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A DECADE OF LOST GROWTH: ECONOMIC POLICY IN SPAIN THROUGH THE GREAT RECESSION

Keith Salmon (Reader in Political Economy, University of Hertfordshire)

k.salmon@herts.ac.uk

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Abstract

In 2008 the Spanish economy sank into recession, returning to growth in 2014. This paper explores the policies that were pursued by two successive governments to escape the recession. It comments on one of the most contentious strategies, that of austerity, and underlines the constraints on policy imposed by membership of the European Monetary Union (EMU) and a decentralised state. The Great Recession and accompanying austerity policy were associated with huge social and economic costs. Policy targets on the debt and deficit were not met. This experience, together with the broader sluggish growth in Europe and the political consequences associated with austerity, pointed to the need for a new policy mix.

Keywords: Austerity; crisis; economic policy; recession; Spain

Introduction

In 2015 and 2016 the Spanish economy recorded one of the fastest growth rates in Europe. Recovery was underway after what became referred to as ‘the Great Recession’, which saw thousands of businesses disappear, property prices collapse, the banking system almost disintegrate, unemployment rise to over a quarter of the labour force, net in-migration flows reverse to out-migration and widespread disillusion with politicians and government. This paper explores the policies that were pursued to escape the crisis by two successive governments, of the Spanish Socialist Workers’ Party (Partido Socialista Obrero Español – PSOE) led by José Luis Rodríguez Zapatero from 2008 to 2011 and then the conservative People’s Party (Partido Popular – PP) led by Mariano Rajoy from 2011 to 2015. In so doing, it comments on one of the most contentious policy issues of the recession, that of the efficacy of austerity: ‘the policy of cutting the state’s budget to promote growth’ (Blyth 2013a, p. 2). Beyond this, the paper illustrates the constraints on policy imposed by membership of the euro area, with progressive pooling of sovereignty and loss of national democratic self-determination. It also underlines the complexity of policy-making and implementation in a decentralised state (Estado de Autonomías), where a wide range of powers are exercised by lower tiers of government, notably the regions (Autonomías).

The austerity debate

Recession struck with little notice from central bankers or economists around the world after a long period of low inflation, low interest rates, low volatility and sustained growth, generally referred to as the ‘Great Moderation’. As the scale of the problems in the financial system unfolded, along with the interconnections between and within economies, orthodox economic theory was found wanting (Stiglitz 2009; Wolf 2014). Following a brief flirtation with Keynesian-style stimuli, policy, especially in Europe, swung towards austerity, splitting policy-makers and the economics profession into advocates or critics of this strategy to escape the crisis. Both Mark Blyth (2013a) and Martin Wolf (2014) have provided extensive discussions of the origins of the policy and along with Paul Krugman (2012) their own highly critical assessments of it. Here it is only necessary to summarise the main arguments as one of the benchmarks by which to assess the efficacy of the policy in the case of Spain.

The argument for austerity was summarised by Blyth (2013b, p. 41) as ‘designed to reduce a state’s debts and deficits, increase its economic competitiveness, and restore ... “business confidence”’. The strategy assumed that private investment would be stimulated, ‘since it signals that the government will be neither crowding out the market for investment nor adding to its debt burden. Consumers and producers will feel confident about the future and spend more, allowing the economy to grow’ (Blyth 2013b, p. 41). In 2010 Jean Claude Trichet (2010) gave three reasons for restoring fiscal sustainability: first that the short-term costs for economic growth tended to be contained or very limited; second, with large budget deficits and debt the risk of sudden economic dislocations might increase, such as a rapid deterioration in confidence; and, third, that systemic economic stability relied on the availability of fiscal buffers.

For both Blyth (2013a; 2013b) and Wolf (2014) three theoretical factors and the experience of policy-making in the Great Depression undermined the austerity argument. First, they disputed Trichet’s claim of the limited short-term costs, arguing that the policy had severe externalities, including high unemployment, whereby the poor were more adversely hurt than the rich (since the poor relied more on government services and support). Second, if all the countries in an integrated economic region (such as the European Union [EU]) applied austerity together, the outcome was likely to be regional contraction (reflecting the ‘paradox of thrift’ and replaying the type of macro-regional contraction that characterised the Great Depression). Third, it was unrealistic to assume that cutting public spending boosted confidence on the basis that consumers would think that their future tax burden would decrease and thus spend more today. For Blyth (2013b), people were much more likely to be concerned about losing their jobs than behaving in such a far-sighted and rational way. Paul Krugman (2010; 2011; 2012) was particularly vociferous in his attacks, ridiculing the claim about confidence by labelling it ‘the confidence fairy’. Similarly, for Stiglitz (2009, p. 321), ‘The “confidence fairy” is more likely to make her appearance with Keynesian policies that restore growth than with austerity measures that destroy it.’

Stimulus measures: the initial response to the emerging crisis 2008–10

As the first signs of an external economic shock were appearing in summer 2007, the PSOE government in Spain had only a few months left in office and was looking towards elections the following spring (for an account of the period to 2012 see Royo [2013]). There appeared to be little cause for concern. In the third and fourth quarter of 2007 the economy was still growing at a healthy pace (over three per cent on an annual basis), government finances were in good shape with debt only 35 per cent of gross domestic product (GDP) following three years of budget surpluses, public spending as a percentage of GDP was relatively low in relation to other euro area countries (39 per cent against a euro area average of 45 per cent; Eurostat), and the banking system was considered by outside observers to be sound (IMF 2008a; The Economist 2008). In the Stability Plan 2007–10 growth was forecast at 3.1 per cent in 2008, three per cent in 2009 and 3.2 per cent in 2010 (Ministerio de Economía y Hacienda 2007). The general budgets of the state (Presupuestos Generales del Estado) for 2008 assumed growth of 3.3 per cent. Revenue and spending were budgeted in line with this to produce a fourth year with a small public sector surplus (Ministerio de Economía y Hacienda 2008).

Following re-election in March 2008 the PSOE government reacted to the slowdown in the economy in an essentially ‘Keynesian’ way, taking a path advocated by the International Monetary Fund (IMF 2008b), by the EU in their Economic Recovery Plan (European Commission 2008) and elsewhere around the world (for example the Economic Stimulus Act of February 2008 in the United States [US]). As Wolf (2014, p. 42) noted: ‘The leaders of the G-20 countries embraced the arguments for a strong policy response, including the strong fiscal response, at their Washington, London and

Pittsburgh summits in 2008 and 2009.’ The government announced a series of stimulus packages designed to underpin demand, complementing monetary policy action by the European Central Bank (ECB) of reducing interest rates. Fiscal action was valued by the government at almost €18 billion over two years (Plan de Estimulo Económico). It included a €400 per taxpayer tax refund in 2008 and 2009, estimated to cost the Treasury €6 billion, and an €8 billion fund for stimulating investment by local authorities (Fondo Estatal de Inversión Local), which began to be used from the second quarter of 2009.

