Why Austerity?

John McHale
Whitaker Institute, NUI Galway
Irish Fiscal Advisory Council

October 30th, 2015

Debating Austerity Conference, Royal Irish Academy, Dublin

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

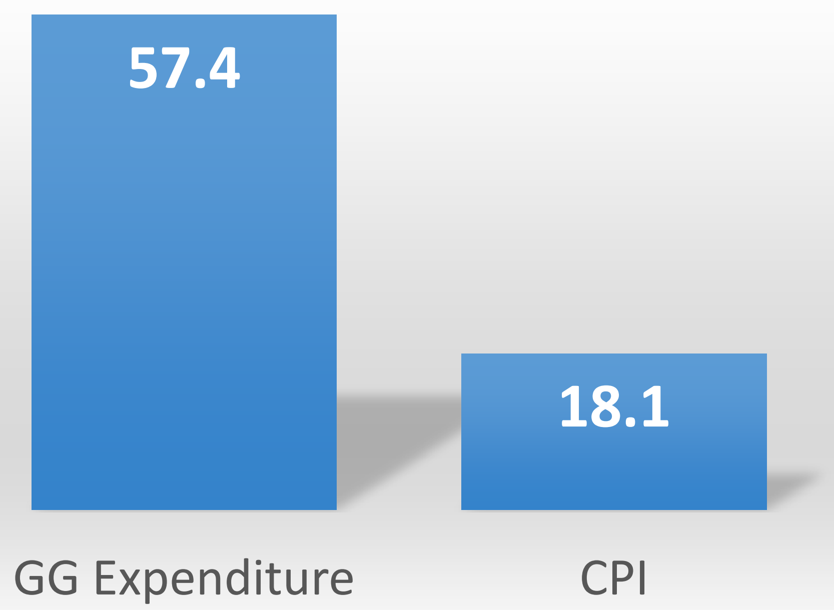
