



Perspectives by Ruth Lea

Economic Adviser to Arbuthnot Banking Group



The UK finances are too weak for another major fiscal boost

Last weekend's meeting of G20 finance ministers and central bank governors, ahead of the G20 meeting of heads of state on 2 April, was widely reported as a conflict between the US, on the one hand, and Continental Europe, on the other, with Britain playing the role of honest broker. The US, goes this scenario, was pushing for Europe to do more by way of a fiscal boost, whereas Europe's priority centred on reforms to the regulation of the financial system. Europe's reaction to exhortations to more fiscal activism, especially from Germany and France, was to see how the fiscal stimuli already implemented would play out before considering further moves.

At first blush, the US would seem to have right on its side. After all, the key priority for the world economy is now to stabilise the global economy and encourage the banks to lend. Governments and central banks must be prepared to fill the gap left by the collapse of private spending. The reform of regulation, clearly necessary and clearly going to happen, is a less immediate priority. When a fire is burning, the sensible reaction is to put out the fire rather than spend time debating how to avoid similar fires in future.

Moreover, recent IMF analysis of the fiscal stimuli so far delivered by the major economies would suggest that the US has, to date, done more than Europe.² The table below, taking a combination of tax cuts and spending increases, shows that the US and China have been the most activist to date, though Germany's effort has not been paltry. The UK's efforts look modest by comparison, comprising the £20bn boost announced in the Pre-Budget Report.

Stimulus package in large countries (% of GDP)

	2008	2009	2010	Total
Canada	0	1.5	1.3	2.7
China	0.4	2.0	2.0	4.3
France	0	0.7	0.7	1.3
Germany	0	1.5	2.0	3.4
India	0	0.5	-	0.5
Italy	0	0.2	0.1	0.3
Japan	0.4	1.4	0.4	2.2
UK	0.2	1.4	-0.1	1.5
US	1.1	2.0	1.8	4.8
Average	0.5	1.6	1.3	3.4

Source: IMF, "The size of the Fiscal Expansion: an analysis for the Largest Countries", February 2009.

But two qualifications should be made. The first, well made by the IMF, is the relevance of automatic stabilizers.³ An example is the impact on government spending on unemployment benefits as economies weaken. As economies weaken and unemployment rises, government expenditure on unemployment benefits also rises. Such an increase in benefits supports the economy – but, at the same time, increases government deficits. Countries where the automatic stabilizers are larger will need a smaller discretionary stimulus, other things being equal. European countries, including the UK, have larger automatic stabilizers than has the US – specifically Europe has more generous and extensive social benefits than the US – so their discretionary stimuli do not need to be so large.

The second qualification concerns the position of individual countries to fiscally expand in order to kick start their economies. Unfortunately, not all the major economies are in such a position. The UK and Italy exercised very poor control of public spending in the boom years, greatly increasing the risks to these countries of activist fiscal policy now. Germany and France, however, are better placed.

The EU's public finances

The table below shows the European Commission's January forecast for the EU's four largest economies. Suffice to say that the economic climate has deteriorated significantly over the past two months and these forecasts will inevitably be considerably downgraded in April when the next set of forecasts are due. Projections for both GDP growth and the public finances will look worse.

But even January's public sector forecasts for Italy and the UK look dreadful. Bearing in mind that the Maastricht criteria for "excessive debt" and "excessive deficits" are that the debt/GDP ratio must be no more than 60% (or heading in the "right direction") and the deficit/GDP ratio must be no more than 3%, it is clear that both of these countries are seriously flouting these criteria. The Commission's expectations of the deterioration in the UK's finances are especially telling and likely to be far more realistic than the Chancellor's relatively optimistic forecasts at the time of Pre-Budget Report.^{4, 5}

Forecasts for large EU countries

	GDP (%YOY)		General Government deficit (% GDP)		General Government gross debt (% of GDP)	
	2009	2010	2009	2010	2009	2010
Eurozone:						
Germany	-2.3	0.7	-2.9	-4.2	69.6	72.3
France	-1.8	0.4	-5.4	-5.0	72.4	76.0
Italy	-2.0	0.3	-3.8	-3.7	109.3	110.3
Eurozone: total	-1.9	0.4	-4.0	-4.4	72.7	75.8
UK	-2.8	0.2	-8.8	-9.6	62.6	71.0
EU: total	-1.8	0.5	-4.4	-4.8	67.4	70.9

Source: European Commission, Interim Forecast, January 2009, available from <http://ec.europa.eu>. Note that the 2010 forecast is based on unchanged policies.

In the annex to this Perspective the (over-optimistic) forecast data for all EU27 countries are provided. Please note the sharply contracting economies of Eastern Europe (to which Austrian, Greek and Italian banks in particular are exposed) and Ireland. There is increasing expectation that some European countries will need some form of bailout to repair their public finances, which have ballooned in the face of bank bailouts and a decade of consumer-led growth. Greece and Ireland head the list, followed by Portugal and possibly Italy, Austria and Spain.⁶

Memo to the Chancellor: a cautious Budget please

The Budget is very late this year – 22 April – but there are already signals coming out of the Government as to what it may look like. The Chancellor appears to be dampening expectations of a considerable fiscal boost – with measures focussed on the beleaguered savers. We have to hope these expectations are fulfilled. The forecasts for the public finances in the Budget will inevitably be much worse than at the time of the Pre-Budget Report for two major reasons: the faster-than-expected deterioration in the economy and the fiscal implications of the further rescue packages for the banks.