By March 2009 the government claimed that some 100 measures had been introduced to fight the crisis since its return to office a year earlier (Consejo de Ministros 2009). According to an estimate by Banco Bilbao Vizcaya Argentaria (BBVA 2009), between 2008 and 2009 the discretionary fiscal stimulus associated with the measures in these packages was equivalent to five per cent of GDP (€50 billion) and if the stimulus of the automatic stabilisers were added then the total stimulus was equivalent to 11.8 per cent of GDP against an EU average of 4.8 per cent. Measures were introduced to support development across the economy, including tax cuts (an income tax rebate, the elimination of wealth tax and a reduction in corporation tax) and direct government support for specific industries (for example the motor-vehicle industry with support for the replacement of old vehicles, in tourism for modernisation, and support for small and medium-size enterprises.

But the crisis was intensifying. Budgets across the public sector were being squeezed by a combination of higher spending (from additional discretionary spending and that required to meet social commitments – the automatic stabilisers) and lower revenue (from tax cuts and falling economic activity): a phenomenon that echoed prior debt crises around the world (Reinhart and Rogoff 2009). Deficit and debt ratios were also deteriorating through both rises in the numerator and falls in the GDP denominator. As a result, the small public sector budget surplus in 2007 was transformed into a deficit in 2008 and a much larger deficit (11 per cent of GDP) in 2009. Divisions in policy were opening up in the central government (Solbes 2013; Zapatero 2013); between the political parties and different departments and tiers of administration; and between other social agents. In the central government the fiscally more conservative Minister of Finance, Pedro Solbes, said there was no more room for fiscal stimulus (Consejo de Ministros 2009), while the day before the Prime Minister, José Zapatero, had said there would be more if necessary (Mallet 2009). The former had become more concerned with market confidence and more pessimistic about the economic outlook, while the latter remained focused on growth.

A government reshuffle in April 2009 bolstered the position of the Prime Minister with changes that included the replacement of the Minister of Finance by Elena Salgado and the Minister of State for the Economy, David Vejera, by José Manuel Campa, the appointment of Manuel Chaves (the President of Andalucía) as third vice-president and minister of territorial policy, and José Blanco as minister of public works. At the same time the Deputy Governor of the Bank of Spain (José Viñals) left the Bank for a post at the IMF. Overall, the reshuffle left a government that was more united around continued government stimulus to counter the crisis, the introduction of labour market reforms only with the consent of the trade unions, and the protection of social spending. In response to a question in the Senate on 14 April 2009 the Vice-President and Minister for the Economy and Finance, Elena Salgado (2009), said that the government’s answer to the crisis would not just be economic but also social, underpinned by a stronger social dialogue. Thus, despite passing a more restrictive budget for 2010, in autumn 2009 further stimulus measures were introduced, for example through another local authority investment fund (Fondo Estatal para el Empleo y la Sostenibilidad Local – FEESL) and one to promote a sustainable economy (Fondo de Economía Sostenible).

Transition to austerity, 2009–11

A shift in emphasis from stimulus to austerity was precipitated by the European Commission after it first issued a warning over Spain's deficit in February 2009 and then invoked the Excessive Deficit Procedure in April. Spain was requested to correct its 'excessive' deficit (over the three per cent of GDP ceiling fixed in Europe's Stability and Growth Pact [SGP]) by 2012; revised to 2013 in November 2009. In response, the first steps towards correcting the deficit were taken in proposals sent to Brussels in the Spanish Stability Plan 2009–13 in April (Ministerio de Economía y Hacienda 2009), which was translated into action in the budget for 2010. Thus the process of reducing the economic stimulus and tightening austerity began from January 2010 and in earnest from May 2010 following the first sovereign rescue package for Greece.

Austerity proposals were tightened in a battery of short- and medium-term measures in January 2010 (Table 1), following disclosure that the public sector deficit for 2009 was over 11 per cent of GDP (Consejo de Ministros 2010). The fiscal objective was to cut a total of €50 billion from public spending over the three-year period 2010 to 2013. Austerity theory suggested that such measures would inspire confidence in the market that Spain could reduce its deficit, control the growth of debt and not crowd out the market for investment. The macroeconomic policy space had shrunk. Convincing the markets of the credibility of policy and avoiding a sovereign rescue became crucial to government action. In this, a key element was the factors that shaped market perceptions. Revelations of corruption throughout the crisis did not help the assessment of the quality of institutions. For some this was judged to be on a par with those in Latin America (for a discussion of the role of institutional weaknesses in the crisis, see Royo [2014] and for the importance of this in determining investment flows Alonso [2015]).

Table 1: Austerity Measures under the PSOE 2009-2011

Measure	Content	Saving*
Budget deficit warning (February 2009)	European Commission issues first warning on deficit	
Excessive Deficit Procedure (April 2009)	Excessive deficit procedure with deficit compliance by 2012 (deadline extended to 2013 in November 2009)	
General State Budgets for 2010 (Approved December 2009)	Elimination for most people of tax deduction of €400 Standard rate of VAT raised from 16% to 18% from July 2010 Tax on income from savings increased from 18% to 20% Civil service pay frozen and near freeze on recruitment	€8bn In 2010
Immediate Action Plan Austerity Plan 2010-13 Update to Stability Plan (January 2010)	Spending by the central administration cut by €5bn for 2010 Freeze on recruitment by the central administration	€50bn 2010-end 2013
Sustainability of Public Finances (March 2010)	Public sector deficit of 3% by 2013 agreed with the regions Regional budgets for 2010 revised. Greater supervision by the central administration of regional budgets agreed	
Extraordinary Measures to Reduce Public Spending (May 2010)	Additional public spending cuts of €5.25bn in 2010 and €10bn in 2011 (1.6% of GDP) Public sector pay cut of 5% in 2010, pay freeze in 2011 Pensions frozen in 2011 Elimination of allowance for babies (baby cheque) from 2011 Spending on capital investment by the state reduced Medicine procurement spending reduced Additional savings agreed with regions and local authorities	€21bn in 2010/2011 €12bn in 2010/2011
State Draft Budgets for 2011 (Approved December 2010)	Spending cut by 3% on budgeted figure for 2010 (7.9% cut in 2010 budgeted state spending)	
Regional Draft Budgets for 2011 (Approved December 2010)	Spending cuts in the range of 6% on budgeted figure for 2010.	
December 2010 Package	Tobacco duty increased	
March 2011 Package	Phased increase of retirement age from 65 to 67 approved	
August 2011 Package	Corporation tax: Fractional tax payments raised for 2011 and fewer deductions allowed to be offset against tax	€2.5bn in 2011
	Reduced spending on pharmaceuticals	€2.4bn in 2011
Constitutional change September 2011	New budget stability regulations for all public administrations	