Origins of the crisis

- 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

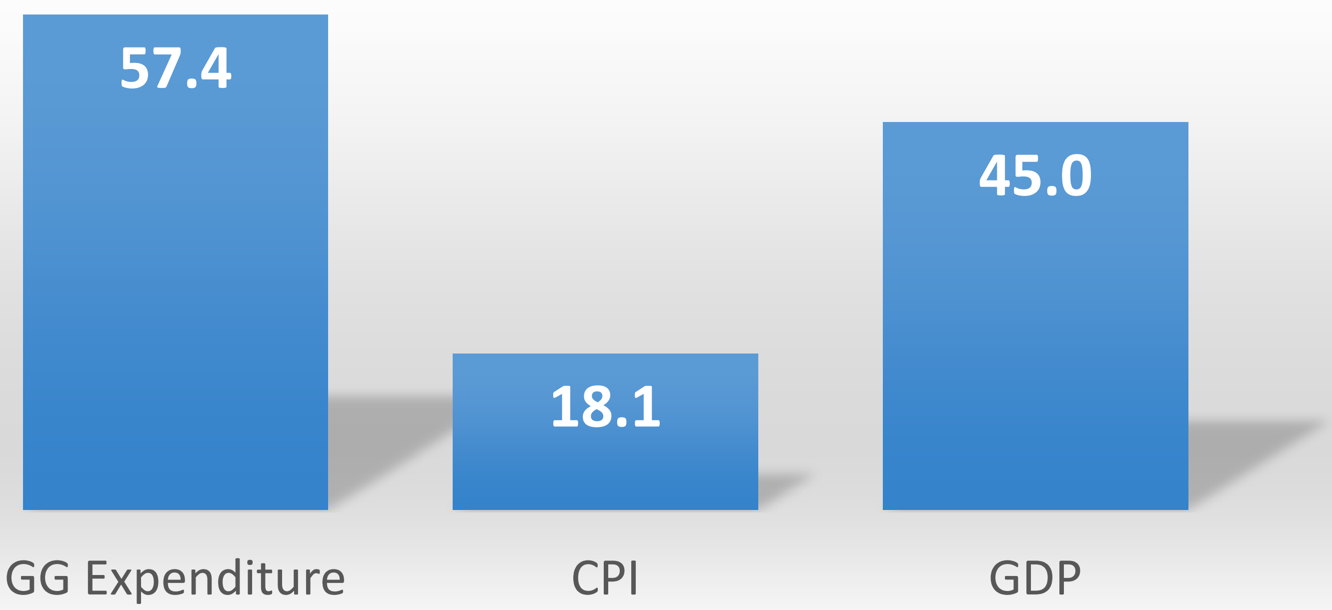
Source: CSO

Spending growth far outstripped inflation



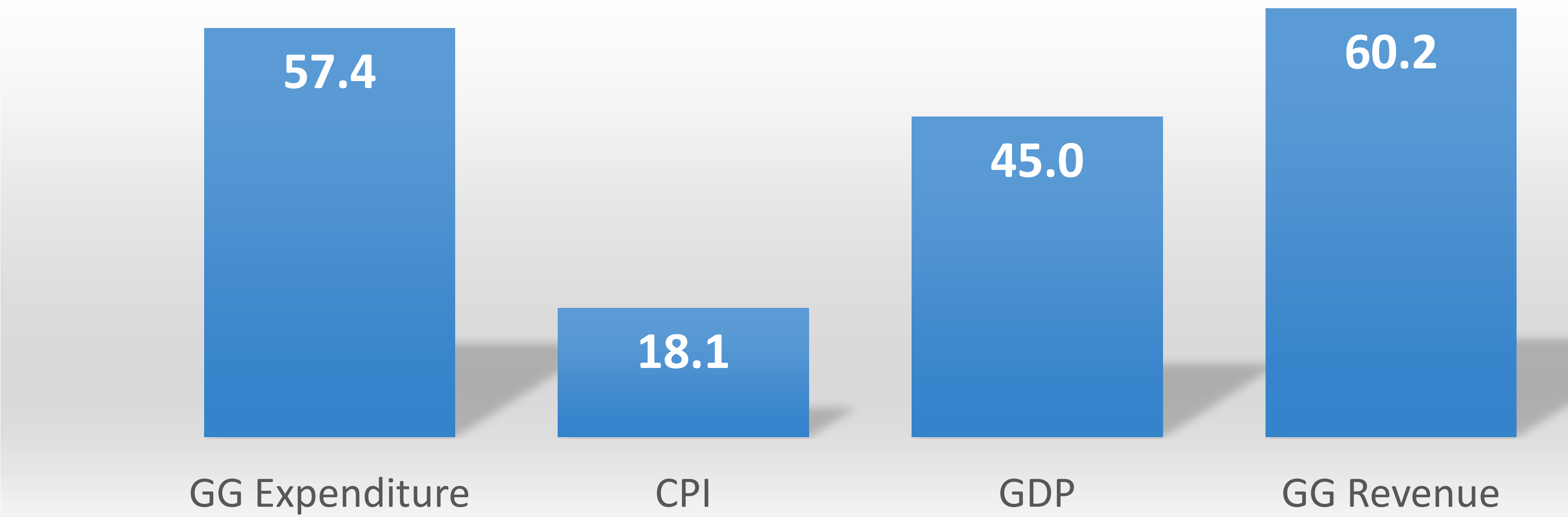
Source: CSO