The Treasury is doubtless reminding the Chancellor of the words of PM James Callaghan at the time of the 1976 sterling crisis and IMF bailout. He told the Labour Party Conference:

“We used to think that you could spend your way out of a recession and increase employment by cutting taxes and boosting government spending. I tell you in all candour that that option no longer exists and, in so far as it ever did exist, it only worked on each occasion since the war by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment as the next step.”

No we can't spend our way out of this recession. But even without another further fiscal boost to the economy, concern is already being expressed that, given the need to fund the likely levels of public debt, there could be a buyers' strike. Steve Brundred, chief executive of the Audit Commission, wrote recently:

“On the basis of the planned levels of borrowing, it [public debt] could exceed 65% of GDP in 2010-11. And at that scale of indebtedness, the Armageddon scenario most feared by the Treasury - that there will be insufficient lenders to match the planned level of borrowing - begins to look a distinct possibility.”⁷

He wasn't just being alarmist.

References

1. G20 comprises: G7 (US, Japan, Germany, France, UK, Italy and Canada), the BRICs (Brazil, Russia, India and China), Turkey, Saudi Arabia, Indonesia, South Korea, South Africa, Australia, Mexico, Argentina and the EU.
2. IMF, “The size of the Fiscal Expansion: an analysis for the Largest Countries, February 2009”, available from www.imf.org
3. Automatic stabilizers are relationships in the economy which reduce the amplitude of the cyclical fluctuations without direct action by, for example, the government. Thus as GDP falls and unemployment rises, spending on state benefits for the unemployed rises, supporting spending.
4. Pre-Budget Report, Facing global challenges: Supporting people through difficult times, HM Treasury, Cm 7484, November 2008.
5. Ruth Lea, “The public finances: time for a radical reappraisal”, Arbuthnot Banking Group, Economic Perspective, 1 December 2008.
6. Ian Dey and David Smith, “Cracks in the Euro”, Sunday Times, 15 March 2009.
7. Steve Brundred, “Our public debt is hitting Armageddon levels”, The Times, 27 February 2009

Annex: Forecasts for EU27 countries: European Commission, January 2009

	GDP (%YOY)		General Government deficit (% GDP)		General Government gross debt (% of GDP)	
	2009	2010	2009	2010	2009	2010
Eurozone:						
Belgium	-1.9	0.3	-3.0	-4.3	91.2	94.0
Germany	-2.3	0.7	-2.9	-4.2	69.6	72.3
Ireland	-5.0	0	-11.0	-13.0	54.8	68.2
Greece	0.2	0.7	-3.7	-4.2	96.2	89.4
Spain	-2.0	-0.2	-6.2	-5.7	46.9	53.0
France	-1.8	0.4	-5.4	-5.0	72.4	76.0
Italy	-2.0	0.3	-3.8	-3.7	109.3	110.3
Cyprus	1.1	2.0	-0.6	-1.0	46.7	45.7
Luxembourg	-0.9	1.4	0.4	-1.4	15.0	15.1
Malta	0.7	1.3	-2.6	-2.5	64.0	64.2
Netherlands	-2.0	0.2	-1.4	-2.7	53.2	55.2
Austria	-1.2	0.6	-3.0	-3.6	62.3	64.7
Portugal	-1.6	-0.2	-4.6	-4.4	68.2	71.7
Slovenia	0.6	2.3	-3.2	-2.8	24.8	25.8
Slovakia	2.7	3.1	-2.8	-3.6	30.0	31.9
Finland	-1.2	1.2	2.0	0.5	34.5	36.1
Eurozone: total	-1.9	0.4	-4.0	-4.4	72.7	75.8
Other:						
Bulgaria	1.8	2.5	2.0	2.0	12.2	10.7
Czech Republic	1.7	2.3	-2.5	-2.3	29.4	30.6
Denmark	-1.0	0.6	-0.3	-1.5	28.4	27.0
Estonia	-4.7	1.2	-3.2	-3.2	6.1	7.6
Latvia	-6.9	-2.4	-6.3	-7.4	30.4	42.9
Lithuania	-4.0	-2.6	-3.0	-3.4	20.0	23.3
Hungary	-1.6	1.0	-2.8	-3.0	72.8	74.0
Poland	2.0	2.4	-3.6	-3.5	47.7	49.7
Romania	1.8	2.5	-7.5	-7.9	21.1	26.8
Sweden	-1.4	1.2	-1.3	-1.4	36.2	36.0
UK	-2.8	0.2	-8.8	-9.6	62.6	71.0
EU: total	-1.8	0.5	-4.4	-4.8	67.4	70.9

Source: European Commission, Interim Forecast, January 2009, available from <http://ec.europa.eu>. Note that the 2010 forecast is based on unchanged policies.

**Ruth Lea, Economic Adviser, Director,
Arbuthnot Banking Group,
ruthlea@arbuthnot.co.uk,
Tel: 07800 608 674**