Perspectives by Ruth Lea

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Keep Britain's cuts in perspective: it's far worse in some eurozone countries

Introduction

In the last Perspective we discussed the outcome of the Spending Review and the overall framework for the spending cuts in the UK.[1] It was clear from that analysis that, despite all the media hype surrounding the overall degree of fiscal retrenchment, the cuts are manageable and they need to be kept in some perspective.

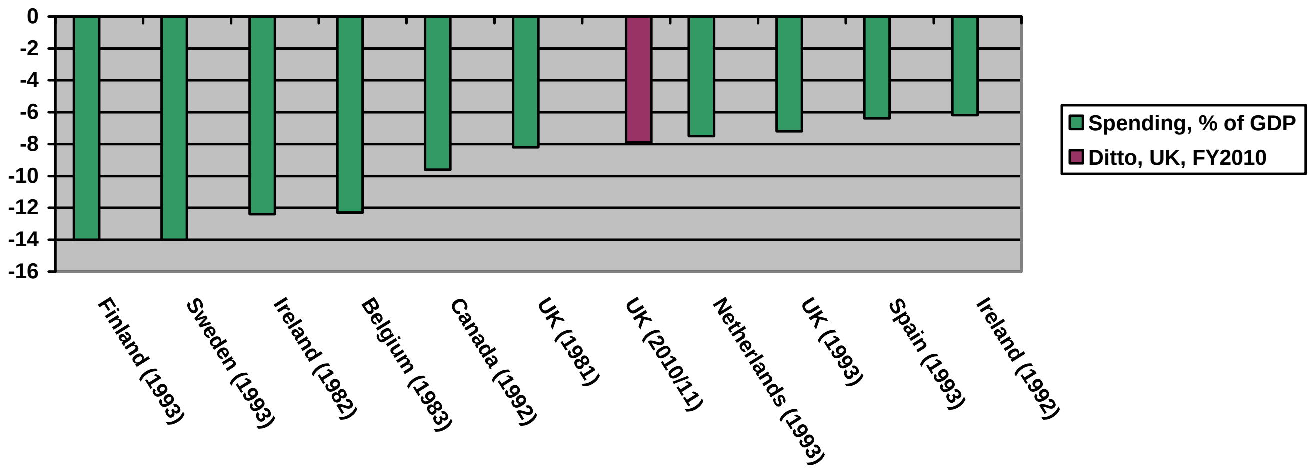
It is a useful exercise to compare the UK's forthcoming spending-cutting exercise with other fiscal reform programmes in recent history. One measure of the fiscal "toughness" is to compare public spending as a % of GDP in the first year of fiscal clampdown with the equivalent ratio a few years later when the reforms have had time to "bed down". Such an exercise was written up in a 2006 ECB paper, which analysed and compared the effects of spending-cutting packages over a period of 7 years for several countries.[2]

The key results are shown in chart 1. The chart shows that, for example, Finland's major belt-tightening exercise began in 1993. Between 1993 and 2000 primary spending (public spending excluding debt interest) as a % of GDP fell by 14%. The detailed figures behind the chart are given in table 1 of the annex – they show that spending as a % of GDP hit 60% in 1993, by 2000 it was 46%. Sweden's ratio also fell by 14% over a 7-year period – from 67% in 1993 to 53% in 2000.

The next in line are the Irish reforms starting in 1982, Belgian reforms of 1983, Canadian reforms of 1992 and the British reforms in the early 1980s. All these countries were undoubtedly helped to reduce the spending/GDP ratio by economic growth, but hard decisions were also taken on spending.