But partially offset by strong economic growth



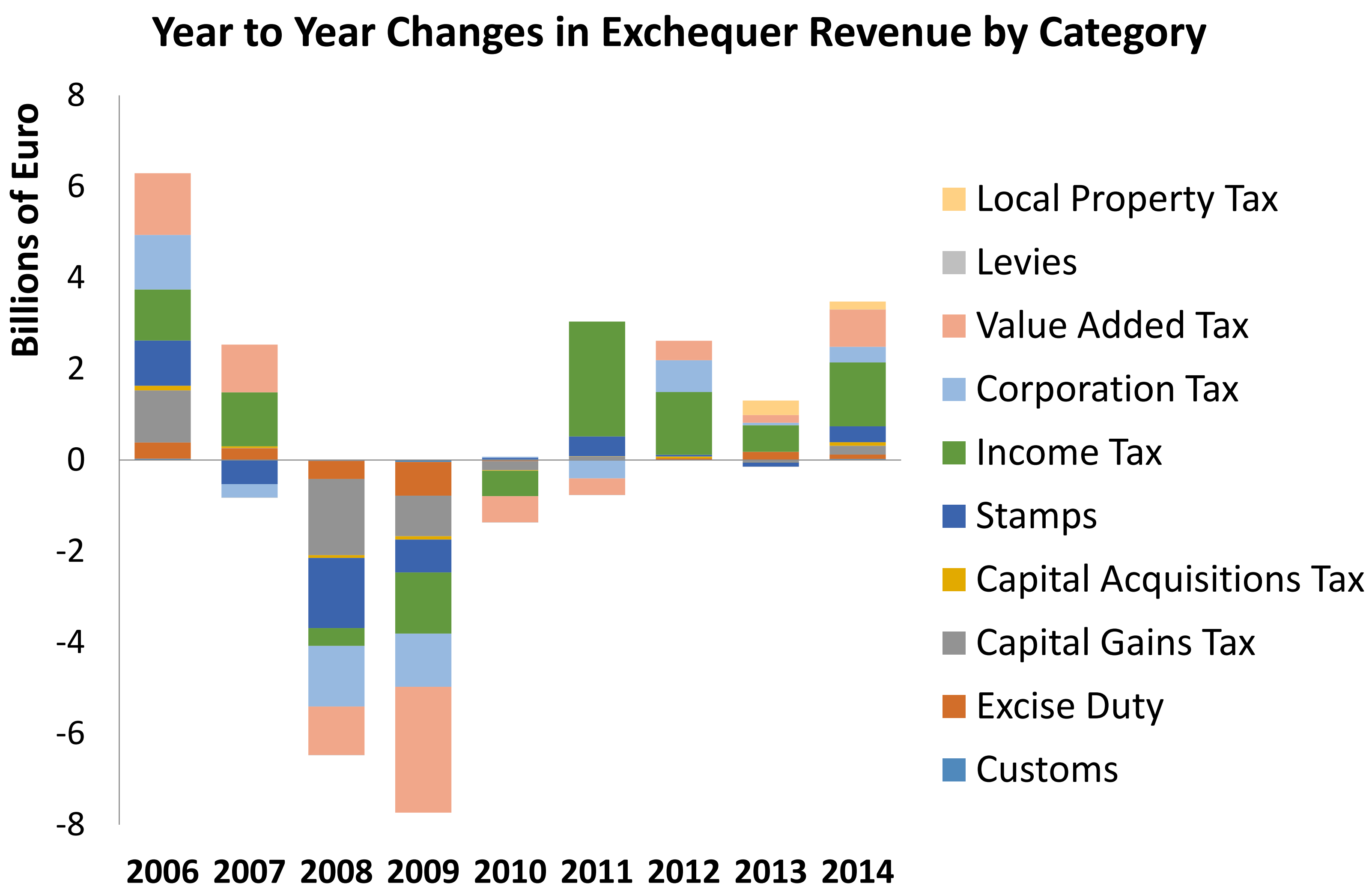
Source: CSO

And revenue actually grew faster than spending – but not sustainable



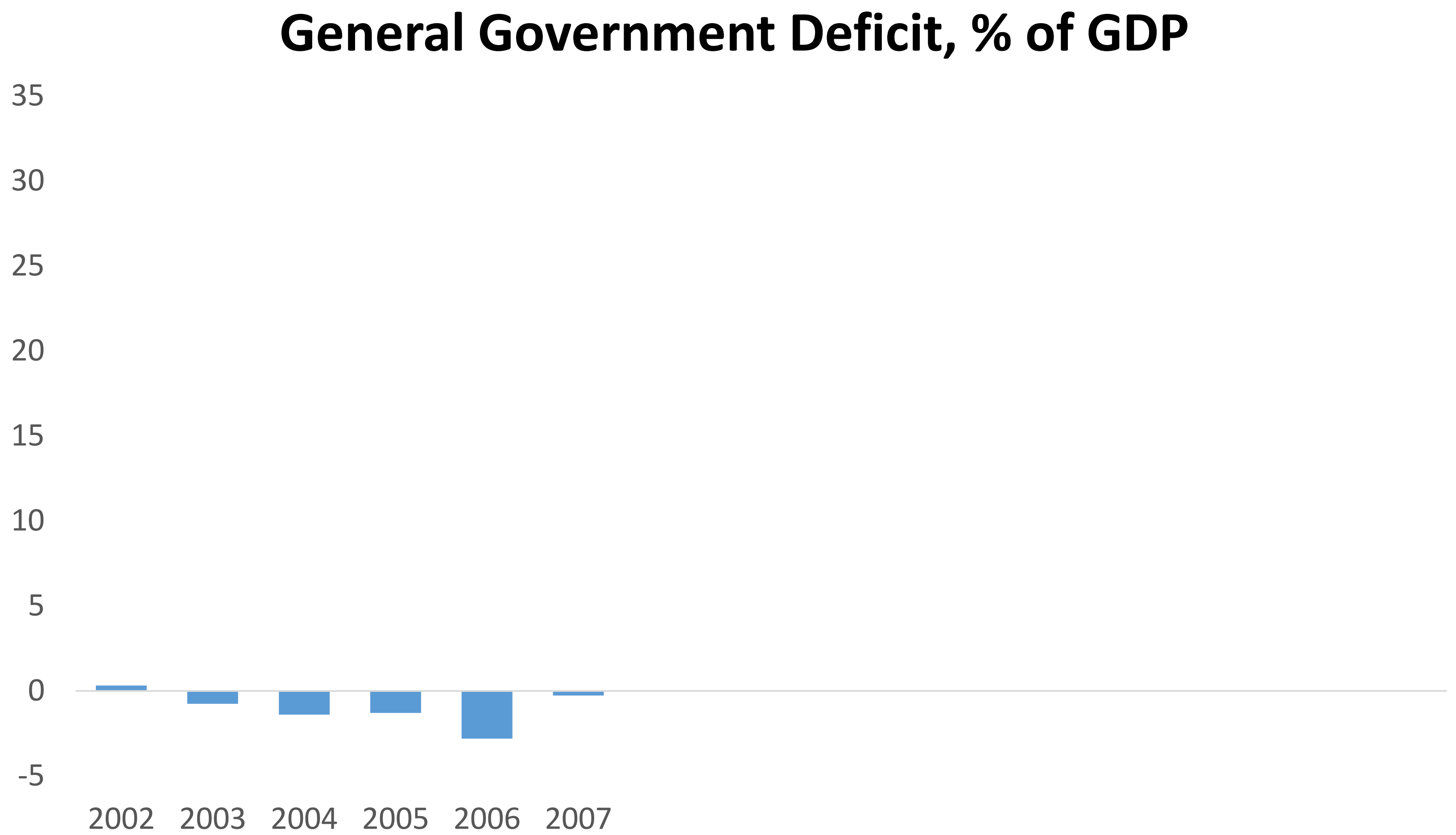
Source: CSO

Bursting of the triple bubble led to a collapse in revenue