* Government estimate

Author compilation

Despite the austerity measures and proposals for labour market and pension reforms, through the first half of 2010 further stimulus measures were implemented. These included the new €5 billion local authority investment fund (FEESL) announced in October 2009, a National Rural Development Programme and in April 2010 a package of measures including an infrastructure plan (Plan Extraordinario de Infraestructuras) and a further economic stimulus plan (Plan Español para el Estímulo de la Economía y del Empleo). The desire to continue with a stimulus strategy was expressed by Elena Salgado in April when she asked the IMF for stimulus measures to continue at least until 2011 (reported in Cincodias 2010).

But resistance to internal and external pressures to ramp up austerity was fading. The crucial turning point came in May 2010, following acceptance by Greece of a sovereign rescue package with the conditionality on economic policy that came with it (Zapatero 2013). Further austerity measures were introduced in May (Plan de Medidas Extraordinarias) that proposed over €5 billion of additional cuts in 2010 and €10 billion in 2011 (including pay cuts for public sector workers and a freeze on pensions). In July the standard rate of value added tax (VAT) was raised from 16 to 18 per cent and Zapatero announced that the budget for 2011 would be austere with no more stimulus measures (it was one of the most restrictive budgets of the whole crisis period, the consolidated state budgets –excluding financial transactions – being cut by almost ten per cent on that for 2010; Ministerio de Hacienda y Administraciones Públicas 2015). More proposed savings were announced in December (including increased duty on tobacco, cuts in subsidies on renewable energy, and partial privatisation of the airports group Aena and the National Lottery) in a bid to shore up the credibility of the government's intentions to meet its deficit targets and bring public finances across all administrations under control.

The battle to convince external institutions and markets that the government could control public spending and meet its medium-term commitments continued into 2011. In response to European Commission recommendations to strengthen measures in the 2011 update to the SGP and a letter from the ECB in August advising further action (Zapatero 2013), that month the government approved more measures to ensure it met its deficit target, estimated to generate another €5 billion of savings in the year. In addition, it underlined its commitment to budget stability by proposing to incorporate budget stability across all administrations into the Constitution, which it did in September.

As the government fought to convince external institutions and the markets of its commitment to sound public finances through adherence to a strict deficit reduction timetable, so it lost support from the electorate, especially its traditional support among the trade unions (a paradox noted by Zapatero [2013]). On 29 September 2010 there was a general strike against labour market reforms, wage cuts in the public sector and pension freezes. Another followed on 27 January 2011, this time aimed at proposed pension reforms. In the short term at least, public spending cuts and higher taxes were exacerbating lower private sector consumption and investment as businesses and consumers sought to reduce their debts. In April 2011 Zapatero said he would not stand for re-election. Regional and local elections in May were a triumph for the opposition party. The PP was left governing in the majority of regions and controlling most of the large cities across the country. Internal party tensions, domestic and external pressures prompted early elections in November 2011.

Lower tiers of administration also adopted a more austere stance from 2010. Most regions raised the taxes that had been ceded to them and the regional component of income tax (often by the maximum allowed under the 2009 reformed regional finance system). Spending was also cut, notably on public investment (especially infrastructure spending). They also began selling public enterprises, which had accumulated in lower tiers of administration in contrast to the sale of the major state-owned enterprises in the 1990s and early years of the twenty-first century.

An assessment of the PSOE policy response

The response of the PSOE to the crisis was first delayed by the election cycle and then inadequate to prevent the crisis intensifying and developing from a crisis in the property and financial sectors to a sovereign debt crisis and a more broadly based recession. Similarly, Royo (2013, p. 102) concludes that the response 'is a story characterised by denial, procrastination ... and unfulfilled promises and commitments'. As in other countries the scale of the crisis surprised the government, especially the collapse in government revenue. In the previous crisis in 1992/93 tax revenues fell in line with GDP, but in this crisis they fell faster, due to the loss of large revenues from the property sector. It should also be emphasised that from 2010 the government was under constant pressure from the markets and external institutions as the epicentre of the euro crisis shifted to Spain. In May 2010 Greece had accepted a European sovereign rescue package, followed in November by Ireland. In May 2011 these two were joined by Portugal. Spain appeared to be next in line. As a much larger economy than the previous three, it had the capacity to sink the euro project.

Individual measures may have been more or less effective, but the outcome of the stimulus phase of policy (along with that elsewhere in the world) was to conjure a recovery in Spain and across Europe in 2009 from steep decline into economic contraction. The shift in policy towards austerity (again not just in Spain) coincided with a renewed decline in the Spanish economy from mid-2010 and contraction from the beginning of 2011. At the same time debt continued to rise.

Given that the government had no direct control over monetary policy and that fiscal policy was constrained by obligations under the Stability and Growth Pact (SGP), the principal criticisms of policy under the PSOE relate to how it dealt with the banking sector, the implementation of other structural reforms and the lack of control over spending in lower tier administrations (notably the regional governments). In the banking sector the government (and the banking supervisor, the Bank of Spain) failed to act decisively or recognise the scale of the problems, preferring to minimise any cost to the government of restructuring (Zurita 2014). In his book *Recuerdos*, Solbes (2013) argues that this was the result of a positive assessment of the banks by the IMF in 2008 (IMF 2008a) and the reticence of banks to reveal their true position. But if the regulator (the Bank of Spain) was not aware of problems, it should have been. If it was aware of problems then there should have been more decisive action. Elsewhere, reforms fell short of what outside agencies such as the European Commission, the IMF and the Organisation for Economic Cooperation and Development (OECD) felt necessary (see for example the 2010 Article IV Consultation Concluding Statement of the IMF Mission; IMF 2010). This was most obvious in the 2010 labour market reforms (Ley 35/2010).¹ As a result, despite the shift to austerity in 2010, market confidence in the capacity of Spain to manage the crisis deteriorated (as measured by higher bond yields).

