Why Austerity?

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Why austerity?

• We’ve been through an extremely difficult fiscal adjustment
  • Huge negative impact on households and businesses

• Was it necessary?

• Understand the options by looking at data from the pre-crisis, crisis and post-crisis periods
Origins of the crisis

• Triple bubble → Crisis
  • Credit
  • House prices
  • Construction

• A “hidden bubble” in the public finances

• Cause of crisis not primarily fiscal

• But it became a fiscal crisis when the public finance bubble burst
Growth in General Government Expenditure, Total Percentage Change, 2002-2007

Source: CSO
Spending growth far outstripped inflation

GG Expenditure: 57.4
CPI: 18.1

Source: CSO
But partially offset by strong economic growth

<table>
<thead>
<tr>
<th>GG Expenditure</th>
<th>CPI</th>
<th>GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>57.4</td>
<td>18.1</td>
<td>45.0</td>
</tr>
</tbody>
</table>

Source: CSO
And revenue actually grew faster than spending – but not sustainable

<table>
<thead>
<tr>
<th>GG Expenditure</th>
<th>CPI</th>
<th>GDP</th>
<th>GG Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>57.4</td>
<td>18.1</td>
<td>45.0</td>
<td>60.2</td>
</tr>
</tbody>
</table>

Source: CSO
Bursting of the triple bubble led to a collapse in revenue

Year to Year Changes in Exchequer Revenue by Category

- Local Property Tax
- Levies
- Value Added Tax
- Corporation Tax
- Income Tax
- Stamps
- Capital Acquisitions Tax
- Capital Gains Tax
- Excise Duty
- Customs

Source: Department of Finance
Had been running surpluses

General Government Deficit, % of GDP
But deficit exploded due to recession and bank bailouts.
Underlying deficit considered to be primarily structural

<table>
<thead>
<tr>
<th>Year</th>
<th>General Government Deficit (% of GDP)</th>
<th>Structural Deficit (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>7.0</td>
<td>7.5</td>
</tr>
<tr>
<td>2009</td>
<td>11.5</td>
<td>9.0</td>
</tr>
<tr>
<td>2010</td>
<td>11.0</td>
<td>9.3</td>
</tr>
<tr>
<td>2011</td>
<td>8.4</td>
<td>8.1</td>
</tr>
<tr>
<td>2012</td>
<td>7.9</td>
<td>6.9</td>
</tr>
<tr>
<td>2013</td>
<td>5.7</td>
<td>4.2</td>
</tr>
<tr>
<td>2014</td>
<td>3.9</td>
<td>3.9</td>
</tr>
<tr>
<td>2015</td>
<td>2.1</td>
<td>3.4</td>
</tr>
</tbody>
</table>
Debt put on an unsustainable path

Source: Eurostat
No choice but to significantly lower the deficit to stabilise the debt ratio and preserve access to borrowing
A large austerity programme was required

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Billions of Euro</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 2008</td>
<td>Expenditure adjustments</td>
<td>1.0</td>
</tr>
<tr>
<td>Budget 2009 (October 2008)</td>
<td>Revenue raising measures</td>
<td>2.0</td>
</tr>
<tr>
<td>February 2009</td>
<td>Expenditure adjustments</td>
<td>2.1</td>
</tr>
<tr>
<td>Supplementary budget (April 2009)</td>
<td>Revenue-raising &amp; expenditure-reducing measures</td>
<td>5.4</td>
</tr>
<tr>
<td>Budget 2010 (December 2009)</td>
<td>Revenue-raising &amp; expenditure-reducing measures</td>
<td>4.1</td>
</tr>
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<td>2.5</td>
</tr>
<tr>
<td><strong>Total ex ante adjustment, 2008 - 2014</strong></td>
<td></td>
<td><strong>30.1</strong></td>
</tr>
</tbody>
</table>

Source: Department of Public Expenditure and Reform
To what extent was the austerity caused by the bailout of the banking system?
Roughly two-thirds of increase in debt due to collapse in the economy

<table>
<thead>
<tr>
<th>Description</th>
<th>Value (€bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Debt (end-2007)</td>
<td>47.1</td>
</tr>
<tr>
<td>Gross Debt (end-2014)</td>
<td>203.3</td>
</tr>
<tr>
<td>Change in Gross Debt</td>
<td>156.2</td>
</tr>
</tbody>
</table>

**Contributions**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value (€bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underlying deficits</td>
<td>97.1</td>
</tr>
<tr>
<td>…of which primary</td>
<td>58.1</td>
</tr>
<tr>
<td>…of which interest</td>
<td>38.9</td>
</tr>
<tr>
<td>Gross debt increasing bank-related costs (capital transfers)</td>
<td>46.8</td>
</tr>
<tr>
<td>Change in EDP Debt Instrument Assets (incl. cash balances)</td>
<td>17.7</td>
</tr>
<tr>
<td>Other stock flow adjustments</td>
<td>-5.4</td>
</tr>
</tbody>
</table>