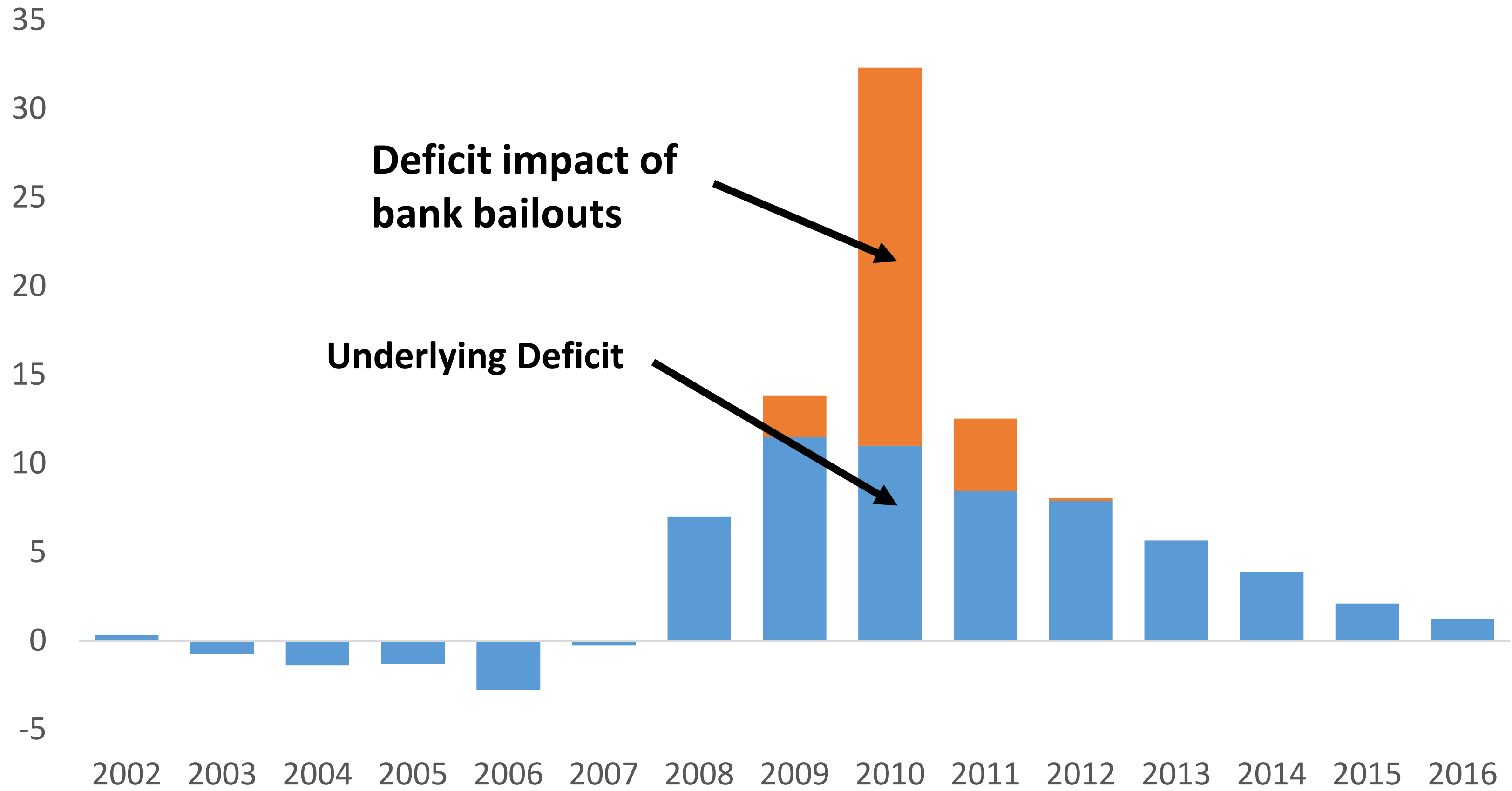


Source: Department of Finance

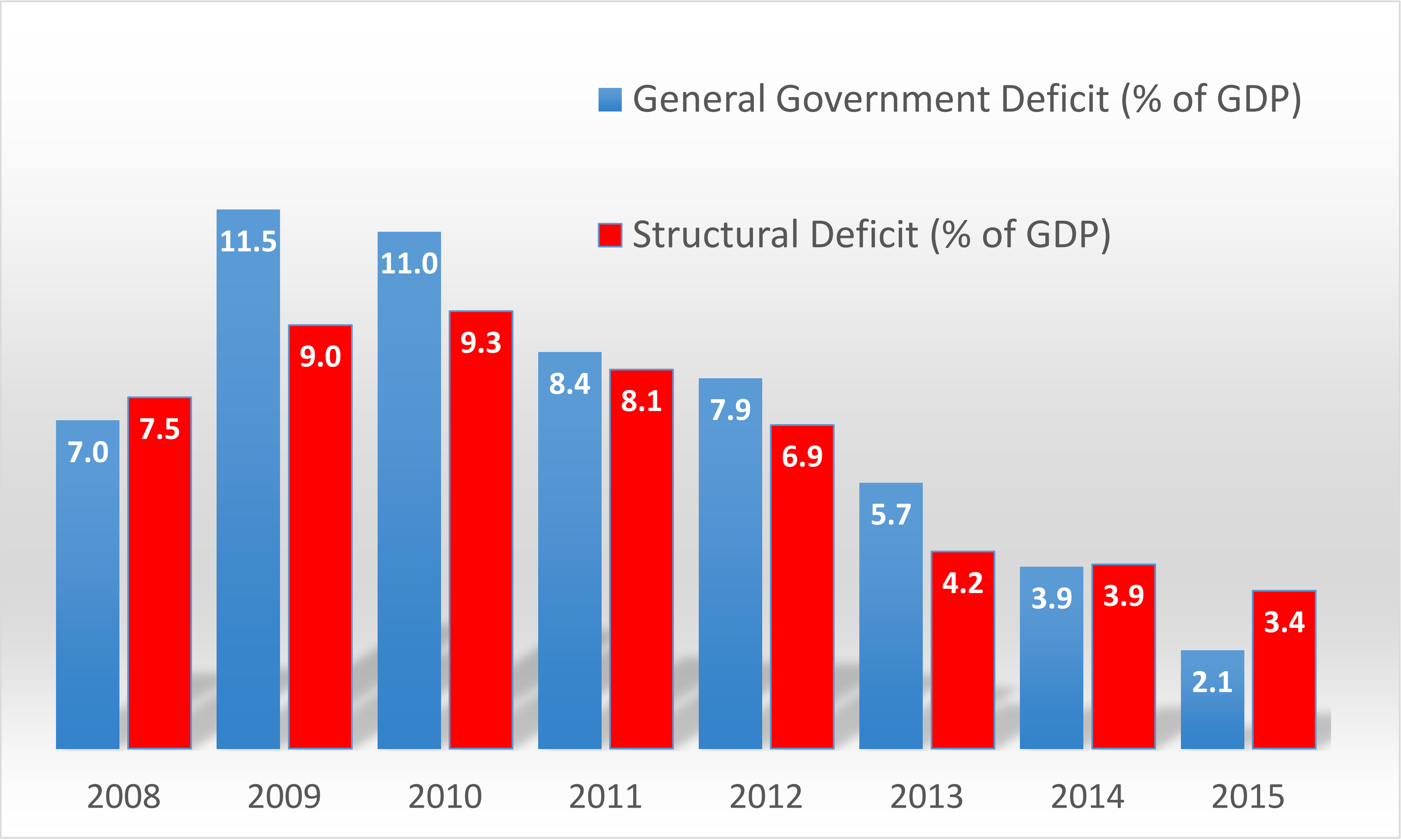
Had been running surpluses



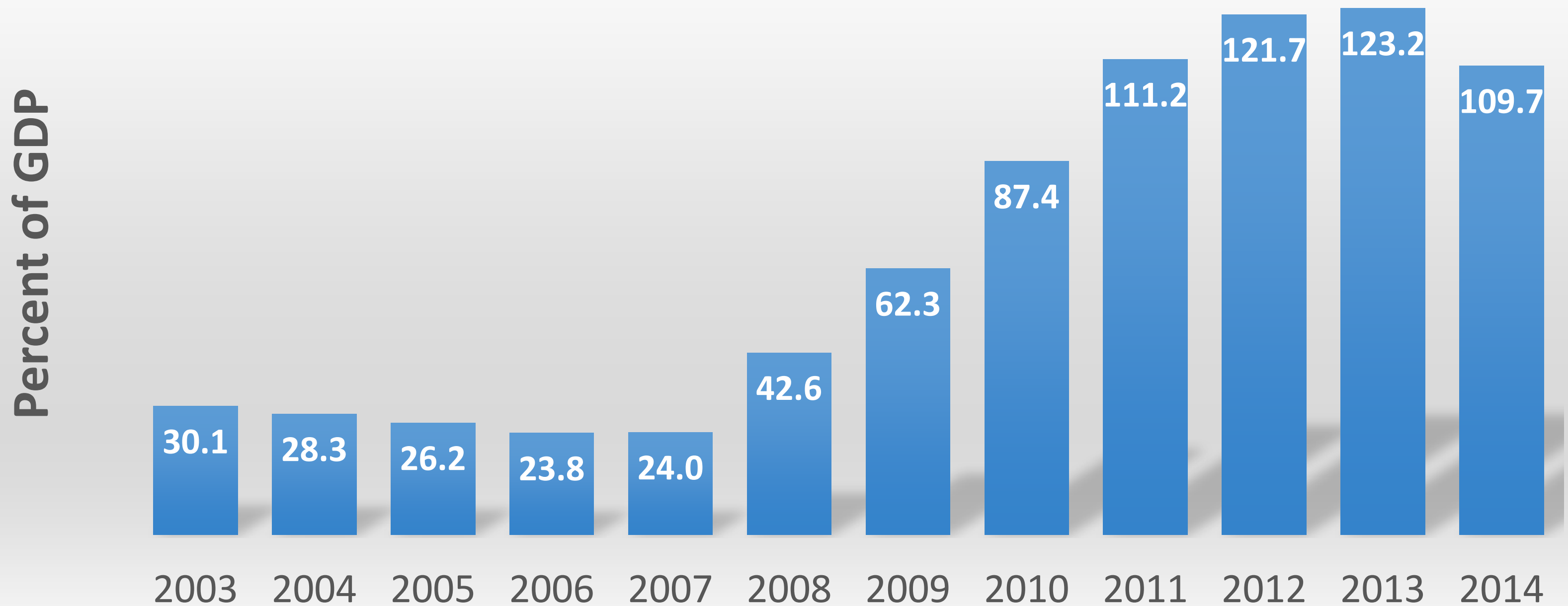
But deficit exploded due to recession and bank bailouts