Austerity: the exit strategy under the PP, 2012–15

Loss of support for the PSOE led to early elections in November 2011 in which the conservative PP led by Mariano Rajoy was returned to office with an absolute majority, reflecting a belief that the conservatives might be better able to manage the economy. The new government faced a contracting economy, unemployment rising (over 22 per cent in the fourth quarter of 2011) and house prices falling (some 25 per cent from their peak). Public finances were fragile, with a large public sector deficit (over nine per cent of GDP), debt piling up (some 70 per cent of GDP), interest repayments on debt (€26 billion in 2011) sapping discretionary public spending, and imbalances at the regional level difficult for the central administration to control. In addition, international financial markets were almost closed to Spanish public administrations and businesses, including the banking sector, which was teetering on the edge of collapse.

A fundamental problem was the close linkage between banks and sovereign debt (the so-called ‘doom loop’), the state being ultimately liable for the banks and the banks vulnerable to movements in public debt markets because they held large quantities of this debt. Lack of conviction in Spain’s ability to exit the crisis without some form of external rescue package was reflected in the high yield on Spanish sovereign debt and spreads over German debt (433 basis points in November 2011; Eurostat).

In his inauguration speech in December 2011 the incoming president Mariano Rajoy set out the government’s priorities: to reduce the deficit, restructure the savings banks, reform the labour market and implement changes to the pension system (Rajoy 2011). The health of public finances was to be restored through further austerity measures – cuts in public spending and higher taxes – coupled with more ambitious structural reforms than those completed by the PSOE (Tables 2 and 3).

Table 2: Budget Adjustment Measures Implemented by the Partido Popular 2011-2015

Measure	Content	Saving*
December 2011 Package Back-dated to 2011	Income tax rates increased, maximum rate raised from 45% to 52% Income tax relief on house mortgages retained Local property tax (IBI) raised	€15bn in 2012
Budget Stability Law (January 2012)	Implemented the change to the Constitution. Objectives: i) to reduce the public sector deficit to zero by 2020 and ii) to reduce debt to within 60% of GDP by 2020	
Corporation tax and tax amnesty (March 2012)	Reform of corporation tax and tax amnesty on overseas earnings	
Budget for 2012 (April) March 2012	Included previous measures for 2012	€27bn in 2012
April 2012 Package	Health and education savings	€10bn
July 2012 Package	Public spending cuts New mortgages tax relief withdrawn Excise duties increased on tobacco and new environmental taxes VAT category changed for new houses	€13.5bn in 2012 €65bn 2012-14
From September 2012	Standard rate of VAT raised to 21%	
Draft Budget 2013 (Sep 2012)		€40bn
Tax Reform 2014, introduced from July 2015 From January 2015	Income Tax bands reduced to five, top tax rate reduced Higher income tax exemption limit Corporation tax rate reduced from 30% to 25% in 2016	

* Government estimates. At the beginning of August 2012 the Government estimated the adjustment measures scheduled at that time amounted to €102bn (10% of GDP): €13bn in 2012, €39bn in 2013 and €50bn in 2014

Author Compilation

Table 3: Structural Measures 2009-2015

Measure	Content of Reforms	Date Approved
Reforms under the PSOE 2008-2011		
Restructuring the Banking System	Fund for the Orderly Restructuring of the Banking Sector Savings banks to form savings bank groups	June 2009
Sustainable Economy Law	Designed to change the economic model through a package of reforms	March 2010
Liberalisation of Services	Implementation of the European Services Directive	
Labour Market Reform	Urgent measures to reform the labour market Reform of the system of collective negotiations Urgent measures to promote employment	June, September 2010 2011 August 2011
Pension Reform	Changes to contribution period and rules on early retirement	2007, introduced 2008
Pension Reform	Sweeping changes to all aspects of the pension system with transition period to 2027	Agreed January 2011 Implemented from 2013
Reforms under the Partido Popular 2012-2015		
Restructuring of the Banking System	Higher provisioning (Guindos 1 and II) EU bank rescue package Exit from European bank rescue package Last wholly state-owned bank sold	Spring 2012 July 2012 January 2014 January 2014
Reform of the Labour Market	Reform of the labour market	February and July 2012
De-indexation Law	Wage and pension increases separated from inflation index	Due in 2013
Law covering the Electricity Market	Reorganisation of the electricity market and funding	December 2013
Reform of the Pension System	Final details for implementing pension reform	December 2013
Co-payments for Pharmaceuticals	These and other health service measures to save €7.4bn	From 1 July 2012
Reform of the Public Administrations	Rationalisation of the provision of services and limits to the autonomy of local authorities	December 2013
Liberalisation of the Railways	The national rail company Renfe split into four companies Competition in passenger transport	July 2012 From July 2013
Law on a Single Market	Single licence for service providers to operate across Spain	Implemented from 2013
Reform of the Tax System	Reform of income tax and corporation tax	Autumn 2014

Author compilation

This stricter approach to austerity sat more easily with the conservative ideology of less government intervention in the economy and greater reliance on the market. Deficit reduction (austerity) as the key to economic regeneration was expressed by a statement made by Rajoy in a press conference following a meeting with the Irish Prime Minister in April 2013 that the best way to create employment was to reduce the deficit (Rajoy 2013). The approach aligned the Spanish government with that of the Conservative-led coalition in the United Kingdom (UK) and with the German approach to an exit strategy.

An initial package of measures was published at the end of December (Royal Decree RD 20/2011). This included tax rises (for example higher rates of income tax), tougher conditions for civil servants (including a pay and recruitment freeze), spending cuts across various government programmes, the widening of co-payments for medicines and further guarantees for bank debt. At the end of March 2012 the PP government approved its first budget. Then, in the face of rising risk premiums on debt, supplemented the budget with further savings drawn mainly on the health service. The economic situation was becoming critical, with the markets increasingly convinced that a rescue of some form was inevitable (for the government's interpretation of this and later policy see Guindos [2016]).

Apart from measures to directly reduce the deficit the PP government pushed through to completion a range of structural reforms, many of which had been attempted under the previous government (Table 3). The most important of these were the completion of restructuring in the banking sector and reform of the labour market, the pension system and the administration.

The first major plank of structural reform, and the most pressing at the end of 2011, related to the banking sector. The banks had used cheap and readily available money borrowed on international money markets to massively expand credit, financing private sector consumption, ambitious business expansion and a property market bubble. When this source of money and credit began to dry up, the property market collapsed, taking the banking sector down with it.

From late 2008 the government sought to address weaknesses in the banks through a process of restructuring centred on the merger of savings banks into larger banking groups (Zurita 2014). But the process was slow and failed to address serious balance sheet and governance issues. On election to office, the PP began to tackle the problems more aggressively with two major packages of measures in February and May 2012 (designated Guindos I and II) designed to clean up the banking system and allay market fears, but the process was overtaken in May by the collapse of one of the largest banking groups in Spain, Bankia. Any remaining confidence in the Spanish banking system evaporated and Spain was forced to accept a European bank rescue package.