We have inserted in the chart the projected reduction in the spending to GDP ratio for the UK, as implied in the *June 2010 Budget* and the *2010 Spending Review*.[3,4] The projections only run to FY2015 (indeed the detailed projections from the Spending Review only run to FY2014). So the comparison is for 5 years from FY2010 to FY2015 rather than for 7 years. One can only guess whether the ratio will start rising after FY2015 or whether it will continue to fall. But what is of note is that the projected reduction in the spending ratio is expected to fall by about 8% over the 5 years. Whilst this is tough it is not out of line with previous reforming endeavours – and indeed less demanding than some. In particular it is not out of line with the effects of measures taken in the early 1980s or the mid 1990s in the UK – though it should of course be noted the current exercise is being undertaken against a background of less favourable international economic circumstances.

Chart 1 Primary expenditure as % GDP, changes over 7 years from specified date



Main source: Hauptmeier, Heipertz & Schuknecht, "Expenditure reform in industrialised countries: a case study approach", ECB, Working Paper no 634, May 2006; note primary expenditure excludes debt interest. For UK

Comparing Britain and the peripheral eurozone

The ECB exercise did not of course take into account the eye-watering austerity packages now being undertaken in some of the eurozone countries, which we discussed in a recent Perspective.[5] But it is instructive to compare the deficit-reduction exercises that are being imposed in these countries with the UK's. Note that the measure of fiscal "toughness" here is overall "deficit-reduction", imposed by a combination of higher taxes and tighter spending, and not just about spending. This measure is, therefore, a more comprehensive measure of fiscal retrenchment than just spending.

Since our last Perspective Ireland announced on 4 November that in its next Budget (7 December 2010), there would be a fiscal of adjustment of €6bn for 2011, twice the €3bn announced envisaged at the time of last year's budget and reflecting the gloomier growth outlook. Ireland's objective is to get the deficit down to 9.5% of GDP in 2011 compared with 32% in 2010 (including the €30bn bank bail-out). The announcement came amid increasing concerns that the Irish government may struggle to secure parliamentary backing for its budget and increasing speculation that Ireland will, after all, have to resort to the recently created European Financial Stability Facility for funding.[6]

The table below compares the UK's deficit-reduction package with those in the peripheral eurozone - and France. The UK's situation is clearly less draconian than in the "PIGS" – though more draconian than in France. The UK also has the advantages of an independent monetary policy, a weaker currency and not being locked inside a currency union with deficient competitiveness compared with a highly competitive Germany. Britain is relatively well placed.

Austerity packages, targets, government deficits as % of GDP

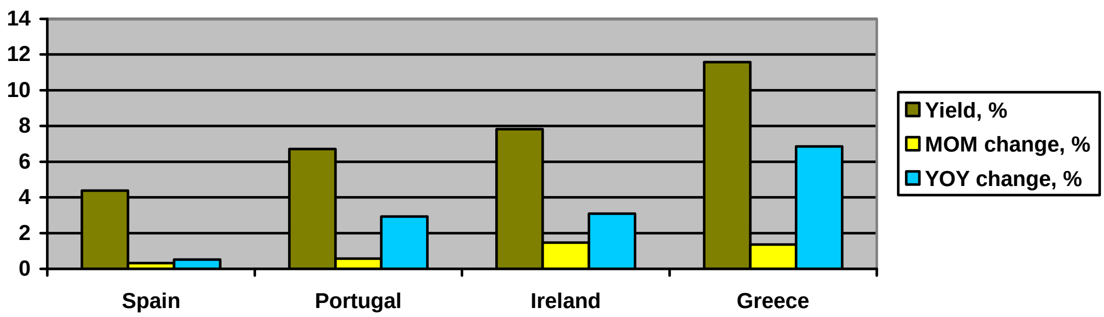
	2009, actual	2012	2013	2014	Total cut	Annual average cut
Ireland	14.3%			3% target	11.3% (5 years)	2.3%
Portugal	9.4%	3% target (was 2013)			6.4% (3 years)	2.1%
Spain	11.2%		3% target		8.2% (4 years)	2.1%
Greece	13.5%			3% target (was 2012)	10.5% (5 years)	2.1%
	15%+			3%	12% (5 years)	2.4%
France	7.6%		3% target		4.6% (4 years)	1.1%
UK	11.3%			2.2% (projection)	9.1% (5 years)	1.8%

Sources: (i) 2009 data, except UK: OECD, *Economic Outlook*, May 2010; (ii) UK: general government net borrowing on a Maastricht basis, *Budget 2010*, table C6. UK data are for financial years.
+ note that the Greek government conceded that the ratio may be "over 15%" (27 October 2010).