Underlying deficit considered to be primarily structural



Debt put on an unsustainable path



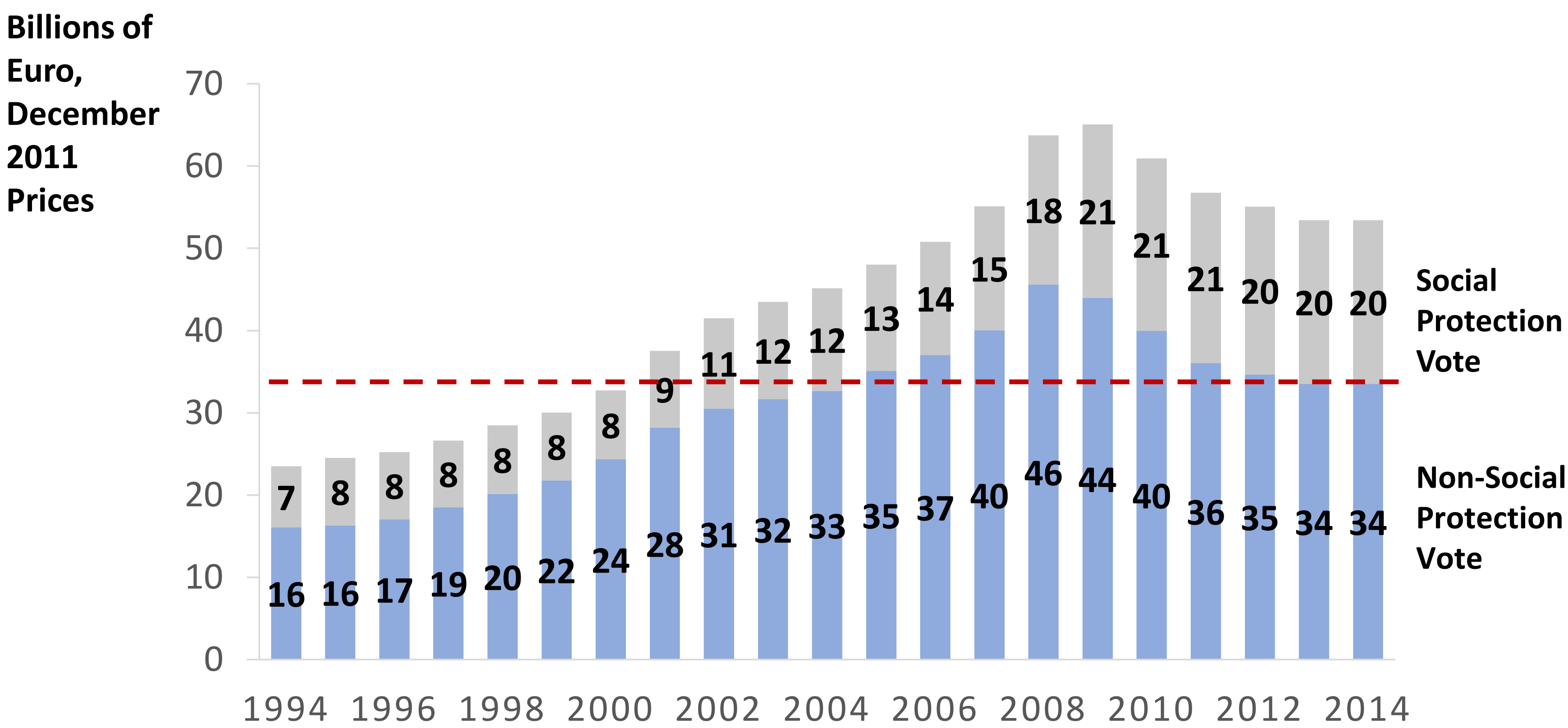
Source: Eurostat

No choice but to significantly lower the deficit to stabilise the debt ratio and preserve access to borrowing

A large austerity programme was required

	Billions of Euro
July 2008 **Expenditure adjustments**	**1.0**
Budget 2009 (October 2008) **Revenue raising measures**	**2.0**
February 2009 **Expenditure adjustments**	**2.1**
Supplementary budget (April 2009) **Revenue-raising & expenditure-reducing measures**	**5.4**
Budget 2010 (December 2009) **Revenue-raising & expenditure-reducing measures**	**4.1**
Budget 2011 (December 2010) **Revenue-raising & expenditure-reducing measures**	**6.0**
Budget 2012 (December 2011) **Revenue-raising & expenditure-reducing measures**	**3.5**
Budget 2013 (December 2012) **Revenue-raising & expenditure-reducing measures**	**3.5**
Budget 2014 (October 2013) **Revenue-raising & expenditure-reducing measures**	**2.5**
Total ex ante adjustment, 2008 - 2014	***30.1***

Evolution of inflation-adjusted *Gross Voted Expenditure*, December 2011 prices, 1994-2014



Source: Department of Public Expenditure and Reform

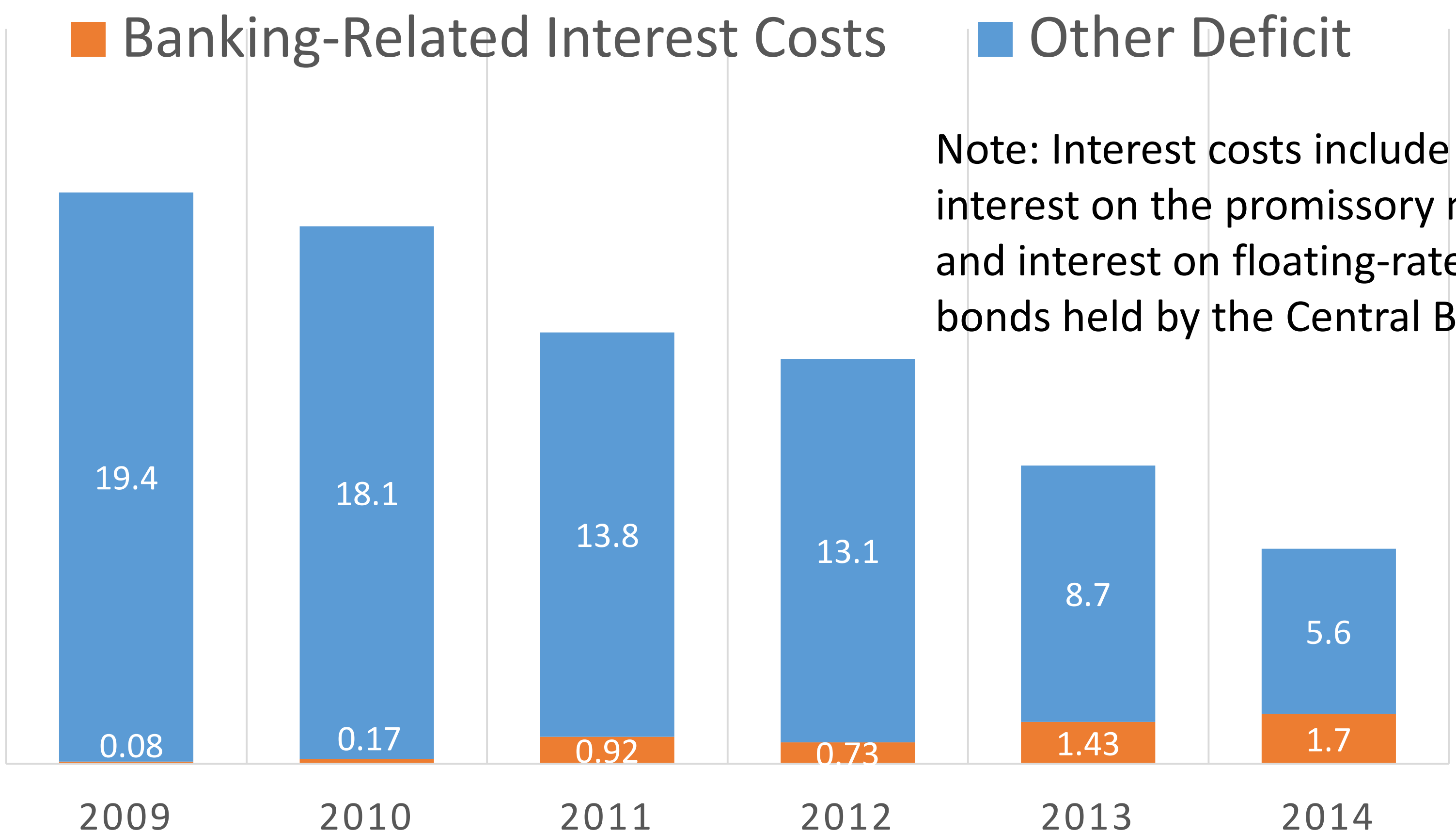
To what extent was the austerity caused by the bailout of the banking system?