A bank rescue was agreed through a memorandum of understanding signed with the Eurogroup on 11 July (European Council 2012). This enabled Spain to draw up to €100 billion of assistance (only €41.3 billion was actually drawn) to complete a process of bank restructuring formally begun in 2009 with the establishment of the Fund for the Orderly Restructuring of the Banking Sector (Fondo de Reestructuración Ordenada Bancaria – FROB). In exchange, Spain was required to accept the conditions of the rescue, which included conditions associated with not just the bank-restructuring process but also its conduct of economic policy. These conditions were monitored by a ‘Troika’ of external organisations: the European Financial Stability Facility (later the European Stability Mechanism), the ECB and the IMF. Thus, accepting the rescue entailed the sacrifice of a further tranche of sovereignty, over the bank-restructuring process, over fiscal policy and over economic policy more generally, adding to that already relinquished through membership of the euro area.

The consequences of conditionality were felt immediately in another austerity package in July 2012 and a new budget stability plan sent to Brussels in August. This time the measures included one recommended for some time by the Eurogroup: raising VAT. From 1 September the standard rate of VAT was raised from 18 to 21 per cent and the reduced rate from eight to ten per cent. In addition some products and services were reclassified to higher rate bands (for example, educational materials from the super-reduced rate of four per cent to the standard rate).

Labour market reform was a second plank in PP structural policy. From the onset of the crisis numerous active labour market measures were introduced to stimulate employment, along with several labour market reforms, including Urgent Measures to Reform the labour Market in 2010 (Ley 35/2010) and reform of the system of collective negotiation in June 2011 (RD Ley 7/2011). These were important from both an economic and a political perspective, as they increased flexibility in the market and were pushed through without the agreement of the unions. But they failed to fully dismantle the traditional system of national collective bargaining, expensive and cumbersome dismissal procedures and variety of employment contracts, as advised by many external organisations such as the European Commission, IMF and OECD. The PP was more ambitious, freeing up the labour market with reforms agreed by the government in February 2012 and passed into law in July (Ley 3/2012). The argument was that as the economy recovered businesses would be more ready to hire people if they knew they could dismiss them more easily in any subsequent downturn.

Reform of the pension system was a third plank in policy. Reform was essential, as demographic ageing, early retirement and the way that pension entitlements were calculated all threatened the long-term viability of the system and public finances. A pension reserve fund, set up in 2000 as a buffer against downturns in the economic cycle, had grown to €63 billion by 2011. But deficits in the system began to drain the fund from 2012 (by December 2016 it had fallen to €16 billion; Ministry of Employment and Social Security database). One reform was introduced in 2008 (Ley 40/2007) which modified the minimum period of work necessary to qualify for pension entitlement and toughened the rules associated with early retirement. Deeper reforms were initiated under the PSOE in 2011 (Ley 27/2011) for implementation from 2013 (though the regulatory framework was not fully approved by parliament until December 2013; Ley 23/2013). The reform envisaged a transition period to 2027 during which time the retirement age would be lifted from 65 to 67 and stricter conditions attached to the minimum period of contributions, pension entitlements and pensions for those retiring early. This underpinned pension sustainability in the long term, but to stem existing losses further pension reforms were under discussion in early 2017.

Just as the European authorities sought to ensure that Spain adopted austerity policies that it felt would lead to an exit from the crisis, so the central government sought to gain more effective control over the public spending of lower tiers of administration in Spain. Central government spending (excluding the social security system) represented only around 20 per cent of all public spending, the social security system some 30 per cent, the regions nearly 40 per cent and the local authorities ten per cent. Thus half of public spending was outside their direct control and very little was what could be described as discretionary. Previous governments had attempted to ensure budget stability through stability laws passed by the PP (Aznar government) in 2001 and 2002, and by the PSOE in 2007. In September 2011 the PSOE enshrined the principle of budget stability into the Constitution and introduced a rule that any public sector surplus was to go into reducing the deficit. Nevertheless, with regional government deficits exceeding targets the PP government moved to enforce its control over the budgets of lower tiers of government through a new law on budget stability (Ley Orgánica 2/2012) implementing measures outlined in the amendment to the Constitution. The law enabled the state to penalise administrations that failed to comply with the law and ultimately to intervene in the budget process. From 2012 regional budgets were subject to greater scrutiny and monitoring processes coordinated through the Fiscal and Finance Policy Committee (CPFF). From 2001 local authorities were required by law to have balanced budgets (Ley 18/2001), but these too ran up deficits in the early years of the crisis. Thus their budgets came under greater central control. In imposing stricter control from the centre, the PP government pushed up against regional autonomy. The tight budget controls and restrictions that were imposed reversed the trend towards greater regional autonomy that had been present up to the crisis.

In summary, the PP ended up delivering the PSOE plan that itself was heavily influenced by external agencies. But the PSOE would probably not have been able to deliver it. Reduced public spending, and in this sense a smaller state and tighter central control, coincided with conservative ideology, but market and other external pressures drove the implementation of austerity measures.

By 2014 external pressure for austerity had eased and in the run-up to elections in December 2015 some concessions were made to specific groups (notably civil servants) and income tax reductions introduced earlier than planned. These concessions contributed to Spain breaching its deficit target once again. But in July 2016 no financial sanctions were imposed and Spain was granted a further two years to meet its deficit target, raising further questions over the euro area fiscal framework.

The government sought to portray its economic policy as a resounding success in its final budget before the General Elections in December 2015 and to use Catalan demands for independence as a rallying call for national solidarity. In the event, the government was partially successful. It gained the largest number of seats in the election, though not enough to form a government. Re-run elections in June 2016 added more seats for the PP, but it remained in a minority with only 137 seats in Congress against the 176 required for a majority. In October, Rajoy eventually formed a minority coalition government with the new centrist party Ciudadanos plus the one seat of the Coalición Canaria, giving him 170 of 350 seats. He was in government, but only just.

External constraints on economic policy

Economic policy is framed within the context of the domestic political economy, market forces and external institutional agreements and pressures. Market forces constrain policy for example through the risk premium on debt, foreign investment flows, other capital flows, as well as private sector consumption and investment decisions. When economic policy does not look credible then the market reacts by imposing costs such as the outflow of capital and higher risk premiums (De Grauwe and Ji 2013). With the exception of the conditionality attached to the bank rescue package in 2012, it was these market consequences that drove the government to comply with the recommendations of external institutions rather than any sanctions that were attached to non-compliance. Inside the market, the debt-rating agencies played an important role in signalling the degree of risk they considered was attached to debt (Sinclair 2008; Gärtner et al. 2011). By 2014 two factors were acting to stifle these market reactions in the euro area. First, the outflow of capital from an economy would normally result in currency devaluation; for individual member states this could not happen (although for the whole group the euro weakened against the US dollar and the pound). Second, the market assessment of risk was stifled by the actions of the ECB.