Confidence continues to fade in the peripheral eurozone
Last week the parlous state of the peripheral eurozone economies (especially Ireland, Greece and Portugal) was jeopardised yet further by sharply increased bond yields. Chart 2 shows the latest data on 10-year bond yields. The key trigger was the EU's proposal for bondholders to share losses on sovereign debt in the case of "bail-outs" (more below). Irish sovereign debt yields rose to record highs, Greek yields were approaching last May's crisis levels and Portuguese yields were sharply higher despite the passing of the latest austerity package in a bid to satisfy the markets that Portugal was "no second Greece". Greek yields were also pushed up by concern over the political stability in Athens. Prime Minister Papandreou has threatened to call a snap general election if voter support for his party should fall significantly.[8]

The eurozone crisis is hitting a political phase, where domestic politics, austerity fatigue and unhappy electorates are moving centre stage.

Chart 2 10-year government bond yields (%), month-on-month, year-on-year changes (%)



Source: *Financial Times*, 6 November 2010, data for 5 November 2010.

The EU Summit: 28-29October 2010

October's European Council meeting was a momentous one. Not merely did the heads of government discuss the need for closer economic governance but, crucially, they discussed a permanent "crisis resolution mechanism" for the eurozone. Both these developments signal closer economic integration in the EU - especially in the eurozone. The conclusions of the meeting included:[9]

- The need for increased fiscal discipline, broader economic surveillance and deeper coordination was endorsed. At France's request it was agreed that politicians should be given considerable discretion concerning the proposed sanctions for those countries breaking the debt and deficit limits. Such discretion was too much discretion in the ECB's judgment.
- The need for a "robust framework for crisis management" was agreed, with a view to taking the final decision on the details at December's summit. This permanent "crisis resolution mechanism" (or rescue package or "bail-out" fund by another name) will be designed to tackle sovereign debt emergencies when the current arrangements expire. The new mechanism will replace the European Financial Stability Facility (EFSF) and the bespoke rescue package for Greece (under which Greece can borrow at 5%), both agreed in May 2010 and which expire in 2013.
- The December meeting will also seek to take the final decision on a "limited treaty amendment so that any change can be ratified at the latest by mid-2013". It looks highly probable that the required change to the Lisbon Treaty will be pushed through under Article 48. This treaty change was at German Chancellor Merkel's insistence in order to prevent Germany's constitutional court from blocking the new "bail-out" fund as a breach of EU law.[10]

Even though the details of the crisis resolution mechanism have yet to be agreed, one thing is very clear. It is intended that the losses/costs of future sovereign bail-outs will be shared between taxpayers and private bondholders however the losses/costs are incurred - whether by default (orderly or otherwise), debt restructuring or rescheduling or a combination of the three.

ECB president Jean-Claude Trichet warned the EU leaders that even talking of imposing losses on bondholders would be dangerous and the proposed loss-sharing rescue system would drive up borrowing costs. Suffice to say last week's sell-off of the bonds of the peripheral eurozone came in on cue – with all the negative consequences for their struggling economies and for the banks that hold their sovereign debt.