Roughly two-thirds of increase in debt due to collapse in the economy

	€bn
Gross Debt (end-2007)	47.1
Gross Debt (end-2014)	203.3
Change in Gross Debt	156.2
Contributions	
Underlying deficits	$\boxed{97.1}$
...of which primary	58.1
...of which interest	38.9
Gross debt increasing bank-related costs (capital transfers)	$\boxed{46.8}$
Change in EDP Debt Instrument Assets (incl. cash balances)	17.7
Other stock flow adjustments	-5.4
Memo Items:	
NPRF funding	20.7
Est. Value of Assets *	16 - 17
Recouped: Disposal of investments (July 2015) **	6.6
Recouped: Income, fees and bank levy (July 2015) ***	6.2
Net actual/imputed interest costs on financing (to 2014) ****	-4.6

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
*** Estimates cover guarantee fees (CIFS/ELG + €0.5bn from IBRC), investment income and the Budget 2014 Bank levy. Details here: 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

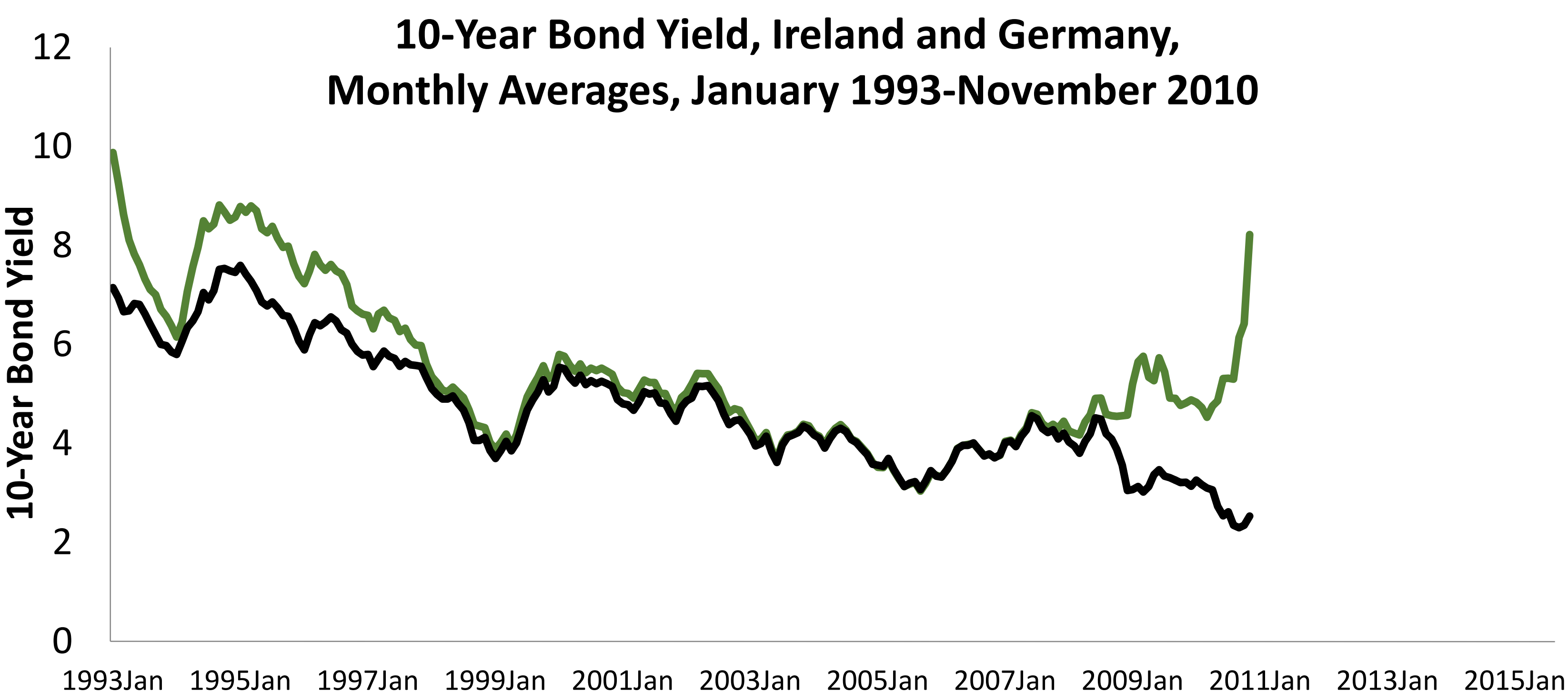


Note: Interest costs include interest on the promissory notes and interest on floating-rate bonds held by the Central Bank

Sources: Department of Finance; Comptroller and Auditor General

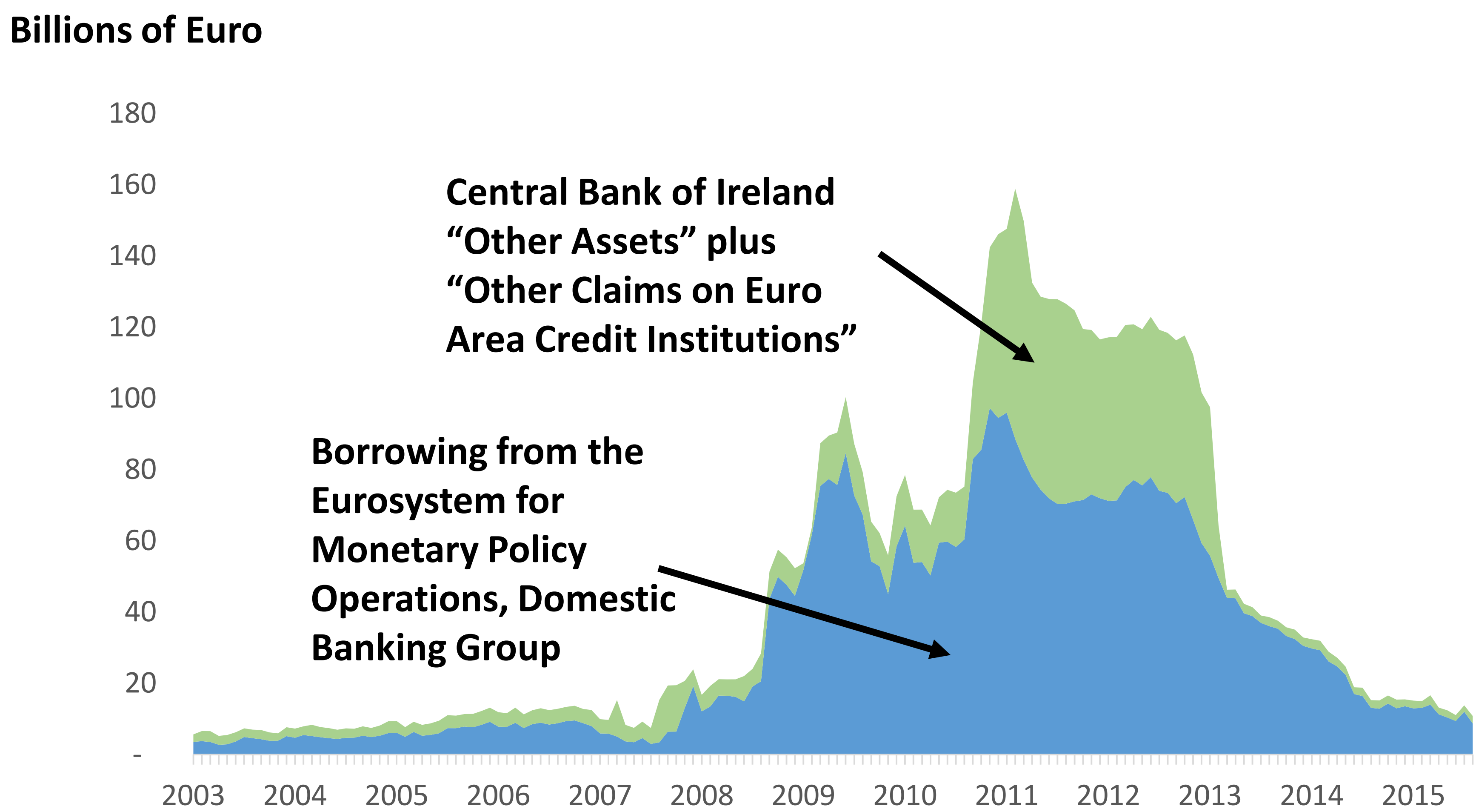
Was the austerity caused by the troika programme?