From the inception of the crisis in mid-2007 European institutions played an important role in shaping policy responses in Spain. The EU set the framework inside which member states drew up their economic and financial policies (including the SGP's ceiling of three per cent of GDP on deficits and 60 per cent on public debt). Once in breach of the SGP (as Spain was in 2009) they were subject to closer supervision. In addition, during the period of Spain's bank rescue package from July 2012 to December 2014, the banking system and economic policy were subject to broader supervision by the Troika. For members of the euro area, supra-national constraints were greater than they were before the crisis. All areas of economic policy were regulated by the EU. In addition to monetary policy, 'ever closer union' tightened constraints on fiscal policy with fiscal rules on debt, deficit and spending backed by sanctions together with greater transparency (Claeys et al. 2016). Finally, it removed bank supervision and resolution to the European level (Busch and Ferrarini 2015).

The role of the ECB was critical. By acting indecisively before 2012 it allowed the financial crisis to fester, deepen and infect the sovereign debt market. The game changer came in July 2012 when the governor of the ECB, Mario Draghi, said at a speech in the City of London, 'The ECB would do whatever is necessary to save the euro and, believe me, it will be sufficient' (Draghi 2012). These words were underpinned in September by the announcement of a new bond purchase scheme known as Outright Monetary Transactions (OMT). From this point bond yields across the euro area began to fall (aided by further interest rate reductions and 'limitless' liquidity for banks) with a narrowing of the spread between Spanish and German ten-year bonds from over 600 basis points in July to an average of 400 in December. As Nicolas Véron (2015, p. 5) concluded: 'there is no doubt that the OMT programme was central in calming markets and bringing to an end the very acute phase of the euro-area crisis'. In Spain, it relieved pressure on government debt issuance and prevented the need for a sovereign rescue package. Nevertheless, continued weakness in the euro

area led the ECB to finally introduce its own quantitative easing programme from March 2015 (announced in October 2014). By March 2015 the yield on Spanish ten-year debt had fallen to close to one per cent and the spread over its German counterpart to less than 100 basis points. On this measure, Spanish debt was considered safer than both US and UK debt. With interest rates close to zero domestic consumption began to revive from 2014, replacing exports as the main driver of recovery and in 2016 Spain was able to finance its debt at record low interest rates. By late 2016 economies around the world remained buoyed by unprecedented loose monetary policy including quantitative easing and negative interest rates, but crucially the Federal Reserve in the US had begun to tighten.

Relaxing austerity and the existential threat to the euro area

By the end of 2016 numerous challenges were facing the European project of 'ever closer union'. At their root was the failure of policy to deliver economic growth and a decisive exit from the economic crisis. European election results in May 2013, election results in Spain in December 2015 and June 2016, the Brexit referendum result in June 2016 and the defeat of the Renzi government in Italy in a constitutional referendum in December all spoke of dissatisfaction with incumbent governments and threatened further upheavals in France, Germany and the Netherlands in 2017. On top of this there had been no solution to the migration crisis and Greek debt problems, while parts of the European financial system remained fragile. These added to other concerns over 'globalisation' and fanned the flames of nationalism. They opened up rifts over policy among the multiplicity of actors involved. On economic issues rifts were notably over the emphasis on austerity and reliance on monetary policy as the means of escaping dismal growth.

Measures amounting to a softening of austerity came as part of the European Commission's country-specific recommendations in early summer 2013. A number of countries, including Spain, were given more time to reach their deficit objectives (for Spain the deadline was extended from 2014 to 2016; then extended again in May 2016 to 2018). In autumn 2014 a stimulus programme was announced by the European Commission (the 'Juncker Plan') designed to use public money to attract private investment across Europe, but within the framework of the SGP. In Spain, in the lead-up to elections in December 2015 the government maintained its rhetoric on austerity while providing income tax reductions through income tax reform, the repayment to civil servants of monies held back in 2012 and the prospect of further tax cuts.

Following the formation of a new Rajoy-led government in November 2016 there was no proposal to change VAT rates even in the face of pressure from the European Commission, but only the proposal to make adjustments to corporation tax and raise duties on tobacco and strong alcoholic drinks. The government claimed that these measures, along with the fight against fraud, would result in an additional €7 billion of revenue (Ministerio de Hacienda y Función Pública 2016). Growth was generating increased revenue while reducing debt and deficit ratios through a higher GDP denominator.

An assessment of austerity policy

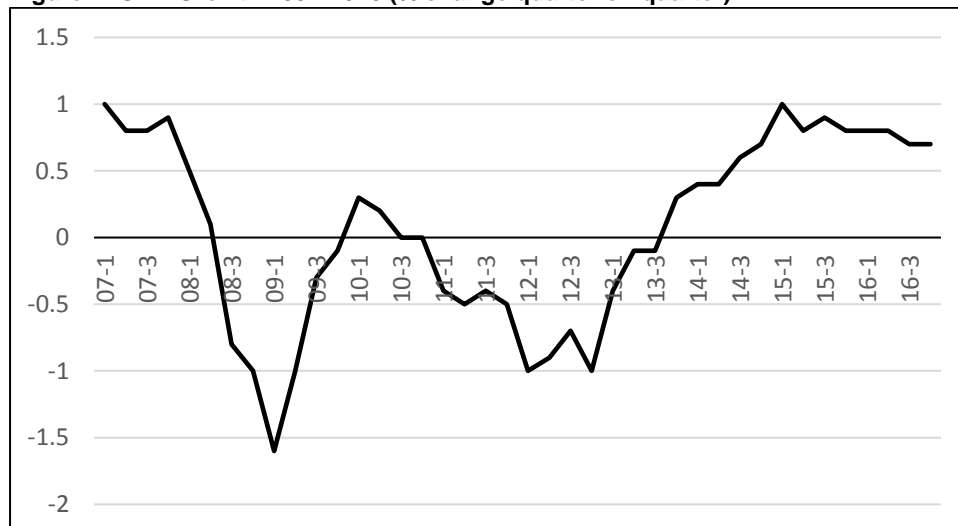
The debate over economic policy through the crisis and into the present continues to rage. A long list of economists (Blyth 2013a; Krugman 2012; Wren-Lewis 2013; Wolf 2014, 2016) have criticised the emphasis on austerity in Europe. The voices in support of austerity have on the whole been quieter, but they have been there (notably in the German central bank and Spanish Ministry of Finance) and strong enough when harnessed to political considerations to drive the policy. Alberto Alesina with others (Alesina and Perotti 1995; Alesina et al. 2015) has authored a string of academic papers largely supportive of austerity. Anders Aslund (2013) wrote a short piece entitled 'Why

austerity works'. Niall Ferguson (2015) was especially critical of Paul Krugman's stance on policy in the UK, claiming that the evidence of growth in 2015 (like that in Spain) demonstrated that austerity did work. Luis Linde, President of the Bank of Spain, joined the debate in 2015, arguing that reducing the imbalances that there were in the economy was common sense (Linde 2015). None of the protagonists in the debate would argue with this. The issues lay in the emphasis on austerity, the mix of policies that constituted it, the time scale over which adjustment was attempted (which in practice was continually extended) and the absence of a fully coordinated European response.