References

1. Ruth Lea, "2010 Spending Review: the Chancellor did stick to his plans", *Arbuthnot Banking Group*, 25 October 2010.
2. Hauptmeier, Heipertz & Schuknecht, "Expenditure reform in industrialised countries: a case study approach", *ECB*, Working Paper no 634, May 2006.
3. HM Treasury, *Budget 2010*, HC61, June 2010.
4. HM Treasury, *Spending Review 2010,* Cm7942, October 2010.
5. Ruth Lea, "Eurozone pain will continue: a lesson from Black Wednesday", *Arbuthnot Banking Group*, 4 October 2010.
6. *FT*, "Dublin increases budget spending cuts", 5 November 2010
7. The European Financial Stability Facility (EFSF), now triple-A rated, refers to the €440bn loan facility for the non-Greek weaker eurozone members and which was part of the €750bn (maximum) May rescue package. The package also included €60bn of EU27 bonds and up to €250bn of IMF loans.
8. *FT*, "Fears grow on Greek stability", 6 November 2010.
9. European Council, "Conclusions of the meeting 28-29 October 2010", EUCO/25/10.
10. Charlemagne, "A grim tale of judges and politicians", *Economist*, 6 November 2010.

Annex

Table 1 Primary expenditure, changes base year (T^0) and 7 years later (T^7), % GDP

	Primary expenditure, T^0		Change compared with maximum T^7		Ranking	
	Nearest year	Ratio (%)	Nearest year	Relative, % of maximum	As % of GDP	Relative, % of maximum
"Ambitious" reformers:						
Finland	1993	60.3	-14.0	-23.2	1	2
Sweden	1993	67.2	-14.0	-20.8	2	5
Ireland (phase 1)	1982	47.5	-12.4	-26.0	3	1
Belgium (phase 1)	1983	53.9	-12.3	-22.7	4	3
Canada	1992	44.9	-9.6	-21.2	5	4
UK (phase 1, Howe)	1981	45.4	-8.2	-18.1	6	6
UK (current, Osborne)+	FY10	**44.4**	**-7.9** (FY15)	-17.8	[7]	[7]
Netherlands (phase 2)	1993	48.5	-7.5	-15.4	7	9
UK (phase 2, Lamont)	1992	44.3	-7.2	-16.2	8	7
Spain	1993	42.6	-6.4	-15.0	9	10
Ireland (phase 2)	1992	38.2	-6.2	-16.1	10	8
Luxembourg	1981	50.5	-5.7	-11.2	11	11
Netherlands (phase 1)	1983	52.8	-5.1	-9.7	12	13
"Timid" reformers:						
Austria	1993	53.1	-4.3	-8.1	13	15
Denmark	1993	54.1	-3.9	-7.2	14	17
New Zealand	1985	46.9	-3.8	-8.2	15	14
US	1992	32.2	-3.4	-10.4	16	12
Italy	1993	44.6	-3.0	-6.6	17	18
Japan	1998	37.6	-2.7	-7.3	18	16
Belgium (phase 2)	1993	45.2	-2.1	-4.6	19	19
Germany	1996	46.7	-0.6	-1.3	20	20
France	1996	51.5	-0.5	-0.9	21	22
Switzerland	1998	34.0	-0.3	-1.0	22	21
Non-reformers:						
Portugal	2004	43.8	0	0	23	23
Greece	2000	43.9	0.4	0.8	24	24
Australia	1985	34.9	0.4	1.1	25	25

Hauptmeier, Heipertz & Schuknecht, "Expenditure reform in industrialised countries: a case study approach", ECB, Working Paper no 634, May 2006; note primary expenditure excludes debt interest.

+ inserted by author and calculated as in table 2.

Table 2 UK Total Managed Expenditure, primary spending, cash terms

	FY10, T^0	FY15 (Budget), T^5	FY15 (SR), T^5	FY15 (SR) minus FY10
TME (£bn)	696.8	757.5	757.5 +3 = 760.5	
Primary spending (£bn)	653.5	691.0	691.0 +3 = 694.0	
TME (% GDP)	47.3	39.8	39.8 +0.2 = 40.0	-7.3
Primary spending (% GDP)	**44.4**	36.3	36.3 +0.2 = 36.5	**-7.9**

Source: HM Treasury, *Budget 2010*, HC61, June 2010, with £3bn added to FY15 in line with 2010 Spending Review's (SR's) increase to FY14 (which only covers period to FY14).

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