State lost its ability to borrow in the second half of 2010



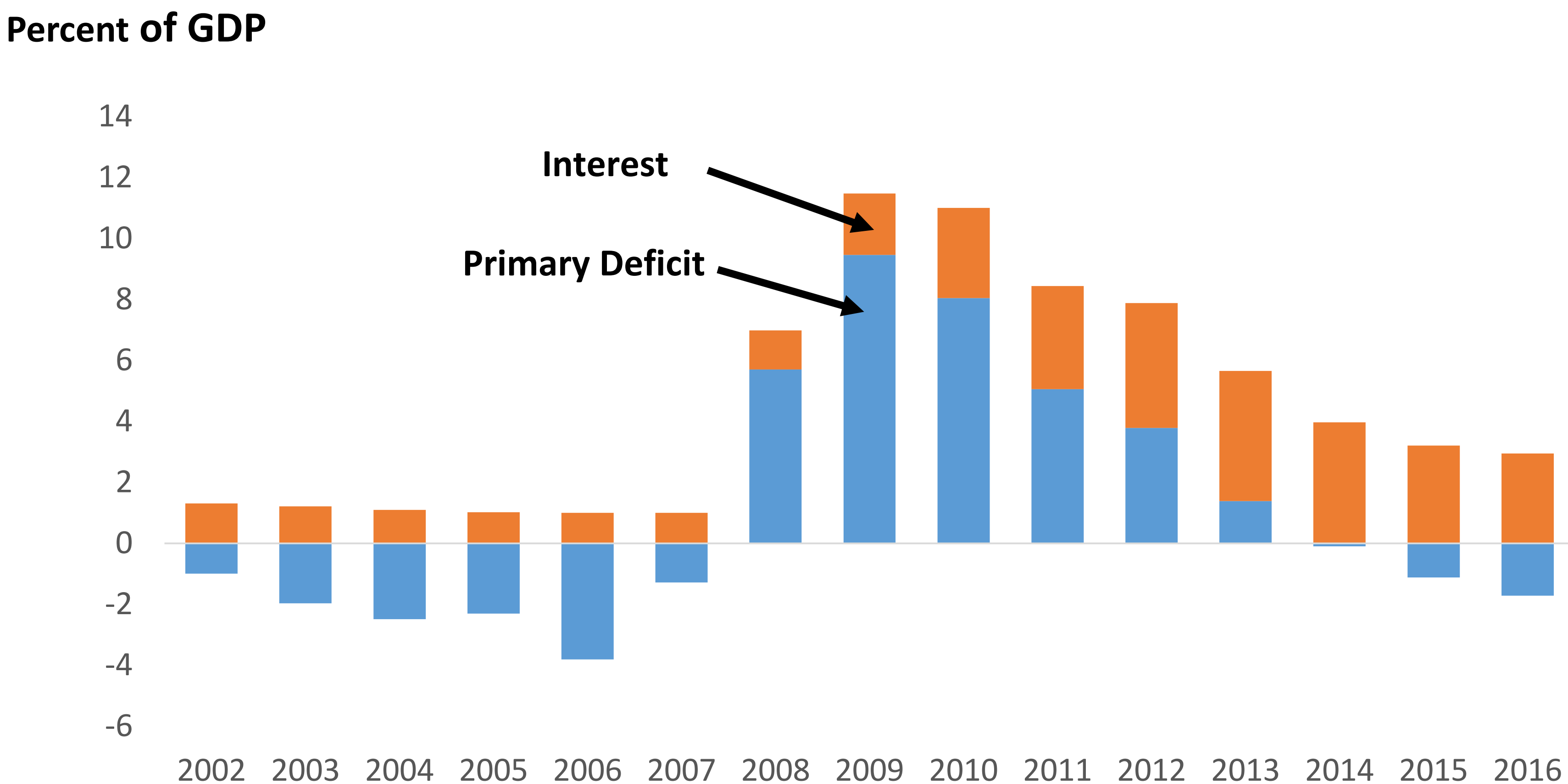
Source: ECB

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

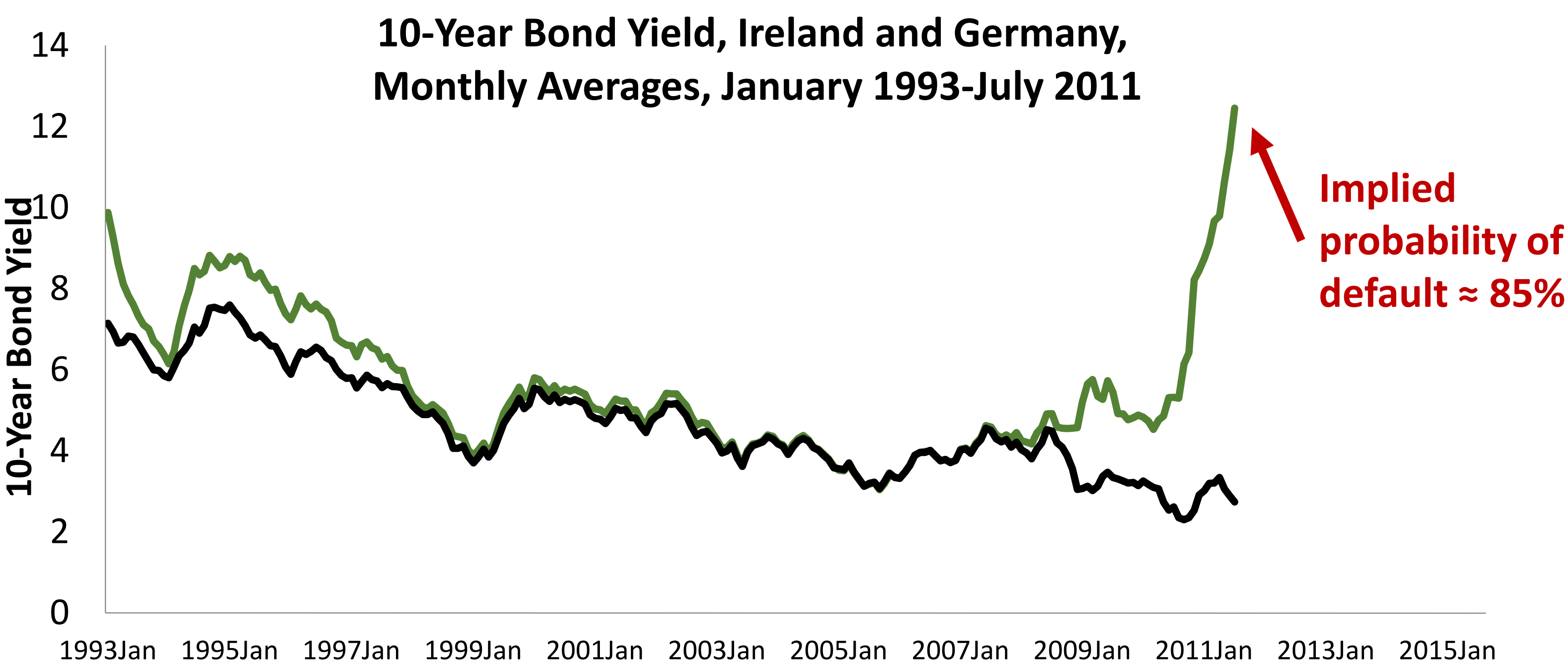


Source: Central Bank of Ireland

Large primary deficit implied massive required adjustment in the absence of assistance



Creditworthiness continued to erode in early months of the programme