The following policy assessment merely attempts to identify some of the changes in macroeconomic magnitudes relating to growth, public finances and the labour market which coincided with economic policy. It excludes any direct assessment of structural reforms, measurement of public revenue and spending, or the policy mix.

Figure 1 shows the rate of growth in GDP from 2007 to 2016, illustrating the combined impact of all the forces influencing the economy, including economic policy. The rate was slowing in the first half of 2007, even before the external shock of a credit crunch. This mild slowdown turned into a dramatic fall from the beginning of 2008 which swept the economy into contraction by the third quarter, where it was to stay almost continuously to the second quarter of 2013. Five years of almost unbroken economic contraction left nominal GDP down eight per cent in 2013 (nine per cent in real terms) on its 2008 level. Assuming real growth of two per cent over the five years 2009 to 2013 (inclusive) there was a real-terms loss of output of over €200 billion (some 20 per cent of GDP in 2013). Only in 2016 was the economy forecast to regain its nominal level of GDP (excluding inflation) in 2008 and its real level (allowing for inflation) in 2018, while Wolf (2016) points to data that suggest real incomes per head were unlikely to return to their pre-crisis levels until at least the end of the decade. Thus the Great Recession and accompanying austerity policy were associated with a decade of lost growth.

Figure 1: GDP Growth 2007-2016 (% change quarter on quarter)



Source: National Statistics Institute (Quarterly National Accounts)

Table 4 shows the budget outcomes for 2007 to 2015 and the deficit reduction path and budget forecasts for 2016 to 2018 (Ministerio de Hacienda y Administraciones Públicas 2016). It is clear that in 2008 and 2009 a combination of increased spending and falling revenue opened up a large deficit, amounting to over €118 billion in 2009 (11 per cent of GDP). About half arose from increased spending and half from a fall in revenue (Eurostat). This was reduced by around €17 billion in 2010 and a further €8 billion (excluding one-off payments) in 2011 (election year). Additional budget savings of €25 billion were made under the PP in 2012 (excluding one-off payments associated with the bank rescue programme). But no further savings were made in 2013 before a slower path of savings was established from 2014 to 2016. In the seven years 2010 to 2016 (inclusive) the government made net budget savings in nominal terms of around €66 billion or €9.4 billion a year; equivalent to a little under one per cent of GDP a year. The initial deficit reduction path set by the European Commission in 2009 that put 2012 as the date for reducing the deficit to three per cent or less was clearly unrealistic. In the event economic policy was not forecast to achieve that target until 2018. An emphasis on austerity made slow progress in reducing the deficit.

Table 4: Evolution of GDP, Debt and Deficits 2007-2018 (2016 to 2018 are government forecasts at December 2016)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Deficit												
% GDP	+2.0	4.4	11.0	9.4	9.6 (9.1)	10.5 (6.8)	7.0 (6.6)	6.0 (5.8)	5.1	4.6	3.1	2.2
€bn	22	49	118	101	103 (93)	109 (68)	72 (68)	62	55	52	36	27
Debt												
% GDP	35.5	39.4	52.7	60.1	69.5	85.7	95.4	100.4	99.8	99.4	99.0	97.7
€bn	384	440	569	649	744	891	978	1041	1073	1114	1157	1185
GDP												
€bn	1081	1116	1079	1081	1070	1040	1026	1037	1076	1118	1163	1210
Growth	3.8	1.1	-3.6	0.0	-1.0	-2.6	-1.7	1.4	3.2	3.2**	2.5**	2.4**

Source: Data for 2007 to 2015 from Bank of Spain (accessed 19 December 2016)

Forecasts 2016 to 2018 from the Ministerio de Hacienda y Administraciones Públicas, 2016

Deficit figures in brackets from Ministry of Finance 2016 and exclude one-off payments mainly in the bank rescue in 2012

GDP €bn is nominal GDP at market prices

Growth is percentage change in real GDP on previous year

A crucial intermediate goal of austerity policy was to reduce public debt. From the end of 2010 to the end of 2014 this grew from 60 per cent of GDP to around 100 per cent (the sixth highest in the EU). An emphasis on austerity policy did not stop an explosion in public debt that at the beginning of 2017 had little chance of being reduced to below the SGP ceiling of 60 per cent of GDP in the medium term.

Changes in the labour market underline the human cost of the recession. The population in employment (the occupied population as measured by the quarterly Labour Force Survey of the National Statistics Institute (Instituto Nacional de Estadística, INE various dates)) fell almost continuously from 20.7 million in the third quarter of 2007 to only 17 million in the first quarter of 2013, a loss of 3.7 million jobs or almost 18 per cent of peak employment (Figure 2). Using contributors to the social security system as a measure of employment, the number fell from a peak of 19.4 million in July 2008 to 16.2 million in February 2013 (Ministerio de Empleo y Seguridad Social 2016). The pension system was undermined by the loss of 3.2 million social security contributors.