**Memo Items:**

<table>
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<th>Description</th>
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<tr>
<td>NPRF funding</td>
<td>20.7</td>
</tr>
<tr>
<td>Est. Value of Assets *</td>
<td>16 - 17</td>
</tr>
<tr>
<td>Recouped: Disposal of investments (July 2015) **</td>
<td>6.6</td>
</tr>
<tr>
<td>Recouped: Income, fees and bank levy (July 2015) ***</td>
<td>6.2</td>
</tr>
<tr>
<td>Net actual/imputed interest costs on financing (to 2014) ****</td>
<td>-4.6</td>
</tr>
</tbody>
</table>

**Sources:** CSO (bank-related costs using CSO April 2015 EDP data on impact of banking interventions); Department of Finance; internal IFAC calculations.

**Notes:** Gross debt increasing bank-related costs capture any capital injections recorded as deficit-increasing (capital transfers).

* EY valuation of NPRF AIB ordinary + preference shares at end-2014 (€11.7bn) + €1.6bn AIB CoCos; ISIF (30 June 2015) €1.6bn BoI ordinary shares (14%); and 75% of PTSB at recent share price.

** Estimates cover BOI, AIB and PTSB equity, CoCos and pref. share transactions including the sale of Irish Life. Details here: [https://www.kildarestreet.com/wrans/?id=2015-07-16a.619](https://www.kildarestreet.com/wrans/?id=2015-07-16a.619)


**** Net interest includes actual interest, where relevant, and imputed interest on financing Bank related costs using CSO April 2015 EDP data on impact of banking interventions.
Contribution of banking-related interest costs to the deficit, billions of euro

Note: Interest costs include interest on the promissory notes and interest on floating-rate bonds held by the Central Bank.

Sources: Department of Finance; Comptroller and Auditor General.
Was the austerity caused by the troika programme?
State lost its ability to borrow in the second half of 2010

10-Year Bond Yield, Ireland and Germany, Monthly Averages, January 1993-November 2010

Source: ECB
Run on the banking system →
Large-scale borrowing from Eurosystem

Central Bank of Ireland
“Other Assets” plus
“Other Claims on Euro Area Credit Institutions”

Borrowing from the Eurosystem for Monetary Policy Operations, Domestic Banking Group

Source: Central Bank of Ireland
Large primary deficit implied massive required adjustment in the absence of assistance
Creditworthiness continued to erode in early months of the programme.

10-Year Bond Yield, Ireland and Germany, Monthly Averages, January 1993-July 2011

Source: ECB

Implied probability of default \( \approx 85\% \)
Multiple uncertainties

• Uncertainty about growth prospects

• Uncertainty about the size of bank losses

• Uncertainty about the capacity of new centre-right/centre-left coalition to make the necessary adjustments

• Uncertainty about the evolution of European support policies
“Catalytic finance” strategy began to work from the second half of 2011

10-Year Bond Yield, Ireland and Germany, Monthly Averages, January 1993-August 2015

Source: ECB
Alternatives?

• Sovereign default
  • Hard ball
  • Debt restructuring

• Burden sharing with bank creditors
Reducing the cost of the bank bailout

- A guarantee was necessary, but September 2008 guarantee too broad, and limited subsequent burden-sharing options

- A resolution regime should have been put in place prior to the expiry of the blanket guarantee in September 2010

- Run on banking system by November 2010
  - Importance of retaining support of Eurosystem
  - Limited savings from “burning” senior unsecured unguaranteed Anglo bondholders
Can we prevent it from happening again?
Some emerging lessons from the banking inquiry

• Difficulty of avoiding pro-cyclical policies in times of strong economic growth

• Importance of risk management
  • Looking beyond central scenarios

• Significant crisis-induced institutional reforms
  • Banking
  • Fiscal
Rationale for a strong budgetary framework

• Avoid pro-cyclicality in good times

• Avoid large forced adjustments in bad times
  • Need to reduce debt to income ratios to safer levels
Complementary domestic and European elements

Domestic ownership adds legitimacy to the European rules

Monitoring, peer pressure and possible sanctions of the European framework enhances the effectiveness of the domestic framework
Synergies between rules, institutions and processes
Summing up

• Crisis caused by bursting of property/credit bubble

• Became a fiscal crisis

• Deficit reduction was unavoidable; failure to adjust would likely have caused much greater austerity

• Roles of bank bailout costs and troika programme need to be put in proper perspective

• Challenge now is not to let it happen again