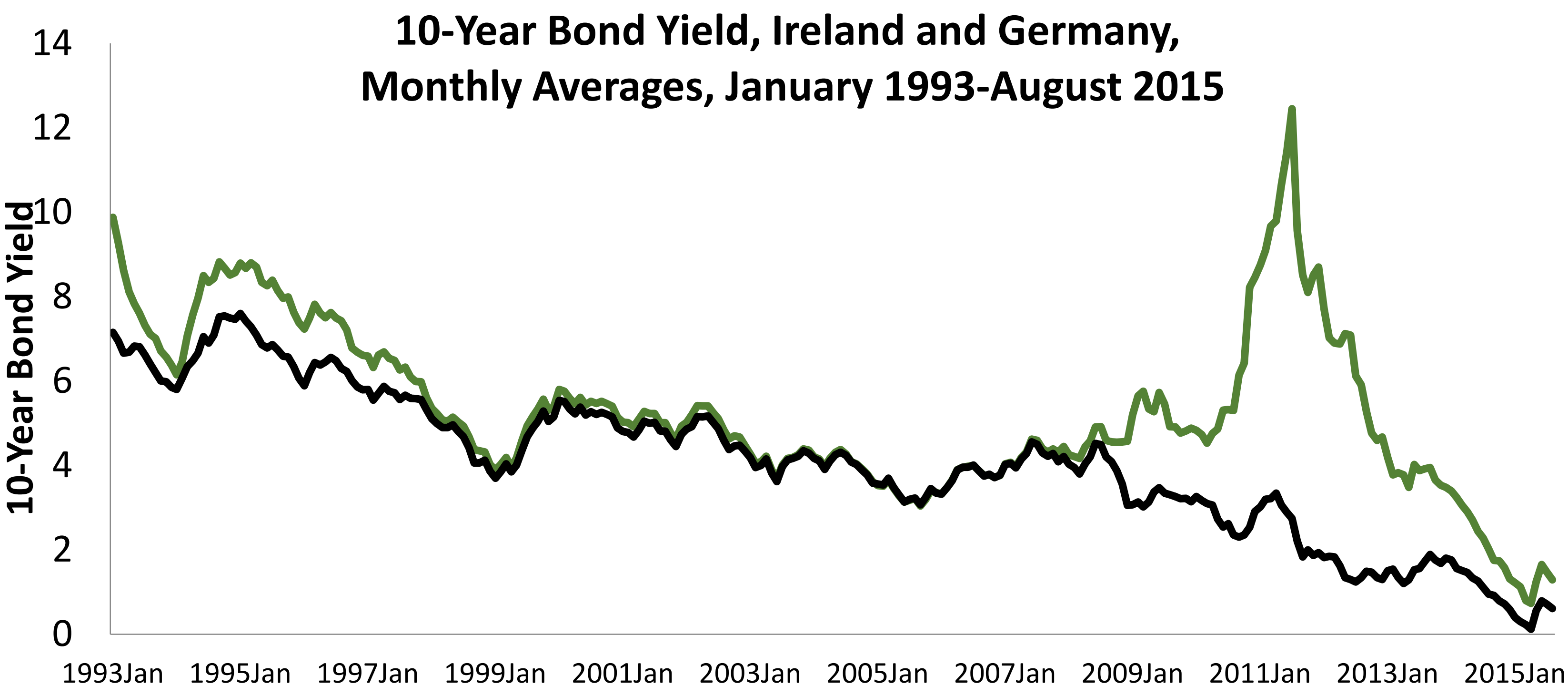


Source: ECB

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



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

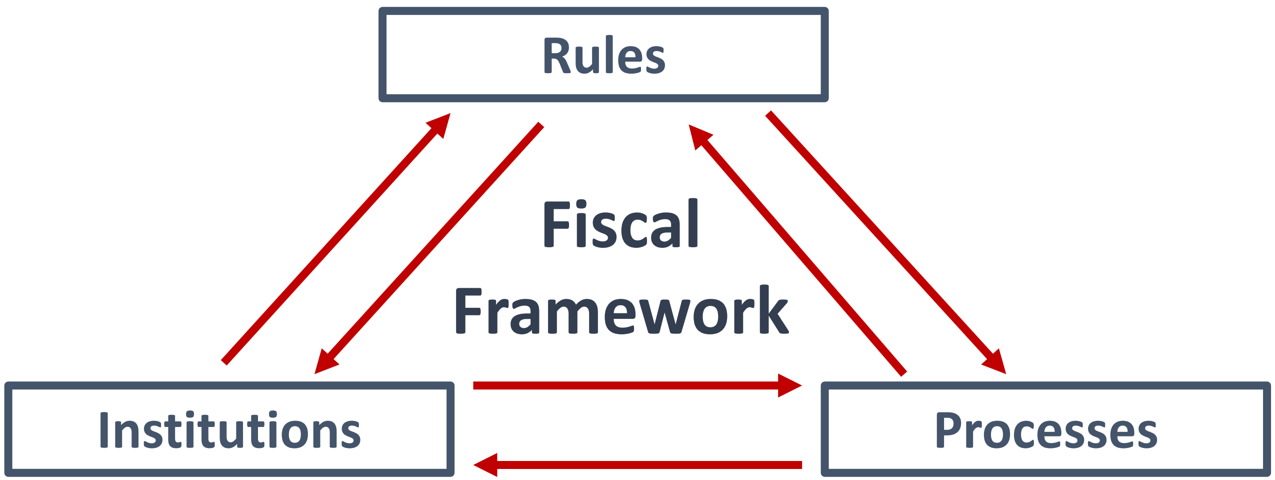
Domestic ownership adds legitimacy to the European rules

Effectiveness of **Domestic** Framework

Effectiveness of **European** Framework

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