Figure 2: Evolution of Employment and Unemployment 2007 to 2016 (million)



Unemployed on right hand scale

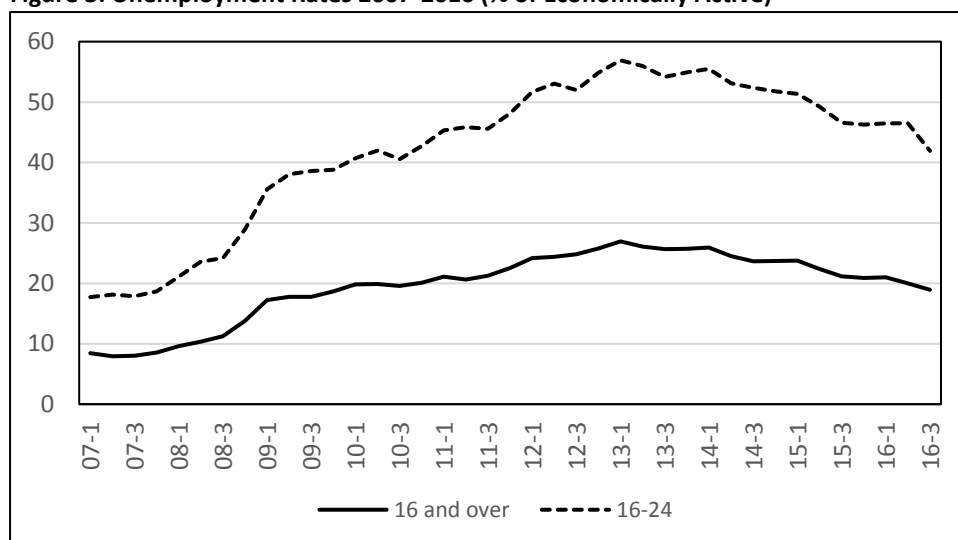
Source: National Statistics Institute (Labour Force Survey)

The fall in the population in work was especially sharp in the final quarter of 2008 to the end of the first quarter of 2009, when the number fell by almost 1.3 million (INE op cit). Then, from the second quarter of 2009 to the second quarter of 2010 employment fell more slowly, by only 400,000 (INE). Through 2010 and 2011 it remained relatively stable at around 18.5 million, before decreasing sharply again from the final quarter of 2011 through to the end of the first quarter in 2013, when the number employed tumbled by over one million. In line with a return to economic growth, employment too began to recover from the end of the first quarter of 2013. By the third quarter of 2016 the population in employment had reached 18.5 million, one million more than in the same quarter of 2014, but still far below the 20.8 million in the third quarter of 2007 (INE). Similarly, contributors to the social security system had risen to 17.85 million in December 2016, but still below the 19.4 million in November 2007 (Ministerio de Empleo y Seguridad Social 2016).

More graphically, the cost of the recession was a rise in unemployment to over a quarter of the labour force (Figure 3). The rate of unemployment (for those aged 16 and over as measured by the Labour Force Survey) increased from eight per cent at the end of the third quarter in 2007 to 11 per cent one year later; it then escalated to over 17 per cent in the winter of 2008/09. In 2010 unemployment stabilised and then resumed its upward path in 2011. In 2012 there was a substantial rise, from 21 per cent at the end of the third quarter in 2011 to peak at almost 27 per cent at the end of the first quarter in 2013. From 2013 unemployment began to fall to 4.3 million (19 per cent) in the third quarter of 2016; a reduction over the previous two years of around one million. The Labour Force Survey data probably overstate the unemployment numbers; nevertheless, lack of employment opportunities and the precarious nature of employment on fixed-term contracts was among the most serious consequences of the crisis. Austerity measures cut employment in the

public sector and froze wages, substantial cuts in public investment contributed to the shrinkage of the construction sector, while broader spending cuts hurt suppliers. Economic policy was associated with a disaster in the labour market.

Figure 3: Unemployment Rates 2007-2016 (% of Economically Active)



Source: National Statistics Institute (Labour Force Survey)

Unemployment was especially acute among young people. A whole generation grew up in a world where it was almost impossible to find a job with an open-ended contract. Among this group (aged 16–24) the unemployment rate rose to 57 per cent in the first quarter of 2013 (Figure 3). Migrants also bore a disproportionate burden of unemployment. For foreign workers the unemployment rate reached almost 40 per cent at the end of the first quarter of 2013 (INE), contributing to a reversal of net international migration from large inflows from the late 1990s to the onset of the crisis to a net outflow from 2010 onwards (Izquierdo et al. 2015). Moreover, the rise in unemployment contributed to the growth of inequality during the crisis years (Ayala 2016; de la Fuente and Onrubia 2016), which in turn has been presented as a factor behind disillusion with established political parties (Rueda 2014).

Conclusion

A decade has passed since the onset of the financial crisis in the US, the legacy of which still reverberates around the world. During this time a variety of policy responses were tried, with a focus in Europe on austerity combined with increasingly accommodative monetary policy. A final verdict on austerity policy remains contested. Nevertheless, some conclusions are possible in the case of Spain.

Firstly, Trichet (2010) argued that the short-term costs for economic growth would be contained or very limited. This was not borne out in Spain. There was a lost decade of growth which affected every corner of the economy. Unemployment rose to previously unimaginable levels, disposable incomes and wealth fell and income inequality increased. The externalities were significant, notably in a disillusion with politicians and government which contributed to the creation of a climate of political instability in Spain and across Europe.

Secondly, the argument was that austerity would enable budget deficits and debt to be reduced. But the policies followed in Spain only reduced the deficit slowly. At the end of 2016 it remained above the SGP ceiling of three per cent (as it did in Greece, France and Portugal). Debt reduction was even more disappointing. It climbed to 100 per cent of GDP and remained at close to this level. Across

Europe debt levels in 2016 were high, at close to or over 100 per cent of GDP in Belgium, Cyprus, France, Greece, Italy and Portugal. Thus concern continued over high levels of debt, exposing economies to sudden economic dislocation, and fiscal buffers remained thin to confront economic instability.

If policy in the euro area disappointed on any particular metric, it was that of growth. In the US and the UK growth was re-established in 2010 and continued through to 2016 (both these also acted early to recapitalise their banking systems). In the euro area, although growth reappeared in 2010, it turned to contraction again in 2012 and 2013, before slow growth was restored from 2014. In Spain the recession was almost unbroken from 2009 to 2013 (inclusive). Supporters of policy in Spain claimed they were vindicated by strong growth in 2015 and 2016. But this was achieved at enormous cost to the economy and society.

Economic policy in Spain during the Great Recession was tightly constrained by the euro area policy framework and implementation conditioned by the decentralised form of the state. The evidence demonstrates the costs associated with the policy, the worst effects of which were masked by reliance on increasingly accommodative monetary policy. By the beginning of 2017 a growing number of international organisations were calling for a broader policy framework. Loosening austerity was a necessary precondition not just for sustaining growth in Spain and re-energising it in Europe but for re-engaging the people with government.

Note

1. All legislation (Ley and RD) can be found on the Official Bulletin of the State website: www.boe.es

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Notes on contributor

Keith Salmon is Reader in Political Economy at Hertfordshire Business School. His research has focused on the European economy, particularly Spain. In the early 1990s he published a book entitled *The Modern Spanish Economy*. Since that time he has continued to research, publish, give conference presentations and provide consultancy on Spain.

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