Group Economics

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Fiscal austerity is coming whether we like it or not

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Over the past decade, Greece has gained a reputation of being a source of surprises. In 2000, the Greek sprinter Kostas Kenteris was the unexpected winner of the men's 200 metres gold medal at the Sydney Olympics. Furthermore, his compatriot, Katerina Thanou, picked up the silver medal in the women's 100 metre sprint. Four years later the stage was set for the duo to repeat their success at the Athens Olympics. However, shortly before the Games began the two athletes were involved in allegedly faking a motorcycle crash hours after missing drug tests and both athletes subsequently pulled out of the Games. The controversy was the biggest Olympics drugs scandal since the disqualification of Ben Johnson in 1988.

On a more positive note, Greece entered the European football championships in 2004 as 150-1 rank outsiders. Once again they surprised the European football fraternity by defeating Portugal, the host nation, to lift the trophy.

In the economic world, Greece is not renowned for its fiscal discipline. Even with this reputation, Greece still managed to shock the European Commission and European markets last October by revealing that its fiscal deficit for 2009 was actually twice the size it previously estimated earlier in the year. This was a staggering admission even allowing for the impact from the recession.

The Greek annual fiscal deficit is set to hit almost 13% as a percentage of GDP and will be the largest within the eurozone. This is more than four times the recommended limit *(3% of GDP)* stipulated in the EU's Stability and Growth Pact. This triggered a loss of confidence in Greece within the capital markets and made it more difficult to secure funding to run the country. The prospect of a sovereign state bankruptcy loomed as the eurozone does not have any fiscal transfer mechanism to support member states in financially difficulty. Indeed, a "no bail-out" clause was enshrined in the Maastricht Treaty.

The Republic initially suffered a similar fate with its severe recession plunging its public finances deep into the red. As a sovereign state, the Republic must borrow to plug its widening deficit. However, given its deteriorating credit worthiness the cost of borrowing spiralled upwards which in turn puts additional pressure on the public finances in a virtuous circle. The only way to address this financial malaise is to regain credibility in the markets to encourage investors to lend at rates that are not extortionate. To regain fiscal credibility a state has two options. First *(the DIY option)*, it can aggressively reduce the deficit itself by raising taxes and cutting public expenditure. Or second, the politically embarrassing option is to call in the lender of last resort, the International Monetary Fund (IMF). The IMF will be happy to lend but with painful strings attached. In the eurozone, there is currently an ongoing debate over a third option – a European Monetary Fund (EMF) – a European version of the IMF with eurozone countries lending Greece emergency funds on condition it delivers austerity.

The Republic has chosen the DIY option and has swiftly implemented a range of politically unpopular policies such as public sector pay cuts and reducing welfare benefit. These measures have kept the annual deficit around 11% of GDP as opposed to a staggering 16%. Following the Republic's preparedness to put economic necessity over political popularity it has had international praise heaped upon it. As a result, in the same way that Ireland was lauded during the Celtic Tiger boom years, it has now become the poster boy for fiscal austerity.

Moving to the UK, it has experienced the political shame of going 'cap in hand' to the IMF for emergency funding back in 1976. It is noted that a key difference between the eurozone and the 'sterling-zone' is the degree of fiscal transfers between regions. UK regions have the luxury of not having to balance their regional accounts. Indeed, most regions persistently run an annual fiscal deficit and it is up to those regions that consistently produce a surplus (*e.g. London and the South East*) to subsidise or 'bail-out' the deficit regions. Furthermore, these inter-regional fiscal transfers have no austere strings attached. However, given that the UK's public finances have deteriorated sharply, and the annual fiscal deficit approaches 12% of GDP*,* there are no surpluses to share with the regions.

As in the eurozone, those economies with the largest fiscal deficits will be the most vulnerable. Within the UK, NI has the largest annual fiscal deficit of any region at almost £9bn or 32% of regional GDP per annum. To put this into perspective, each household receives an annual subsidy of £20,000 per annum courtesy of the surpluses generated primarily by London and the South East. To date, there have been no strings attached to this subsidy; however, a recent report by the Institute of Public Policy Research (IPPR) has highlighted growing English resentment to the scale of fiscal subsidy heading north to fund a devolved Scotland. It won't take long for middle-England to look north west to the scale of unconditional funding going to NI and for them to question the distinct lack of bang for their donated buck. In the same way that Germans are apoplectic about the thought of subsidising Greece's financial incompetence, it is not unrealistic, nor unreasonable, for Middle-England to demand more austerity in the high deficit regions of the UK.

Like financial markets, the electorate do not like nasty surprises and it is important that Governments manage expectations. From this perspective it is vital that Governments don't write policy cheques that their public finances cannot cash. The Greek Prime Minister George Papandreou has learnt this the hard way. Papandreou's election manifesto included a raft of popular policies, such as real wage increases and additional welfare spending. However, with a ballooning fiscal deficit, the Greek Prime Minister has had to perform policy U-turns that are politically unpopular but of economic necessity. In less than six months Papandreou has gone from promising rising prosperity to announcing fiscal austerity in record time. Clearly, the bigger the surprise to the electorate the bigger the reaction and this has been all too apparent with the ongoing demonstrations on the streets of Athens.

Similarly in NI, the Executive has written a series of policy cheques (*e.g. water charges deferral*) that the local public finances cannot sustain. Let there be no mistake, after the General Election, the NI executive will have to deliver its own austerity package or 'portfolio of pain' to an unsuspecting public. Following the general election the Stormont executive needs to engage in some frank communication to an electorate that has suffered from a fiscal deficit attention disorder for too long. To coin a phrase from the US Treasury Secretary, Tim Geithner, it is time for the executive to "*put foam on the runway*" as a fiscal hard landing is now in prospect.

However, the forthcoming public expenditure shock is not all bad news. Historically, fiscal crises have provided an important turning point for both fiscal /economic policy as open and honest debate often follows.

Looking back to the 1976 sterling / IMF crisis, the then Prime Minister, Jim Callaghan candidly told the Labour Party conference that *"for too long we postponed facing up to fundamental choices and fundamental changes in our society and our economy…."* This statement strikes a chord with the position the UK and NI both find themselves in today.

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