working of the fiscal policy: a sufficient size of the public budget, a countercyclical stance of fiscal policy, and a coordinate management of fiscal and monetary policies.

In the years before the crisis, the Spanish public authorities adopted a number of discretionary fiscal measures that worked against those conditions. As a result of these measures, first, the capacity of fiscal policy to work against the economic crisis was severely limited, stressing the impact of the global financial and economic crisis. Second, Spain entered the crisis with an excessive fiscal deficit that, with the burst of the crisis became unsustainable.

In sum, the Spanish case shows that not all discretionary fiscal policy is always, by definition, positive. That is, the discretionary management of fiscal instruments does not always come with an effective countercyclical fiscal policy. This opens the door to the possibility or need of the existence the fiscal rules that guarantee the countercyclical working of fiscal policy. However, this point is outside the scope of the paper.

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